



**ICE Clear Europe Limited -
Multilateral Clearing Organization Request**

Analysis of UK Clearing House Regime

10 March 2008

ICE Clear Europe Limited
Multilateral Clearing Organization
Request for Determination

1. GENERAL

- 1.1 ICE Clear Europe Limited (the "Clearing House") understands that the FSA is minded to grant it recognition as a Recognized Clearing House ("RCH") in the United Kingdom ("UK") under the UK's Financial Services and Markets Act 2000 ("FSMA") and supervised by the UK Financial Services Authority ("FSA").
- 1.2 The Clearing House hereby requests that the Commodity Futures Trading Commission ("CFTC") issue an Order pursuant to Section 409(b)(3) of the Federal Deposit Insurance Corporation Improvement Act 1991 (codified as 12 U.S.C. §§4422) ("FDICIA") determining that the UK legal and regulatory regime operated by the FSA in the recognition and subsequent supervision of the Clearing House satisfies appropriate standards thereby permitting the Clearing House to operate a multilateral clearing organization ("MCO") for the clearing of United States ("US") over-the-counter ("OTC") derivative instruments, or otherwise to engage in activities that constitute such a MCO.
- 1.3 The Clearing House is making this request for the purpose of facilitating its proposed OTC derivatives clearing activities in the US, namely the clearing of transactions executed on the IntercontinentalExchange, Inc. ("ICE, Inc.") exempt commercial market ("ECM"). The Clearing House anticipates clearing all of the ICE, Inc. OTC business. The Clearing House acknowledges and accepts that an MCO, absent registration with the CFTC, is not permitted to clear derivatives contracts traded on US boards of trade that are designated contract markets ("DCMs").
- 1.4 In support of this Request, the Clearing House has provided certain information in support of the Clearing House's belief that the UK legal and regulatory regime operated by the FSA in the recognition and subsequent supervision of the Clearing House satisfies appropriate standards, including:
 - (a) Summary of the UK legal and regulatory regime for RCHs;
 - (b) Comparative analysis of the core principles for registration as a derivatives clearing organization ("DCO") as set out in the Commodity Exchange Act as amended ("CEA") as against the UK legal and regulatory regimes operated by the FSA for clearing houses; and
 - (c) Description of the Clearing House and clearing services (set out in the Schedule to this Request.
- 1.5 In this context, we note that US DCOs have been found equivalent by the FSA to UK recognized clearing houses and that the UK clearing house, LCH Clearnet Limited, is a DCO.

1.6 The following documents are included as annexes to this request:

Annex No.	Document
1	Part XVIII of the Financial Services and Markets Act 2000
2	Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001, as amended
3	FSA's Recognised Investment Exchanges and Recognised Clearing Houses Sourcebook ("REC") – see http://fsahandbook.info/FSA/html/handbook/REC
4	Recognition Order [to follow]
5	ICE Clear Europe Limited Rules dated 31 January 2008

1.7 The Clearing House is willing and able to co-operate with the CFTC in the provision of information relevant to this application and in other ways. If the CFTC would like a copy of any further legislation referred to in this memorandum or copies of procedural or other documents produced by the Clearing House, please let us know.

2. UK LEGAL AND REGULATORY REGIME FOR RECOGNIZED CLEARING HOUSES

FSMA

- 2.1 FSMA is a UK Act of Parliament which makes provision about the regulation of financial services and markets in the UK. Amongst other things, it confers various functions and powers on the FSA, including setting out its general duties; regulatory objectives; and matters the FSA must have regard to.
- 2.2 In summary, the FSA's regulatory objectives are: market confidence; public awareness; the protection of consumers; and the reduction of financial crime. In discharging these functions the FSA must have regard to: the need to use its resources efficiently; the responsibilities of management within authorized firms; the principle that burdens should be proportionate to benefits; desirability of facilitating innovation; the international character of financial services and markets; the need to minimize the adverse effects on competition; and the desirability of facilitating competition. The FSA's general functions include: making rules; preparing and issuing codes; giving of general guidance; and determining general policy and principles.¹
- 2.3 The FSA may give guidance consisting of: such information and advice as it considers appropriate with respect to the operation of FSMA and any rules made under it; any matters relating to the FSA's functions; to meet the FSA's regulatory objectives; or, on any other matters where the FSA believe it desirable.²
- 2.4 To qualify for the making of a Recognition Order, a clearing house must demonstrate that it satisfies the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (SI 2001/995) (as amended, the "Recognition Requirements Regulations") (see Annex 2). The requirements of the Recognition Requirements Regulations are referred to herein as the "Recognition Requirements". Furthermore, the UK anti-trust body, the Office of Fair Trading (the "OFT") must issue a report to Her Majesty's Treasury ("HMT") as to whether any regulatory provisions³ in the application have a significantly adverse effect on competition (alone or in combination with other regulatory provisions);⁴ and HMT must approve the making of the Recognition Order.⁵
- 2.5 The FSA has made a series of rules requiring reporting by recognized clearing houses and will be the Clearing House's main regulator. The OFT must also keep under review the regulatory provisions and practices of a UK RCH to assess whether they have a significantly adverse effect on competition (alone or in combination with others).⁶

¹ Section 2 FSMA.

² Section 157 FSMA.

³ Defined in section 302 FSMA: (a) the rules of a ... clearing house; (b) any guidance issued by a ... clearing house; ... and (d) the arrangements or criteria in [the required particulars, i.e. particulars of the clearing arrangements it makes or proposes to make with a recognized investment exchange; or if the clearing house proposes to provide clearing services for persons other than recognized investment exchanges, particulars of the criteria which it will apply when determining to whom it will provide those services].

⁴ Section 303 FSMA.

⁵ Section 290 FSMA.

⁶ Section 304 FSMA.

Recognition Requirements

- 2.6 The Clearing House is subject to the ongoing supervision of the FSA and must continue to satisfy the Recognition Requirements if it is to remain a UK RCH.⁷
- 2.7 The Recognition Requirements include provisions in respect of:
- (a) Financial Resources;
 - (b) Suitability;
 - (c) Systems and controls
 - (d) General safeguards for investors;
 - (e) Access to facilities;
 - (f) Settlement and clearing services;
 - (g) Transaction recording;
 - (h) Financial crime and market abuse;
 - (i) Custody;
 - (j) Promotion and maintenance of standards;
 - (k) Rules and consultation;
 - (l) Discipline;
 - (m) Complaints; and
 - (n) Default rules.
- 2.8 The Recognition Requirements are transcribed into and expanded upon by FSA Guidance⁸ in the FSA's sourcebook for Recognized Investment Exchanges and Recognized Clearing Houses ("REC") (see <http://fsahandbook.info/FSA/html/handbook/REC> ("REC")). Both the Recognition Requirements Regulations and the FSA Guidance on the Recognition Requirements are described in detail below and annexed to this request.

REC

- 2.9 The FSA Handbook (see <http://fsahandbook.info/FSA/html/handbook/>) includes the REC sourcebook (Annex 3), which is divided into various chapters:
- (a) REC 1: Introduction;
 - (b) REC 2: Recognition Requirements. This chapter contains the Recognition Requirements and sets out FSA Guidance on those requirements. The Recognition Requirements must be satisfied by applicants for Recognized Body status (i.e.

⁷ Section 286 FSMA.

⁸ Section 157 FSMA.

exchanges and clearing houses) before recognition is granted and by all UK Recognized Bodies at all times while they are recognized. The same standards apply both on initial recognition and throughout the period that Recognized Body status is held;

- (c) REC 3: Notification Rules for UK recognised bodies. This chapter sets out notification rules made by the FSA under section 293 of FSMA, which apply to all UK Recognized Bodies. The Rules also set out the requirements for the form and method of notification;
- (d) REC 4: Supervision. This chapter sets out the FSA's approach to the supervision of Recognized Bodies;
- (e) REC 5: Applications for Recognition (UK Recognised Bodies). This chapter sets out FSA Guidance for UK applicants and entities which are considering making an application for recognition as a UK Recognized Body under sections 287 (exchanges) or 288 (clearing houses) of FSMA;
- (f) REC 6: Overseas Investment Exchanges and Overseas Clearing Houses. This chapter summarizes the UK legal background for overseas exchanges or clearing houses wishing to undertake regulated activities in the UK, applications, recognition requirements,⁹ notification requirements, FSA supervision of such bodies; and
- (g) REC 7: Fees.

2.10 The Clearing House believes that chapters 2 and 3 of REC are of most relevance to this Request, and therefore more detail is set out below.

REC Chapter 2: Recognition Requirements:

2.11 This section of the Request takes each of the Recognition Requirements applicable to clearing houses, as transcribed into chapter 2 of REC (the Recognition Requirements Regulations text has been italicized) and summarizes relevant FSA Guidance.

REC 2.3: Financial resources

Paragraph 16 of the Schedule to the Recognition Requirements Regulations provides that:

"The clearing house must have financial resources sufficient for the proper performance of its functions as a recognised clearing house. In considering whether this requirement is satisfied, the Authority may ... take into account all the circumstances, including the clearing house's connection with any person, and any activity carried on by the clearing house, whether or not it is an exempt activity."¹⁰

2.12 In summary, FSA REC Guidance provides that:

- (a) In assessing whether the Clearing House has sufficient financial resources in relation to counterparty and market risks the FSA has regard to the amount and liquidity of assets and the likely availability of liquid financial resources during periods of major market turbulence or other periods of major stress for the financial system; and the

⁹ Section 292(3) FSMA.

¹⁰ Paragraph 16 of the Schedule to the Recognition Requirements Regulations.

nature and scale of exposures to counterparty and market risks and, where relevant, the counterparties to which the Clearing House is exposed.¹¹

- (b) The FSA considers that the Clearing House will have sufficient financial resources (after allowing for the financial resources necessary to cover counterparty and market risks) if it has at any time liquid financial assets amounting to at least six months' operating costs; and net capital of at least this amount (usually in the form of equity).¹²

REC 2.4: Suitability

Paragraph 17 of the Schedule to the Recognition Requirements Regulations provides that:

"The clearing house must be a fit and proper person to perform the functions of a recognised clearing house. In considering whether this requirement is satisfied, the Authority may ... take into account all the circumstances, including the clearing house's connection with any person."¹³

2.13 FSA Guidance in REC expands on this to consider the following matters in this regard:

- (a) Governance;¹⁴
- (b) Regulatory arrangements, policies and resources;¹⁵
- (c) Fitness and propriety;¹⁶
- (d) Management of conflicts of interest;¹⁷
- (e) Connected companies/individuals;¹⁸ and
- (f) Key individuals.¹⁹

REC 2.5: Systems and controls

Paragraph 18 of the Schedule to the Recognition Requirements Regulations provides that:

"The clearing house must ensure that the systems and controls used in the performance of its functions are adequate, and appropriate for the scale and nature of its business. This requirement applies in particular to systems and controls concerning—

¹¹ REC 2.3.5G.

¹² REC 2.3.6G.

¹³ Paragraph 17 of the Schedule to the Recognition Requirements Regulations.

¹⁴ REC 3.6G.

¹⁵ REC 4.2G; REC 2.5G; REC 2.3G.

¹⁶ REC 2.4.3G – REC 2.4.6G.

¹⁷ REC 2.5.10G – REC 2.5.16G.

¹⁸ REC 2.5.11G.

¹⁹ REC 5.2.14G.

- (a) the transmission of information;*
- (b) the assessment and management of risks to the performance of the clearing house's functions;*
- (c) the operation of its clearing service; and*
- (d) (where relevant) the safeguarding and administration of assets belonging to users of the clearing house's facilities.'*²⁰

2.14 FSA Guidance in REC expands on this to consider:

- (a) Duties and responsibilities within the clearing house; staffing and resources; staff supervision; board oversight.²¹
- (b) Information transmission (within the clearing house; and to members).²²
- (c) Risk management of general, operational, legal, market and counterparty risks (which will include a review of the risk department, frequency of monitoring and review of risk or exposure limits, arrangements for monitoring and assessing intra-day movements in exposures and risks, margin, and stress-testing etc.).²³
- (d) Monitoring of settlement arrangements.²⁴
- (e) Safeguarding and administration of assets (including audit trail of assets and instructions).²⁵
- (f) Management of conflicts of interest (personal and structural).²⁶
- (g) Internal and external audit.²⁷
- (h) IT systems.²⁸

REC 2.6: General safeguards for investors

Paragraph 19(1) of the Schedule to the Recognition Requirements Regulations provides that:

"The clearing house must ensure that its facilities are such as to afford proper protection to investors."

²⁰ Paragraph 18 of the Schedule to the Recognition Requirements Regulations.

²¹ REC 2.5.3G.

²² REC 2.5.5G.

²³ REC 2.5.6G – REC 2.5.7G.

²⁴ REC 2.5.8G.

²⁵ REC 2.5.9G.

²⁶ REC 2.5.10G – 2.5.16 G.

²⁷ REC 2.5.17G.

²⁸ REC 2.5.18 – REC 2.5.20G.

2.15 FSA Guidance in REC expands on this to refer to the Clearing House's rules, procedures and arrangements for monitoring and overseeing the use of its facilities to prevent the use of its facilities for abusive or improper purposes; and requires that the Clearing House safeguard against fraud.²⁹

REC 2.7: Access to facilities

Paragraph 19(2) of the Schedule to the Recognition Requirements Regulations provides that:

"Without prejudice to the generality of sub-paragraph 19(1) of the Recognition Requirements, the clearing house must ensure that access to the clearing house's facilities is subject to criteria designed to protect the orderly functioning of those facilities and the interests of investors;"

2.16 FSA Guidance in REC expands on this to refer to the Clearing House:

- (a) Limiting access as a member to persons: over whom it can with reasonable certainty enforce its rules contractually; who are competent and appropriate (in terms of size/nature of their business); and who have sufficient financial resources.³⁰
- (b) Having objective and non-discriminatory membership criteria.³¹
- (c) Having appropriate arrangements to permit electronic access (including procedures, controls, security governing members).³²

REC 2.7.2A: Access to central counterparty, clearing and settlement facilities

Paragraph 21A of the Schedule to the Recognition Requirements Regulations provides that:

"The clearing house must make transparent and non-discriminatory rules, based on objective criteria, governing access to central counterparty, clearing or settlement facilities provided by it. The rules must enable an investment firm or a credit institution authorised by the competent authority of another EEA State (including a branch established in the United Kingdom of such a firm or institution) to have access to those facilities on the same terms as a UK firm for the purposes of finalising or arranging the finalisation of transactions in financial instruments. The clearing house may refuse access to those facilities on legitimate commercial grounds."

2.17 This Requirement was brought in to implement a provision of the Markets in Financial Instruments Directive 2004/39/EC ("MIFID"),³³ supporting the free movement of financial services within the European Union (i.e. permitting access to the Clearing House by members from other EU countries).

²⁹ REC 2.6.4G.

³⁰ REC 2.7.3G(1).

³¹ REC 2.7.3G(2).

³² REC 2.7.4G.

³³ Article 34 of MIFID, implemented 1 November 2007; Paragraph 7C of the Recognition Requirements for Investment Exchanges and Clearing Houses (Amendment) Regulations.

REC 2.8: Settlement and clearing services

Paragraph 19(2)(b) of the Schedule to the Recognition Requirements Regulations provides that:

"The clearing house must ensure that its clearing services involve satisfactory arrangements for securing the timely discharge (whether by performance, compromise or otherwise) of the rights and liabilities of the parties to transactions in respect of which it provides such services (being rights and liabilities in relation to those transactions);"

2.18 FSA Guidance in REC expands on this to refer to the Clearing House's rules and practices relating to clearing and settlement; arrangements for making deliveries and payments, collecting margin and holding collateral; procedures to detect and deal with settlement failures (noting that the FSA does not consider a failure of a specific transaction to be a breach of this Requirement).³⁴

REC 2.9: Transaction recording

Paragraph 19(2)(c) of the Schedule to the Recognition Requirements Regulations provides that:

"The clearing house must ensure that satisfactory arrangements are made for recording transactions which are cleared or to be cleared by means of its facilities;"

2.19 FSA Guidance in REC includes arrangements for maintaining an audit trail of transactions (between three and five years).³⁵

REC 2.10: Financial Crime and market abuse

Paragraph 19(2)(d) of the Schedule to the Recognition Requirements Regulations provides that:

"Without prejudice to the generality of sub-paragraph 19(1) of the Recognition Requirements, the clearing house must ensure that appropriate measures are adopted to reduce the extent to which the clearing house's facilities can be used for a purpose connected with market abuse or financial crime, and to facilitate their detection and monitor their incidence."

2.20 FSA Guidance in REC provides that in considering whether this Requirement is satisfied the FSA will have regard to:

- (a) Whether the Clearing House's Rules enable it to disclose information to the FSA or other appropriate bodies; and
- (b) Whether the arrangements, resources, systems and procedures of the Clearing House enable it to monitor the use of its facilities for abnormal/improper use; and cooperate with relevant bodies in the prevention, investigation and pursuit of market abuse and financial crime.³⁶

³⁴ REC 2.8.3G.

³⁵ REC 2.9.3G.

³⁶ REC 2.10.3G.

REC 2.11: Custody

Paragraph 19(2)(e) of the Schedule to the Recognition Requirements Regulations provides that:

"The clearing house must ensure that where the clearing house's facilities include making provision for the safeguarding and administration of assets belonging to users of those facilities, satisfactory arrangements are made for that purpose."

2.21 FSA Guidance in REC expands on this to consider:

- (a) The level of protection against the risk of theft or other types of loss;
- (b) Whether the arrangements ensure that assets are only used or transferred in accordance with owner's instructions;
- (c) Whether there are adequate arrangements to ensure the proper segregation of assets belonging to the Clearing House from those belonging to members;
- (d) Record keeping;
- (e) Reconciliation of assets held; and
- (f) Frequency of statements.³⁷

REC 2.13: Promotion and maintenance of standards

Paragraph 20 of the Schedule to the Recognition Requirements Regulations provides that:

"The clearing house must be able and willing to promote and maintain high standards of integrity and fair dealing in the carrying on of regulated activities by persons in the course of using the facilities provided by the clearing house. The clearing house must be able and willing to cooperate, by the sharing of information or otherwise, with the FSA, with any other authority, body or person having responsibility in the United Kingdom for the supervision or regulation of any regulated activity or other financial service, or with an overseas regulator within the meaning of section 195 of FSMA."

2.22 FSA Guidance in REC expands on this to refer to the extent to which the Clearing House complies with codes of conduct etc. which users of the UK financial system would normally expect to apply; and the extent to which the Clearing House is able to obtain and disclose otherwise confidential information to the FSA and other appropriate bodies; and its general willingness to cooperate with the FSA.³⁸

REC 2.14: Rules and consultation

Paragraph 21 of the Schedule to the Recognition Requirements Regulations provides that:

"The clearing house must ensure that appropriate procedures are adopted for it to make rules, for keeping its rules under review and for amending them. The procedures must include procedures for consulting users of the clearing house's facilities in appropriate cases. The clearing house

³⁷ REC 2.11.3G.

³⁸ REC 2.13.3G – 2.13.6G.

must consult users of its facilities on any arrangements it proposes to make for dealing with penalty income in accordance with paragraph 22(3) below (or on any changes which it proposes to make to those arrangements)."

2.23 FSA expands on this in REC by setting out guidance on arrangements for reviewing and amending rules; and processes for consulting members on rule changes.³⁹

REC 2.15: Discipline

Paragraph 22 of the Schedule to the Recognition Requirements Regulations provides that:

"The clearing house must have effective arrangements for monitoring and enforcing compliance with its rules. The arrangements must include procedures for—

(a) investigating complaints made to the clearing house about the conduct of persons in the course of using the clearing house's facilities; and

(b) the fair, independent and impartial resolution of appeals against decisions of the clearing house.

Where the arrangements include provision for requiring the payment of financial penalties, they must include arrangements for ensuring that any amount so paid is applied only in one or more of the following ways—

(a) towards meeting expenses incurred by the clearing house in the course of the investigation of the breach in respect of which the penalty is paid, or in the course of any appeal against the decision of the clearing house in relation to that breach;

(b) for the benefit of users of the clearing house's facilities;

(c) for charitable purposes."

2.24 FSA expands on this in REC by setting out guidance on arrangements for monitoring and enforcing member compliance with the Clearing House's rules including the taking of appropriate disciplinary action; retaining authority over members for at least one year after it has ceased to be a member; and arrangements for the application of penalty income (which, essentially, should not be treated as general revenue).⁴⁰

REC 2.16: Complaints

Paragraph 23 of the Schedule to the Recognition Requirements Regulations provides that:

"(1) The clearing house must have effective arrangements for the investigation and resolution of complaints arising in connection with the performance of, or failure to perform, any of its regulatory functions.

(2) But sub-paragraph (1) does not extend to—

³⁹ REC 2.14.3G – 2.14.6G.

⁴⁰ REC 2.15.3G - 2.15.6G.

(a) complaints about the content of rules made by the clearing house, or

(b) complaints about a decision against which the complainant has the right to appeal disciplinary matters.

(3) The arrangements must include arrangements for a complaint to be fairly and impartially investigated by a person independent of the clearing house, and for him to report on the result of his investigation to the clearing house and to the complainant.

(4) The arrangements must confer on the person mentioned in sub-paragraph (3) the power to recommend, if he thinks it appropriate, that the clearing house—

(a) makes a compensatory payment to the complainant,

(b) remedies the matter complained of,

or takes both of those steps.

(5) Sub-paragraph (3) is not to be taken as preventing the clearing house from making arrangements for the initial investigation of a complaint to be conducted by the clearing house."

2.25 FSA Guidance in REC expands on this by outlining the procedures that should be adopted by the Clearing House when handling a complaint, including the appointment of an independent complaints investigator.⁴¹

REC 2.17: Default rules in respect of market contracts

Paragraph 24 of the Schedule to the Recognition Requirements Regulations provides that:

"(1) The clearing house must have default rules which, in the event of a member of the clearing house being or appearing to be unable to meet his obligations in respect of one or more market contracts, enable action to be taken to close out his position in relation to all unsettled market contracts to which he is a party.

(2) The rules may authorise the taking of the same or similar action where a member appears to be likely to become unable to meet his obligations in respect of one or more market contracts. "

Content of rules

Paragraph 25 of the Schedule to the Recognition Requirements Regulations provides that:

"(1) The rules must provide—

(a) for all rights and liabilities of the defaulter under or in respect of unsettled market contracts to be discharged and for there to be paid by or to the defaulter such sum of money (if any) as may be determined in accordance with the rules;

(b) for the sums so payable by or to the defaulter in respect of different contracts to be aggregated or set off so as to produce a net sum;

⁴¹ REC 2.16.3G - 2.16.4G

(c) for that sum—

(i) if payable by the defaulter to the clearing house, to be set off against any property provided by or on behalf of the defaulter as cover for margin (or the proceeds of realization of such property) so as to produce a further net sum;

(ii) if payable by the clearing house to the defaulter, to be aggregated with any property provided by or on behalf of the defaulter as cover for margin (or the proceeds of realization of such property); and

(d) for the certification by or on behalf of the clearing house of the sum finally payable or, as the case may be, of the fact that no sum is payable.

(2) The reference in sub-paragraph (1) to the rights and liabilities of a defaulter under or in respect of an unsettled market contract includes (without prejudice to the generality of that provision) rights and liabilities arising in consequence of action taken under provisions of the rules authorising—

(a) the effecting by the clearing house of corresponding contracts in relation to unsettled market contracts to which the defaulter is party;

(b) the transfer of the defaulter's position under an unsettled market contract to another member of the clearing house;

(c) the exercise by the clearing house of any option granted by an unsettled market contract.

(3) A "corresponding contract" means a contract on the same terms (except as to price or premium) as the market contract but under which the person who is the buyer under the market contract agrees to sell and the person who is the seller under the market contract agrees to buy.

(4) Sub-paragraph (3) applies with any necessary modifications in relation to a market contract which is not an agreement to sell.

(5) The reference in sub-paragraph (1) to the rights and liabilities of a defaulter under or in respect of an unsettled market contract does not include, where he acts as agent, rights or liabilities of his arising out of the relationship of principal and agent."

Notification to other parties affected

Paragraph 26 of the Schedule to the Recognition Requirements Regulations provides that:

"The clearing house must have adequate arrangements for ensuring that parties to unsettled market contracts with a defaulter are notified as soon as reasonably practicable of the default and of any decision taken under the rules in relation to contracts to which they are a party."

Cooperation with other authorities

Paragraph 27 of the Schedule to the Recognition Requirements Regulations provides that:

"The clearing house must be able and willing to cooperate, by the sharing of information and otherwise, with the Secretary of State, any relevant office-holder within the meaning of section 189

of the Companies Act 1989,⁴² and any other authority or body having responsibility for any matter arising out of or connected with the default of a member of the clearing house."

Margin

Paragraph 28 of the Schedule to the Recognition Requirements Regulations provides that:

"(1) The rules of the clearing house must provide that in the event of a default, margin provided by the defaulter for his own account is not to be applied to meet a shortfall on a client account.

(2) This paragraph is without prejudice to the requirements of any rules relating to clients' money made by the Authority under sections 138 and 139 of FSMA."

2.26 FSA Guidance in REC on the requirement for default rules is very limited, primarily because the default rules' Recognition Requirement is detailed and prescriptive and interacts with UK insolvency law. Upon an insolvency of a clearing member, when taking action under its default rules in respect of market contracts, security transfer orders or payment transfer orders, the Clearing House is protected from the normal operation of insolvency law which might otherwise leave this action open to challenge by an insolvency practitioner.⁴³

REC Chapter 3: Notification Rules

2.27 The information the Clearing House must provide to the FSA includes notification of:

- (a) Its annual audited reports and accounts and consolidated annual report and accounts for the Group; monthly or quarterly management accounts; and annual budget.⁴⁴
- (b) Any presentation of a petition for winding up, the appointment of a receiver of liquidator, or the making of a voluntary arrangement with creditors;⁴⁵
- (c) Any institution of any legal proceedings against it;⁴⁶
- (d) Changes in its constitution, fees and charges, key personnel, auditors and persons to whom it provides clearing services;⁴⁷
- (e) The dismissal of or any disciplinary actions taken against or relating to any key individual;⁴⁸

⁴² A relevant office-holder as defined in section 189 of the Companies Act 1989, which is in summary: (a) the official receiver; (b) (in relation to a company) any person acting as its liquidator, provisional liquidator, administrator or administrative receiver; (c) (in relation to an individual or a debtor within the Bankruptcy (Scotland) Act 1985) a trustee in bankruptcy, interim receiver of property, or permanent or interim trustee in the sequestration of an estate; (d) any person acting as administrator of an insolvent estate of a deceased person.

⁴³ Part VII Companies Act 1989; Settlement Finality Regulations 1999.

⁴⁴ REC 3.8.1R; 3.8.4R; 3.8.6R.

⁴⁵ REC 3.11.1R.

⁴⁶ REC 3.12.1R.

⁴⁷ REC 3.4R; 3.6.1R; 3.7.1R; 3.9.2R; Section 293 (7) FSMA.

⁴⁸ REC 3.5.1R.

- (f) Inability to operate any of its facilities during normal hours of operation;⁴⁹
- (g) The provision, or ceasing of provision of clearing services certain instruments;⁵⁰
- (h) Any disciplinary action taken against a member or an employee of a member;⁵¹
- (i) The appointment of persons by another regulatory body to investigate any aspect of the clearing services;⁵²
- (j) Evidence tending to suggest that any person has been carrying on unauthorized investment business or committed a criminal offence under FSMA,⁵³ and
- (k) A default of a clearing member.⁵⁴

2.28 Separate provisions require notification to the FSA of certain changes to rules and other regulatory provisions.⁵⁵

2.29 Finally, a separate set of notification rules will apply to the Clearing House as a result of it being designated as a “designated system” for purposes of the Financial Markets & Insolvency (Settlement Finality) Regulations 1999. The Clearing House intends (but is not obliged) to apply for such status. If designated, the Clearing House will be required to provide the FSA with:

- (a) a list of participants in its system, updated with any changes within seven days of such change;
- (b) information relating to the Clearing House’s system as requested from time to time;
- (c) notice of changes to the Clearing House’s rules or guidance; and
- (d) 14 days’ advance notice of any proposed changes to its default arrangements.⁵⁶

⁴⁹ REC 3.15.6R.

⁵⁰ REC 3.14.4R.

⁵¹ REC 3.20R.

⁵² REC 3.19R.

⁵³ REC 3.21R.

⁵⁴ REC 3.23R.

⁵⁵ Section 300A et seq FSMA.

⁵⁶ Article 10.Financial Markets & Insolvency (Settlement Finality) Regulations 1999.

3. DCO CORE PRINCIPLES: COMPARATIVE ANALYSIS WITH UK REQUIREMENTS

Core Principle A: IN GENERAL

To be registered and to maintain registration as a derivatives clearing organization, an applicant shall demonstrate to the Commission that the applicant complies with the core principles specified in this paragraph. The applicant shall have reasonable discretion in establishing the manner in which it complies with the core principles.

An entity preparing to submit to the Commission an application to operate as a derivatives clearing organization is encouraged to contact Commission staff for guidance and assistance in preparing its application. Applicants may submit a draft application for review prior to the submission of an actual application without triggering the application review procedures of §39.3 of the Commission's regulations. The Commission also may require a derivatives clearing organization to demonstrate to the Commission that it is operating in compliance with one or more core principles.

UK Requirements

- 3.1 FSMA contains a general prohibition whereby no person may carry on a regulated activity in the UK unless he is either an authorized person or an exempt person.⁵⁷
- 3.2 A Recognized Clearing House (“RCH”) is exempt from the general prohibition as respects any regulated activity which is carried on for the purposes of, or in connection with, the provision of clearing services by the clearing house.⁵⁸
- 3.3 Applications to the FSA for recognition as a UK RCH can be made under section 288 of FSMA. An applicant needs to demonstrate to the FSA that it is able to meet the Recognition Requirements before a recognition order can be made.
- 3.4 The FSA encourages (but does not require) prospective applicants to submit a draft Application for Recognition as a clearing house for review prior to the formal submission. The Clearing House submitted a detailed application which was subject to extensive review by the FSA.
- 3.5 FSA Guidance on the Recognition process is set out in Chapter 5 of the FSA’s REC Sourcebook.

Core Principle B: FINANCIAL RESOURCES

The applicant shall demonstrate that the applicant has adequate financial, operational, and managerial resources to discharge the responsibilities of a derivatives clearing organization.

In addressing Core Principle B, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. *The resources dedicated to supporting the clearing function:*

⁵⁷ Section 19 FSMA.

⁵⁸ Section 285 FSMA.

a. The level of resources available to the clearing organization and the sufficiency of those resources to assure that no material adverse break in clearing operations will occur in a variety of market conditions; and

b. The level of member/participant default such resources could support as demonstrated through use of hypothetical default scenarios that explain assumptions and variables factored into the illustrations.

2. The nature of resources dedicated to supporting the clearing function:

a. The type of the resources, including their liquidity, and how they could be accessed and applied by the clearing organization promptly;

b. How financial and other material information will be updated and reported to members, the public, if and when appropriate, and to the Commission on an ongoing basis; and

c. Any legal or operational impediments or conditions to access.

UK Requirements

3.6 A UK RCH must have financial resources sufficient for the proper performance of its functions as a UK RCH (the financial resources requirement).⁵⁹

3.7 In determining whether this Recognition Requirement is met, the FSA has regard to:

(a) The amount and liquidity of assets and the likely availability of liquid financial resources during periods of major market turbulence or other periods of major stress for the financial system; and the nature and scale of exposures to counterparty and market risks and, where relevant, the counterparties to which it is exposed.⁶⁰

(b) The FSA considers that the Clearing House will have sufficient financial resources (after allowing for the financial resources necessary to cover counterparty and market risks) if it has at any time liquid financial assets amounting to at least six months' operating costs; and net capital of at least this amount (usually in the form of equity).⁶¹

3.8 In addition, the Clearing House must ensure that the systems and controls used in the performance of its functions are adequate, and appropriate for the scale and nature of its business (the systems and controls requirement). This requirement applies in particular to systems and controls concerning the assessment and management of risks to the performance of the clearing house's functions; and the operation of its clearing services.⁶²

3.9 FSA Guidance in REC expands on this to cover:

⁵⁹ Paragraph 16 of the Schedule to the Recognition Requirements Regulations.

⁶⁰ REC 2.3.5G.

⁶¹ REC 2.3.6G.

⁶² Paragraph 18 of the Schedule to the Recognition Requirements Regulations.

- (a) Duties and responsibilities within the clearing house; staffing and resources; staff supervision; Board oversight.⁶³
 - (b) Information transmission (within the clearing house; and to members).⁶⁴
 - (c) Risk management of general, operational, legal, market and counterparty risks (which will include a review of the risk department, frequency of monitoring and review of risk or exposure limits, arrangements for monitoring and assessing intra-day movements in exposures and risks, margin, and stress-testing etc.).
 - (d) Monitoring of settlement arrangements.
 - (e) Safeguarding and administration of assets (including audit trail of assets and instructions).⁶⁵
 - (f) IT systems.⁶⁶
- 3.10 Finally, the Clearing House must ensure that access to its facilities is subject to criteria designed to protect the orderly functioning of those facilities and the interests of investors (the access to facilities requirement).⁶⁷ In assessing compliance with this requirement the FSA considers whether the Clearing House:
- (a) Limits access as a member to persons: over whom it can with reasonable certainty enforce its rules contractually; who are competent and appropriate (in terms of size/nature of their business); and who have sufficient financial resources.⁶⁸
 - (b) Has objective and non-discriminatory membership criteria.⁶⁹
 - (c) Has appropriate arrangements to permit electronic access (including procedures, controls, security governing members).⁷⁰
- 3.11 In relation to default scenarios, the Clearing House must ensure that the systems and controls used in the performance of its functions are adequate, and appropriate for the scale and nature of its business. This requirement applies in particular to systems and controls concerning the assessment and management of risks to the performance of the clearing house's functions.⁷¹ The FSA considers the frequency with which exposures and risks incurred by the Clearing House are monitored against risk or exposure limits or other appropriate control parameters, the frequency with which risk or exposure limits (or other control parameters) are reviewed, the reliability of the arrangements for monitoring and assessing intra-day movements in

⁶³ REC 2.5.3G.

⁶⁴ REC 2.5.5G.

⁶⁵ REC 2.5.9G.

⁶⁶ REC 2.5.18G – REC 2.5.20G.

⁶⁷ Paragraph 19(2)(a) of the Schedule to the Recognition Requirements Regulations.

⁶⁸ REC 2.7.3 G(1).

⁶⁹ REC 2.7.3 G(2).

⁷⁰ REC 2.7.4G.

⁷¹ REC 2.5.6G - REC 2.5.7G.

exposures and risks, the robustness of the arrangements for calculating, collecting and holding margin payments and the allocation of losses and arrangements for stress testing of the adequacy of the clearing house's financial resources to cover its exposures which may arise, for example with substantial movements in market values or counterparty defaults.⁷²

Core Principle C: PARTICIPANT AND PRODUCT ELIGIBILITY

The applicant shall establish (i) appropriate admission and continuing eligibility standards (including appropriate minimum financial requirements) for members of and participants in the organization; and (ii) appropriate standards for determining eligibility of agreements, contracts, or transactions submitted to the applicant.

In addressing Core Principle C, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Member/participant admission criteria:

a. How admission standards for its clearing members/participants would contribute to the soundness and integrity of operations; and

b. Matters such as whether these criteria would be in the form of organization rules that apply to all clearing members/participants, whether different levels of membership/participation would relate to different levels of net worth, income, and creditworthiness of members/participants, and whether margin levels, position limits and other controls would vary in accordance with these levels.

2. Member/participant continuing eligibility criteria:

a. A program for monitoring the financial status of its members/participants; and

b. Whether and how the clearing organization would be able to change continuing eligibility criteria in accordance with changes in a member's/participant's financial status.

3. Criteria for instruments acceptable for clearing:

a. The criteria, and the factors considered in establishing the criteria, for the types of agreements, contracts, or transactions it will clear; and

b. How those criteria take into account the different risks inherent in clearing different agreements, contracts, or transactions and how they affect maintenance of assets to support the guarantee function in varying risk environments.

4. The clearing function for each instrument the organization undertakes to clear.

UK Requirements

3.12 The Clearing House must ensure that access to its facilities is subject to criteria designed to protect the orderly functioning of those facilities and the interests of investors (the access to

⁷² REC 2.5.7G.

facilities Requirement).⁷³ In assessing compliance with this requirement the FSA considers whether the Clearing House:

- (a) Limits access as a member to persons: over whom it can with reasonable certainty enforce its rules contractually; who are competent and appropriate (in terms of size/nature of their business); and who have sufficient financial resources.⁷⁴
- (b) Has objective and non-discriminatory membership criteria.⁷⁵
- (c) Has appropriate arrangements to permit electronic access (including procedures, controls, security governing members).⁷⁶

3.13 In addition, the clearing house must ensure that the systems and controls used in the performance of its functions are adequate, and appropriate for the scale and nature of its business. This requirement applies in particular to systems and controls concerning—

- (a) the transmission of information;
- (b) the assessment and management of risks to the performance of the clearing house's functions;
- (c) the operation of its clearing services; and
- (d) (where relevant) the safeguarding and administration of assets belonging to users of the clearing house's facilities.⁷⁷

3.14 This would include FSA consideration of:

- (a) Risk management of general, operational, legal, market and counterparty risks (to include a review of the Clearing House risk department, frequency of monitoring and review of risk or exposure limits, arrangements for monitoring and assessing intra-day movements in exposures and risks, margin, and stress-testing etc.); membership admission criteria and ongoing membership criteria; and monitoring of settlement arrangements (in so far as they contribute to risk management).
- (b) Safeguarding and administration of assets (including audit trail of assets and instructions).⁷⁸

3.15 In relation to the criteria for instruments acceptable for clearing, there are various rules which apply to UK recognised exchanges, such as ICE Futures Europe, but no specific requirements applicable to the Clearing House. The relevant exchange must make clear and transparent rules concerning the admission of financial instruments to trading on any financial market operated by it.. The rules must ensure that all financial instruments admitted to trading on any regulated market operated by the exchange are capable of being traded in a fair, orderly and

⁷³ Paragraph 19(2)(a) of the Schedule to the Recognition Requirements Regulations.

⁷⁴ REC 2.7.3 G(1).

⁷⁵ REC 2.7.3 G(2).

⁷⁶ REC 2.7.4G.

⁷⁷ Paragraph 18 of the Schedule to the Recognition Requirements Regulations.

⁷⁸ REC 2.5.9G.

efficient manner. The exchange's rules must ensure that all transferable securities admitted to trading are freely negotiable; and that all derivatives admitted to trading are designed so as to allow for their orderly pricing as well as for the existence of effective settlement conditions. The exchange must maintain arrangements to provide sufficient publicly available information (or satisfy itself that sufficient information is publicly available) to enable users to form investment judgments, taking into account both the nature of the users and the types of instrument traded. The exchange must regularly review whether the financial instruments admitted to trading on a regulated market operated by it comply with the admission requirements for those instruments.⁷⁹

3.16 Specifically in relation to derivatives, exchanges are required to verify that the following conditions are satisfied in respect of listed securities:

- (a) the terms of the contract establishing the financial instrument must be clear and unambiguous, and enable a correlation between the price of the financial instrument and the price or other value measure of the underlying;
- (b) either:
 - (i) the price or other value measure of the underlying must be reliable and publicly available; or
 - (ii) all of the following conditions are satisfied:
 - (A) the contract establishing that instrument must be likely to provide a means of disclosing to the market, or enabling the market to assess, the price or other value measure of the underlying, where the price or value measure is not otherwise publicly available;
 - (B) the exchange must ensure that appropriate supervisory arrangements are in place to monitor trading and settlement in such financial instruments;
 - (C) the exchange must ensure that settlement and delivery, whether physical delivery or by cash settlement, can be effected in accordance with the contract terms and conditions of those financial instruments.
- (c) sufficient information of a kind needed to value the derivative must be publicly available;
- (d) the arrangements for determining the settlement price of the contract must be such that the price properly reflects the price or other value measure of the underlying; and
- (e) where the settlement of the derivative requires or provides for the possibility of the delivery of an underlying security or asset rather than cash settlement, there must be adequate arrangements to enable market participants to obtain relevant information about that underlying, as well as adequate settlement and delivery procedures for the underlying.⁸⁰

⁷⁹ Paragraph 7A of the Schedule to the Recognition Requirements Regulations.

⁸⁰ REC 2.12.2E.

Core Principle D: RISK MANAGEMENT

The applicant shall have the ability to manage the risks associated with discharging the responsibilities of a derivatives clearing organization through the use of appropriate tools and procedures.

In addressing Core Principle D, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Use of risk analysis tools and procedures:

- a. How the adequacy of the overall level of financial resources would be tested on an ongoing periodic basis in a variety of market conditions;*
- b. How the organization would use specific risk management tools such as stress testing and value at risk calculations; and*
- c. What contingency plans the applicant has for managing extreme market events.*

2. Use of collateral:

- a. What forms and levels of collateral would be established and collected;*
- b. How amounts would be adequate to secure prudentially obligations arising from clearing transactions and, where applicable, performing as a central counterparty;*
- c. The factors considered in determining appropriate margin levels for an instrument cleared and for clearing members/participants;*
- d. The appropriateness of required or allowed forms of margin given the liquidity and related requirements of the clearing organization;*
- e. How the clearing organization would value open positions and collateral assets; and*
- f. The proposed margin collection schedule and how it would relate to changes in the value of market positions and collateral values.*

3. Use of credit limits:

If systems would be implemented that would prevent members/participants and other market participants from exceeding credit limits and how they would operate.

UK Requirements

- 3.17 The Clearing House must ensure that the systems and controls used in the performance of its functions are adequate, and appropriate for the scale and nature of its business (the systems and controls requirement). This requirement applies in particular to systems and controls concerning—
- (a) the transmission of information;
 - (b) the assessment and management of risks to the performance of the clearing house's functions;

- (c) the operation of the matters mentioned in paragraph 19(2)(b) below; and
- (d) (where relevant) the safeguarding and administration of assets belonging to users of the clearing house's facilities.⁸¹

3.18 FSA Guidance in REC expands on this to cover:

- (a) Duties and responsibilities within the clearing house; staffing and resources; staff supervision; Board oversight.⁸²
- (b) Information transmission (within the clearing house; and to members).⁸³
- (c) Risk management of general, operational, legal, market and counterparty risks (which will include a review of the risk department, frequency of monitoring and review of risk or exposure limits, arrangements for monitoring and assessing intra-day movements in exposures and risks, margin, and stress-testing etc.).⁸⁴
- (d) Monitoring of settlement arrangements.⁸⁵
- (e) Safeguarding and administration of assets (including audit trail of assets and instructions).⁸⁶
- (f) Management of conflicts of interest (personal and structural).⁸⁷
- (g) Internal and external audit.⁸⁸
- (h) IT systems.⁸⁹
- (i) Contingency Plans and back-up facilities.

3.19 In particular, the Clearing House must ensure that the systems and controls used in the performance of its functions are adequate, and appropriate for the scale and nature of its business. This requirement applies in particular to systems and controls concerning the assessment and management of risks to the performance of the Clearing House's functions.⁹⁰ The FSA considers the frequency with which exposures and risks incurred by the Clearing House are monitored against risk or exposure limits or other appropriate control parameters, the frequency with which risk or exposure limits (or other control parameters) are reviewed,

⁸¹ Paragraph 18 of the Schedule to the Recognition Requirements Regulations.

⁸² REC 2.5.3G.

⁸³ REC 2.5.5G.

⁸⁴ REC 2.5.6G – REC 2.5.7G.

⁸⁵ REC 2.5.8G.

⁸⁶ REC 2.5.9G.

⁸⁷ REC 2.5.10 – 2.5.16G.

⁸⁸ REC 2.5.17G.

⁸⁹ REC 2.5.18 – 20G.

⁹⁰ REC 2.5.6G - REC 2.5.7G.

the reliability of the arrangements for monitoring and assessing intra-day movements in exposures and risks, the robustness of the arrangements for calculating, collecting and holding margin payments and the allocation of losses and arrangements for stress testing of the adequacy of the clearing house's financial resources to cover its exposures which may arise, for example with substantial movements in market values or counterparty defaults.⁹¹

- 3.20 In considering whether the Clearing House meets the systems and controls requirement, the FSA would take into account matters substantially similar to those in Core Principle D.

Core Principle E: SETTLEMENT PROCEDURES

The applicant shall have the ability to (i) complete settlements on a timely basis under varying circumstances; (ii) maintain an adequate record of the flow of funds associated with each transaction that the applicant clears; and (iii) comply with the terms and conditions of any permitted netting or offset arrangements with other clearing organizations.

In addressing Core Principle E, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Settlement timeframe:

- a. Procedures for completing settlements on a timely basis during times of normal operating conditions; and*
- b. Procedures for completing settlements on a timely basis in varying market circumstances including during a period when one or more significant members/participants have defaulted.*

2. Recordkeeping:

- a. The nature and quality of the information collected concerning the flow of funds involved in clearing and settlement; and*
- b. How such information would be recorded, maintained and accessed.*

3. Interfaces with other clearing organizations:

How compliance with the terms and conditions of netting or offset arrangements with other clearing organizations would be met, including, among others, common banking or common clearing programs.

UK Requirements

- 3.21 The Clearing House must ensure that the systems and controls used in the performance of its functions are adequate, and appropriate for the scale and nature of its business (the systems and controls Requirement). This requirement applies in particular to systems and controls concerning—
- (a) the transmission of information;
 - (b) the assessment and management of risks to the performance of the clearing house's functions;

⁹¹ REC 2.5.7G.

- (c) the operation of the matters mentioned in paragraph 19(2)(b) below; and
 - (d) the safeguarding and administration of assets belonging to users of the clearing house's facilities.⁹²
- 3.22 FSA Guidance in REC expands on this to cover the safeguarding and administration of assets (including audit trail of assets and instructions).⁹³
- 3.23 Further, the Clearing House must ensure that its clearing services involve satisfactory arrangements for securing the timely discharge (whether by performance, compromise or otherwise) of the rights and liabilities of the parties to transactions in respect of which it provides such services (being rights and liabilities in relation to those transactions) (the settlement and clearing services Requirement).⁹⁴
- 3.24 In considering whether the Clearing House satisfies this requirement, the FSA takes into account the Clearing House's rules and practices relating to clearing and settlement; arrangements for making deliveries and payments, collecting margin and holding collateral; procedures to detect and deal with settlement failures (noting that the FSA does not consider a failure of a specific transaction to be a breach of this Requirement).⁹⁵
- 3.25 Finally, the Clearing House must ensure that satisfactory arrangements are made for:
- (a) Recording transactions which are cleared or to be cleared by means of its facilities,⁹⁶ which should include arrangements for maintaining an audit trail of transactions (between three and five years) (the transaction recording Requirement).⁹⁷
 - (b) The safeguarding and administration of assets belonging to members (where the Clearing House offers such facilities).⁹⁸ The FSA will take into consideration record keeping; reconciliation of assets held; and frequency of statements (the custody Requirement).⁹⁹

Core Principle F: TREATMENT OF FUNDS

The applicant shall have standards and procedures designed to protect and ensure the safety of member and participant funds.

In addressing Core Principle F, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Safe custody:

⁹² Paragraph 18 of the Schedule to the Recognition Requirements Regulations.

⁹³ REC 2.5.9G.

⁹⁴ Paragraph 19(2)(b) of the Schedule to the Recognition Requirements Regulations.

⁹⁵ REC 2.8.3G.

⁹⁶ Paragraph 19(2)(c) of the Schedule to the Recognition Requirements Regulations.

⁹⁷ REC 2.9.3G.

⁹⁸ Paragraph 19(2)(e) of the Schedule to the Recognition Requirements

⁹⁹ REC 2.11.3G.

- a. *The safekeeping of funds, whether in accounts, in depositories, or with custodians, and how it would meet industry standards of safety;*
- b. *Any written terms regarding the legal status of the funds and the specific conditions or prerequisites for movement of the funds; and*
- c. *The extent to which the deposit of funds in accounts in depositories or with custodians would limit concentration of risk.*

2. *Segregation between customer and proprietary funds:*

Requirements or restrictions regarding commingling customer funds with proprietary funds, obligating customer funds for any purpose other than to purchase, clear, and settle the products the clearing organization is clearing, or procedures regarding customer funds which are subject to cross-margin or similar agreements, and any other aspects of customer fund segregation.

3. *Investment standards:*

- a. *How customer funds would be invested consistent with high standards of safety; and*
- b. *How the organization will gather and keep associated records and data regarding the details of such investments.*

UK Requirements

- 3.26 The Recognition Requirements Regulations require that the Clearing House's default rules provide that in the event of a default, margin provided by the defaulter for its own account is not to be applied to meet a shortfall on a client account.¹⁰⁰
- 3.27 Clearing Members which are UK financial institutions regulated by the FSA are subject to separate FSA rules in respect of the segregation of client and house assets.¹⁰¹ FSA rules applicable to financial institutions regulated in the UK require the Clearing House to acknowledge in writing to Clearing Members that hold segregated client money that the Clearing Member is under an obligation to keep certain client money separate from the Company's own money, placing client money in a client bank account. The Clearing Member is entitled to instruct the Clearing House as to whether any transaction or collateral is in respect of its customer account or proprietary account. The Clearing House must acknowledge that the customer account is not to be combined with the proprietary account, nor is any right of set-off to be exercised by the Clearing House against money credited to the customer account in respect of any sum owed to the Clearing House in relation to the proprietary account.¹⁰²
- 3.28 The Clearing House must in turn ensure that its facilities include making provision for the safeguarding and administration of assets belonging to users of those facilities, satisfactory arrangements are made for that purpose (the custody requirement).¹⁰³ This would include whether the arrangements ensure that assets are only used or transferred in accordance with

¹⁰⁰ Paragraph 28 of the Schedule to the Recognition Requirements.

¹⁰¹ FSA Handbook, Client Assets Sourcebook (CASS).

¹⁰² CASS 7.8.2R.

¹⁰³ Paragraph 19(2)(e) of the Schedule to the Recognition Requirements.

owner's instructions; whether there are adequate arrangements to ensure the proper segregation of assets belonging to the Clearing House from those belonging to members; and record keeping.¹⁰⁴

- 3.29 In considering whether the Clearing House meets the custody requirement, the FSA would consider matters substantially similar to those required by Core Principle F, including in particular the safekeeping of funds (however held) i.e. written terms regarding the legal status of the funds and the specific conditions or prerequisites for movement of the funds (contained within the Clearing House Rules and Procedures); the extent to which the deposit of funds deals with concentration risk; and investment standards.¹⁰⁵

Core Principle G: DEFAULT RULES AND PROCEDURES

The applicant shall have rules and procedures designed to allow for efficient, fair, and safe management of events when members or participants become insolvent or otherwise default on their obligations to the derivatives clearing organization.

In addressing Core Principle G, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Definition of default:

a. The events that will constitute member or participant default;

b. What action the organization would take upon a default and how the organization would otherwise enforce the definition of default; and

c. How the organization would address situations related to but which may not constitute an event of default, such as failure to comply with certain rules, failure to maintain eligibility standards, actions taken by other regulatory bodies, or other events.

2. Remedial action:

The authority pursuant to which, and how, the clearing organization may take appropriate action in the event of the default of a member/participant which may include, among other things, closing out positions, replacing positions, set-off, and applying margin.

3. Process to address shortfalls:

Procedures for the prompt application of clearing organization and/or member/participant financial resources to address monetary shortfalls resulting from a default.

4. Use of cross-margin programs:

How cross-margining programs would provide for clear, fair, and efficient means of covering losses in the event of a program participant default.

¹⁰⁴ REC 2.11.3G.

¹⁰⁵ REC 2.11.3G.

5. Customer priority rule:

Rules and procedures regarding priority of customer accounts over proprietary accounts of defaulting members/participants and, where applicable, in the context of specialized margin reduction programs such as cross-margining or trading links with other exchanges.

UK Requirements

3.30 The Clearing House must have default rules in respect of market contracts (the default rules Requirement).¹⁰⁶ Pursuant to provisions of the Companies Act 1989 and Financial Markets and Insolvency (Settlement Finality) Regulations 1999, various mandatory insolvency laws applicable in the UK and Europe are disapplied in favour of the default rules and proceedings of a clearing house, payment instructions made by a clearing house, contracts with clearing members for the transfer of a security and the use of collateral by a clearing house pursuant to its default rules. The Recognition Requirements Regulations applicable to default rules are prescriptive, have been summarized in paragraph 2.27 and are attached as Annex 2. The Recognition Requirements are designed to ensure that the default rules of the clearing house are capable of being effective in light of UK insolvency laws. The default rules must enable the Clearing House to take action in relation to a member who appears unable, or likely to become unable, to meet his obligations in respect of one or more unsettled market contracts. Such action (and the clearing house's default rules) must provide for all rights and liabilities of the defaulter and any counterpart to an unsettled market contract to be discharged. Subsequently, a net sum must be paid between the clearing member and the clearing house (after obligations and liabilities of the clearing member, including in respect of unsettled contracts and margin, have been set off against one another). Where property has been provided by the defaulter to the clearing house by way of margin, that property may be set off against any amount owing by the defaulter (for example, pursuant to a market contract). "House" and "Customer" margin and contracts are considered separately under these requirements, resulting in two "net sums" being payable where the clearing member has segregated customers. At the conclusion of this process, the Clearing House must certify the sum finally payable in each case, which is either provable in the insolvency (if the amount is payable by the clearing member) or repaid to the clearing member's insolvency practitioner (if the amount is payable by the clearing house).¹⁰⁷

3.31 In relation to shortfalls of collateral and the replenishment of the default fund, the Clearing House must ensure that the systems and controls used in the performance of its functions are adequate, and appropriate for the scale and nature of its business (the systems and controls requirement). This requirement applies in particular to systems and controls concerning the assessment and management of risks to the performance of the clearing house's functions and the operation of its default rules.¹⁰⁸ The FSA considers, among others, the frequency with which exposures and risks incurred by the Clearing House are monitored against risk or exposure limits or other appropriate control parameters, the frequency with which risk or exposure limits (or other control parameters) are reviewed, the robustness of the arrangements for calculating, collecting and holding margin payments and the allocation of losses and arrangements for stress testing of the adequacy of the clearing house's financial resources to cover its exposures in the event of a counterparty default.¹⁰⁹

¹⁰⁶ Part IV of the Schedule to the Recognition Requirements Regulations.

¹⁰⁷ REC 2.17.4G – 2.17.5G.

¹⁰⁸ Paragraph 18 of the Schedule to the Recognition Requirements Regulations.

¹⁰⁹ REC 2.5.7G.

- 3.32 In addition, the Clearing House must ensure that its clearing services involve satisfactory arrangements for securing the timely discharge (whether by performance, compromise or otherwise) of the rights and liabilities of the parties to transactions in respect of which it provides such services (the settlement and clearing services requirement).¹¹⁰ In determining whether such satisfactory arrangements exist, the FSA considers the Clearing House's Rules and procedures; procedures to detect and deal with the failure of a member to settle in accordance with the rules; arrangements for taking action to settle a trade if a member does not settle in accordance with its rules; arrangements for monitoring members; settlement performance; and the Clearing House's default rules and procedures.¹¹¹
- 3.33 There are no specific FSA rules dealing with cross-margining. However, the FSA is able to and will consider such issues in the context of general rules relating to systems and controls, settlement and clearing services and custody and undertakes extensive due diligence on such proposals.
- 3.34 The priority and segregation of customer and proprietary accounts is discussed in paragraphs 3.26 to 3.29.

Core Principle H: RULE ENFORCEMENT

The applicant shall (i) maintain adequate arrangements and resources for the effective monitoring and enforcement of compliance with rules of the applicant and for resolution of disputes; and (ii) have the authority and ability to discipline, limit, suspend, or terminate a member's or participant's activities for violations of rules of the applicant.

In addressing Core Principle H, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Surveillance:

Arrangements and resources for the effective monitoring of compliance with rules relating to clearing practices and financial surveillance.

2. Enforcement:

Arrangements and resources for the effective enforcement of rules and authority and ability to discipline and limit or suspend a member's/participant's activities pursuant to clear and fair standards.

3. Dispute resolution:

Where applicable, arrangements and resources for resolution of disputes between customers and members/participants, and between members/participants.

UK Requirements

- 3.35 The Clearing House must have effective arrangements for monitoring and enforcing compliance with its rules (the Discipline Requirement). The arrangements must include procedures for investigating complaints about the conduct of persons in the course of using

¹¹⁰ Paragraph 19(2)(b) of the Schedule to the Recognition Requirements Regulations.

¹¹¹ REC 2.8.3G.

the Clearing House; and the fair, independent and impartial resolution of appeals against decisions of the Clearing House.¹¹² Separately, the Clearing House must be able to ensure that its members are persons against whom it is able to enforce its rules contractually.¹¹³

- 3.36 In determining whether the Clearing House's arrangements are effective, the FSA will consider the Clearing House's ability to monitor and oversee the use of its facilities; assess compliance with its rules and settlement arrangements; take appropriate disciplinary action; and suspend a member's access to its facilities.¹¹⁴

Core Principle I: SYSTEM SAFEGUARDS

The applicant shall demonstrate that the applicant (i) has established and will maintain a program of oversight and risk analysis to ensure that the automated systems of the applicant function properly and have adequate capacity and security; and (ii) has established and will maintain emergency procedures and a plan for disaster recovery, and will periodically test backup facilities sufficient to ensure daily processing, clearing, and settlement of transactions.

In addressing Core Principle I, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Oversight/risk analysis program:

a. Whether a program addresses appropriate principles and procedures for the oversight of automated systems to ensure that its clearing systems function properly and have adequate capacity and security. The Commission believes that the guidelines issued by the International Organization of Securities Commissions (IOSCO) in 1990 and adopted by the Commission on November 21, 1990 (55 FR 48670), as supplemented in October 2000, are appropriate guidelines for an automated clearing system to apply.

b. Emergency procedures and a plan for disaster recovery; and

c. Periodic testing of back-up facilities and ability to provide timely processing, clearing, and settlement of transactions.

2. Appropriate periodic objective system reviews/testing:

a. Any program for the periodic objective testing and review of the system, including tests conducted and results; and

b. Confirmation that such testing and review would be performed or assessed by a qualified independent professional.

UK Requirements

- 3.37 The clearing house must ensure that the systems and controls used in the performance of its functions are adequate, and appropriate for the scale and nature of its business (the systems and controls Requirement). This Requirement applies in particular to systems and controls

¹¹² Paragraph 22 of the Schedule to the Recognition Requirements Regulations.

¹¹³ REC 2.7.3G(1)(a).

¹¹⁴ REC 2.15.3G.

concerning the assessment and management of risks to the performance of the clearing house's functions; the operation of clearing services; and the safeguarding and administration of assets belonging to users of the clearing house's facilities.¹¹⁵

- 3.38 In considering whether the Clearing House meets the systems and controls requirement the FSA takes into account various matters including risk management of general, operational, legal, market and counterparty risks (which will include a review of the risk department, frequency of monitoring and review of risk or exposure limits, arrangements for monitoring and assessing intra-day movements in exposures and risks, margin, and stress-testing etc.); and the arrangements to ensure business continuity in the event that an information technology system fails.¹¹⁶

Core Principle J: REPORTING

The applicant shall provide to the Commission all information necessary for the Commission to conduct the oversight function of the applicant with respect to the activities of the derivatives clearing organization.

In addressing Core Principle J, applicants and registered derivatives clearing organizations may describe or otherwise document:

- 1. Information available to or generated by the clearing organization that will be made routinely available to the Commission, upon request and/or as appropriate, to enable the Commission to perform properly its oversight function, including information regarding counterparties and their positions, stress test results, internal governance, legal proceedings, and other clearing activities;*
- 2. Information the clearing organization will make available to the Commission on a non-routine basis and the circumstances which would trigger such action;*
- 3. The information the organization intends to make routinely available to members/participants and/or the general public; and*
- 4. Provision of information:*
 - a. The manner in which all relevant routine or non-routine information will be provided to the Commission, whether by electronic or other means; and*
 - b. The manner in which any information will be made available to members/participants and/or the general public.*

UK Requirements

- 3.39 The Clearing House must be able and willing to cooperate, by the sharing of information or otherwise, with the FSA (the promotion and maintenance of standards Requirement).¹¹⁷
- 3.40 The Clearing House must also comply with notification rules made by the FSA under section 293 of FSMA (the FSA has the power to add to, reduce, or amend these notification rules).

¹¹⁵ Paragraph 18 of the Schedule to the Recognition Requirements Regulations.

¹¹⁶ REC 2.5.7G; REC 2.5.18G-REC 2.5.20G.

¹¹⁷ Paragraph 20 of the Schedule to the Recognition Requirements Regulations.

These rules are made by the FSA in order to ensure that it is provided with notice of events and information which it reasonably requires for the exercise of its functions under FSMA, and are set out in Chapter 3 of REC (see paragraph 2.28 above). Other notification rules under FSMA and the Financial Markets & Insolvency (Settlement Finality) Regulations 1999 are described in paragraph 2.29 to 2.30.

- 3.41 In meeting the notification rules, the Clearing House may, unless the rule expressly provides otherwise, give notice orally or in writing, but where it gives notice or information orally, it must confirm that notice or information in writing promptly.
- 3.42 Under section 294 of FSMA, the FSA may, on the application or with the consent of the Clearing House, direct that any notification rules is not to apply, or is to apply with such modifications as may be specified in the waiver.
- 3.43 In relation to participants and members, the clearing house is required to have membership criteria which are objective,¹¹⁸ is required to transmit information promptly and accurately to members, other market participants and (where relevant) other persons.¹¹⁹ In respect of the transmission of information, the FSA's systems and control requirements, discussed in paragraph 2.16, are relevant.

Core Principle K: RECORDKEEPING

The applicant shall maintain records of all activities related to the business of the applicant as a derivatives clearing organization in a form and manner acceptable to the Commission for a period of 5 years.

In addressing Core Principle K, applicants and registered derivatives clearing organizations may describe or otherwise document:

- 1. The different activities related to the entity as a clearing organization for which it must maintain records; and*
- 2. How the entity would satisfy the performance standards of Commission regulation 1.31 (17 CFR 1.31), reserved in this part 39 and applicable to derivatives clearing organizations, including:*
 - a. What "full" or "complete" would encompass with respect to each type of book or record that would be maintained;*
 - b. The form and manner in which books or records would be compiled and maintained with respect to each type of activity for which such books or records would be kept;*
 - c. Confirmation that books and records would be open to inspection by any representative of the Commission or of the U.S. Department of Justice;*
 - d. How long books and records would be readily available and how they would be made readily available during the first two years; and*
 - e. How long books and records would be maintained (and confirmation that, in any event, they would be maintained for at least five years).*

¹¹⁸ REC 2.7.3G(2).

¹¹⁹ REC 2.5.5G.

UK Requirements

- 3.44 The Clearing House must ensure that satisfactory arrangements are made for recording transactions which are cleared or to be cleared by means of its facilities (the transaction recording requirement).¹²⁰ This should include arrangements for maintaining an audit trail of a minimum of between three and five years.¹²¹
- 3.45 Whilst section 165 of FSMA (FSA's power to require information) empowers the FSA to require the Clearing House (amongst others) to provide or produce specified information or documents; or information or documents of a specified description, the FSA would expect most information to be shared with the FSA voluntarily, under the promotion and maintenance of standards requirement.¹²²

Core Principle L: PUBLIC INFORMATION

The applicant shall make information concerning the rules and operating procedures governing the clearing and settlement systems (including default procedures) available to market participants.

In addressing Core Principle L, applicants and registered derivatives clearing organizations may describe or otherwise document:

Disclosure of information regarding rules and operating procedures governing clearing and settlement systems:

- a. Which rules and operating procedures governing clearing and settlement systems should be disclosed to the public, to whom they would be disclosed, and how they would be disclosed;*
- b. What other information would be available regarding the operation, purpose and effect of the clearing organization's rules;*
- c. How members/participants may become familiar with such procedures before participating in operations; and*
- d. How members/participants will be informed of their specific rights and obligations preceding a default and upon a default, and of the specific rights, options and obligations of the clearing organization preceding and upon the member's/participant's default.*

UK Requirements

- 3.46 The Clearing House must ensure that systems and controls used in the performance of its functions are adequate and appropriate for the scale and nature of its business (the systems and controls Requirement). This Requirement applies in particular to systems and controls concerning the transmission of information,¹²³ whereby information should be transmitted promptly and accurately within the Clearing House, to members; and other relevant persons.¹²⁴ The Clearing House's Rules have already been subject to extensive consultation

¹²⁰ Paragraph 19(2)(c) of the Schedule to the Recognition Requirements Regulations.

¹²¹ REC 2.9.3G.

¹²² Paragraph 20 of the Schedule to the Recognition Requirements Regulations.

¹²³ Paragraph 18 of the Schedule to the Recognition Requirements Regulations.

¹²⁴ REC 2.5.5G.

and the Clearing House is required to consult users of its facilities on future rule amendments (in appropriate cases).¹²⁵ Other notification requirements applicable to the Clearing House are described in paragraph 2.29 to 2.30.

Core Principle M: INFORMATION SHARING

The applicant shall (i) enter into and abide by the terms of all appropriate and applicable domestic and international information-sharing agreements; and (ii) use relevant information obtained from the agreements in carrying out the clearing organization's risk management program.

In addressing Core Principle M, applicants and registered derivatives clearing organizations may describe or otherwise document:

- 1. Applicable appropriate domestic and international information-sharing agreements and arrangements including the different types of domestic and international information-sharing arrangements, both formal and informal, which the clearing organization views as appropriate and applicable to its operations.*
- 2. How information obtained from information-sharing arrangements would be used to carry out risk management and surveillance programs:*
 - a. How information obtained from any information-sharing arrangements would be used to further the objectives of the clearing organization's risk management program and any of its surveillance programs including financial surveillance and continuing eligibility of its members/participants;*
 - b. How accurate information is expected to be obtained and the mechanisms or procedures which would make timely use and application of all information; and*
 - c. The types of information expected to be shared and how that information would be shared.*

UK Requirements

- 3.47 The Clearing House must be able and willing to promote and maintain high standards of integrity and fair dealing in the carrying on of regulated activities by persons in the course of using the facilities provided by the clearing house; and must be able and willing to cooperate, by the sharing of information or otherwise, with the FSA, with any other authority, body or person having responsibility in the United Kingdom for the supervision or regulation of any regulated activity or other financial service, or with an overseas regulator (the promotion and maintenance of standards Requirement).¹²⁶ In determining whether the Clearing House satisfies the promotion and maintenance of standards requirements, the FSA will take into account the extent to which the Clearing House complies with codes of conduct etc. which users of the UK financial system would normally expect to apply; and whether the Clearing House participates in appropriate international fora.¹²⁷

¹²⁵ Paragraph 21 of the Schedule to the Recognition Requirements Regulations.

¹²⁶ Paragraph 20 of the Schedule to the Recognition Requirements Regulations.

¹²⁷ REC 2.13.3G – REC 2.13.6 G.

Core Principle N: ANTITRUST CONSIDERATIONS

Unless appropriate to achieve the purposes of this Act, the derivatives clearing organization shall avoid (i) adopting any rule or taking any action that results in any unreasonable restraint of trade; or (ii) imposing any material anticompetitive burden on trading on the contract market.

Pursuant to section 5b(c)(3) of the Act, a registered derivatives clearing organization or an entity seeking registration as a derivatives clearing organization may request that the Commission issue an order concerning whether a rule or practice of the organization is the least anticompetitive means of achieving the objectives, purposes, and policies of the Act. The Commission intends to apply section 15(b) of the Act to its consideration of issues under this core principle in a manner consistent with that previously applied to contract markets.

UK Requirements:

OFT Review of Clearing House Applicants

3.48 On receiving the Clearing House’s application for Recognition the FSA was required to send to HM Treasury and the Office of Fair Trading (the UK’s anti-trust regulator) (“OFT”) a copy of the Clearing House’s regulatory provisions together with such information as the FSA possessed as a result of the application that the FSA considered would assist the OFT in discharging its functions in connection with the application. The OFT is required to issue a report as to whether any of these provisions have a significantly adverse effect on competition (alone or in combination).¹²⁸ Following the granting of Recognition, the OFT must keep the Clearing House’s regulatory provisions and practices under review.¹²⁹

FSA Competition Oversight

3.49 In discharging its functions, which includes the supervision and regulation of clearing houses, the FSA is required to have regard to a number of matters. These matters include “*the need to minimise the adverse effects on competition that may arise from anything done in the discharge of [its] functions*” and “*the desirability of facilitating competition between those who are subject to any form of regulation by the [FSA]*”.

FSA Review of New Rules

3.50 Under section 300A et seq. of the FSMA, the FSA has the right to disallow “excessive regulatory provisions” of a clearing house. This power applies if it appears to the authority that a proposed provision will impose a requirement on persons affected directly or indirectly by it; and that requirement is “excessive”. A requirement is regarded as excessive for these purposes if:

- (a) it is not required under European Community law or any enactment or rules of law in the United Kingdom; and

¹²⁸ Section 302 FSMA provides that “regulatory provisions” means – the rules of the clearing house; any guidance issued by the clearing house; the particulars of any arrangements it has with a Recognised Investment Exchange (and, if the clearing house proposes to provide clearing services for persons other than Recognised Investment Exchange’s, particulars of the criteria which it will apply when determining to whom it will provide those services); and “practices” means – the practices of the clearing house in respect of its clearing arrangements.

¹²⁹ Sections 302-306 FSMA.

- (b) either: (i) it is not justified as pursuing a reasonable regulatory objective; or (ii) it is disproportionate to the end to be achieved.¹³⁰

3.51 In considering whether a requirement is excessive, the FSA must have regard to all the relevant circumstances, including the effect of existing legal and other requirements, the global character of financial services and markets and the international mobility of activity, the desirability of facilitating innovation and the impact of the proposed provision on market confidence.¹³¹

General powers of the OFT

3.52 In addition to the procedures described above in respect of the Clearing House's regulatory provisions, the OFT has powers to take action in respect of matters that do not form part of the regulatory provisions.

3.53 The relevant legislation is the Competition Act 1998 ("**Competition Act**"), specifically, the Chapter I and II prohibitions contained therein.¹³² Chapter I is concerned with anti-competitive agreements and Chapter II with abuse of dominance.

Chapter I prohibition

3.54 The Chapter I prohibition¹³³ is concerned with anti-competitive agreements. The wording of the prohibition mirrors that of the prohibition in Article 81(1) of the EC Treaty¹³⁴. The main elements of the Chapter I prohibition are as follows:

3.55 The Chapter I prohibition prohibits agreements that have an effect on trade within the UK or a part of the UK, and restrict competition in the UK or a part of the UK. The effect on trade and competition can be actual or potential but must be appreciable.

3.56 An agreement caught by the Chapter I prohibition is automatically void and unenforceable. However, if the anti-competitive restrictions can be severed from the rest of the agreement, the unenforceability only affects the anti-competitive restrictions. An agreement falling within the Chapter I prohibition may be exempt from the prohibition if it gives rise to benefits that outweigh its anti-competitive effects.¹³⁵

¹³⁰ Section 300A(3) FSMA.

¹³¹ Section 300A(4) FSMA.

¹³² With the entry into force of EC Regulation 1/2003 (OJ 2003 L1/1) and the decentralization of the enforcement of EC competition law, the OFT, as the UK national competition authority, is responsible for the application and enforcement of Articles 81 and 82 of the EC Treaty. Similar principles apply to both Article 81/82 and the Chapter I/II prohibitions.

¹³³ Section 2 Competition Act.

¹³⁴ In 1957, various international organizations merged to establish the European Economic Community (EEC), pursuant to the Treaty of Rome. The United Kingdom joined the EEC pursuant to an act of accession to the Treaty of Rome in 1973 and the passing by Parliament of the European Communities Act 1972. The current version of the Treaty of Rome is available at this link: <http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/ce321/ce32120061229en00010331.pdf>. A further Treaty on European Union was signed in Maastricht on 7 February 1992 and came into force on 1 November 1993 but does not deal with matters relating to competition law.

¹³⁵ Section 9 Competition Act.

- 3.57 If, after conducting an investigation, the OFT concludes that an agreement infringes the Chapter I prohibition and does not benefit from any form of exemption or exclusion, it can issue a decision which will usually include a requirement that the parties modify or cease the anti-competitive behavior.¹³⁶ The parties may also be fined.¹³⁷
- 3.58 The Chapter I prohibition contains a non-exhaustive list of examples of anti-competitive agreements, which mirror the examples contained in Article 81(1).¹³⁸
- (a) fixing purchase or selling prices or other trading conditions;
 - (b) limiting or controlling production, markets, technical developments or investment;
 - (c) sharing markets or sources of supply;
 - (d) applying dissimilar conditions to equivalent transactions with other parties, thereby placing them at a competitive disadvantage; and
 - (e) making contracts conditional on additional obligations that are not connected with the subject matter of the contract.
- 3.59 The OFT guideline *Agreements and concerted practices* gives a number of further examples of agreements that could infringe the Chapter I prohibition, depending on the particular facts of each case:
- (a) collusive tendering (or "bid-rigging");
 - (b) joint buying or selling;
 - (c) information-sharing agreements;
 - (d) exchanges of price or non-price information;
 - (e) restrictions on advertising; and
 - (f) standardization agreements.

Chapter II prohibition

- 3.60 The Chapter II prohibition is closely modeled on Article 82 of the EC Treaty, with the substitution of "the United Kingdom" for "the Community". It provides that: "...any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom".¹³⁹
- 3.61 Alleged violations of the Chapter II prohibition by a clearing house would be investigated in the first instance by the OFT.

¹³⁶ Section 32 Competition Act.

¹³⁷ Additionally, the restrictions (and sometimes the agreement itself) may be unenforceable, and third parties may bring an action for damages or, in appropriate cases, an injunction in the civil courts

¹³⁸ Section 2(2) Competition Act.

¹³⁹ Section 18(1) Competition Act.

- 3.62 If, after conducting an investigation, the OFT concludes that an agreement infringes the Chapter II prohibition, the undertaking(s) may be ordered to cease or modify the abuse. The undertaking(s) may also be fined up to 10% of its relevant turnover where the undertaking intentionally or negligently infringes the prohibition.¹⁴⁰
- 3.63 The Chapter II prohibition sets out a non-exhaustive list of specific conduct which may constitute an abuse, which is the same as that contained in Article 82 of the EC Treaty:¹⁴¹
- (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions (for example, excessively high or low pricing practices);
 - (b) limiting production, markets or technical development to the prejudice of consumers (for example, output restrictions, or refusals to deal);
 - (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage (for example, discriminatory pricing practices, or the imposition of other contract terms which favour certain customers over others);
 - (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of the contract (for example, tying obligations, where a supplier agrees to supply particular products or services only if the purchaser agrees to buy other unrelated products or services from the supplier);
 - (e) refusals to supply, including refusal to allow access to essential facilities or the provision of such access on discriminatory terms; and
 - (f) tying.

European Competition Regulation

- 3.64 Essentially identical rules as those set out in Chapter 1 and Chapter 2 of the Competition Act, but with different jurisdictional scope, apply at a European level.¹⁴² If an agreement “may affect trade between Member States and have as its object or effect the prevention, restriction or distortion of competition within the common market”, a matter falling within Chapter 1 would be subject to the jurisdiction of the European Commission.¹⁴³ Similarly, an abuse of a dominant position “within the common market or in a substantial part of it” is subject to European Commission jurisdiction.¹⁴⁴ The competence of the European Commission over a particular matter does not prevent or restrict the OFT from also considering a matter at a national level.

¹⁴⁰ Section 36 Competition Act. Additionally, third parties may bring an action for damages or, in appropriate cases, an injunction in the civil courts.

¹⁴¹ Section 18 Competition Act.

¹⁴² Title VI Treaty of Rome.

¹⁴³ Article 81 Treaty of Rome.

¹⁴⁴ Article 82 Treaty of Rome.

SCHEDULE

1. DESCRIPTION OF THE CLEARING HOUSE

- 1.1 The Clearing House is a newly formed subsidiary of the ICE Group, and was incorporated in England and Wales on 19 April 2007 as a private limited company under the Companies Act 1985 (as amended) with registered number 06219884. The Clearing House's registered office is at International House, 1 St. Katharine's Way, London E1W 1UY. The Clearing House's operations will be provided from its registered address.
- 1.2 The Clearing House was formed to provide clearing services to certain markets within the ICE Group. At launch, the markets it will clear are the markets operated by ICE Futures Europe (a UK RIE) and ICE Inc. (a US ECM).
- 1.3 Details relating to the ICE Group and its markets and clearing services can be found at www.theice.com.
- 1.4 Launch of the Clearing House's services is anticipated to be in Q3 2008, and, at launch, will not include the offer of clearing services to ICE Futures US or any other US DCM, or any markets other than those mentioned above.

2. STRUCTURE AND CONSTITUTION

- 2.1 The Clearing House is part of the ICE Group, being an indirect subsidiary of a US company, ICE Inc.
- 2.2 ICE Inc. is a NYSE-listed public company and is therefore subject to various US legal and reporting obligations, including: the Sarbanes-Oxley Act; public company reporting obligations; and duties under Delaware corporation law.
- 2.3 The ICE Group runs on a for-profit basis. Companies in its group include three derivatives exchanges (ICE Futures, a UK RIE supervised by the FSA; ICE Futures US, a US DCM supervised by the CFTC and recognized as an ROIE; and the Winnipeg Commodity Exchange, Inc. supervised by the Manitoba Securities Commission), a US Exempt Commercial Market (ICE, Inc.), a US clearing house (ICE Clear US, a US DCO supervised by the CFTC and that has applied for recognition in the UK as a recognised overseas clearing house or ROCH), and the WCE Clearing Corporation.
- 2.4 ICE Inc. is headquartered in Atlanta, Georgia. ICE Futures is headquartered in London, UK. ICE Futures US and ICE Clear US are both headquartered in New York, N.Y.
- 2.5 The Clearing House will be directed by its Board comprising a minimum of six members, being:
 - (a) Non-executive Chairman (Sir Bob Reid).
 - (b) President and Chief Operating Officer (Paul Swann).
 - (c) ICE Inc. representatives (Jeffrey C. Sprecher, ICE, Inc. Chairman; and Scott Hill, ICE, Inc. Chief Financial Officer).
 - (d) A minimum of two independent non-executive directors (to include Lord Fraser of Carmyllie and Christopher Moorhouse).

- 2.6 The Board will have two standing committees: the Risk Committee (which will include user representatives) and the Audit Committee.
- 2.7 The constitution of the Clearing House is set out in its Memorandum and Articles of Association, which, *inter alia*, contain details of:
- (a) the structure and appointment of the Board of Directors; and
 - (b) procedures in relation to general and extraordinary company and Board meetings (including quorum).

3. **MEMBERSHIP**

- 3.1 An applicant to become a Clearing Member of the Clearing House must meet certain membership criteria (detailed in Rule 201(a)) at the time of making its application and thereafter whilst a Clearing Member which include, among other things:
- (a) holding sufficient capital;
 - (b) being party to a Clearing Membership Agreement;
 - (c) holding all necessary regulatory authorizations, licenses, permissions and approvals;
 - (d) it and its directors and officers being fit and proper;
 - (e) having appropriate technical and operational systems and controls;
 - (f) having appropriate business continuity procedures;
 - (g) being able to meet margin requirements;
 - (h) having contributed to the Guaranty Fund as appropriate; and
 - (i) not being subject to an insolvency or other event of default.
- 3.2 An application for clearing membership must be made in writing in the prescribed form.
- 3.3 Prior to a formal application being processed, the Clearing House's Membership Department will liaise with the applicant to ensure that the application form and supporting documentation are complete. Each application shall be considered by the Risk Committee which shall have delegated authority from the Board to approve or reject such application with a right of appeal due to the applicant in the event of a rejection.
- 3.4 Each Clearing Member will be obliged to sign a Clearing Member Agreement with the Clearing House which will include provisions pursuant to which the Clearing House's Rules become contractually binding on both the Clearing Member and Clearing House. In addition, specific obligations to comply with relevant membership criteria and other membership obligations, to meet margin and Guaranty Fund requirements and to post collateral will be included in the agreement. The Clearing Member will also be required to enter into appropriate "give-up" agreements with its customers pursuant to which it becomes party to, and solely liable to the Clearing House in respect of, contracts that it will clear and guarantee on behalf of non-clearing ICE Futures Members and ICE OTC Participants.

4. CLEARING SERVICE (INCLUDING STRUCTURE OF TRANSACTIONS)

Background

- 4.1 At launch, the Clearing House will only provide clearing services to ICE Futures and ICE Inc. and will not provide clearing services to any other market. The clearing services provided for ICE Futures and ICE Inc. are separately set out in Clearing Services Agreements and include, *inter alia*:
- (a) Trade registration and management;
 - (b) Position Management, margin and collateral;
 - (c) Treasury, cash payment/receipt and billing;
 - (d) Risk management;
 - (e) Guaranty Fund; and
 - (f) Contract expiry and deliveries.
- 4.2 The Clearing House will accept transactions on the basis of an open offer mechanism, pursuant to which contracts arise automatically on the occurrence of certain events. Essentially, at the point an open buy order matches with an open sell order, the Clearing House will become the buyer to the seller and the seller to the buyer. For off-screen trades which are registered with the Clearing House for clearing (i.e. Block Trades, Exchange for Physical and Exchange for Swaps for ICE Futures and Block Trades for ICE OTC) a contract will form upon complete details being sent to ICE Futures or ICE Inc. and accepted through their systems. The liabilities and obligations of the Clearing House will extend only to, and be enforceable only by, Clearing Members.
- 4.3 Clearing Members will have rights and obligations set out in the Rules and Clearing Membership Agreement. Every Clearing Member will agree to be bound by the Rules as a result of becoming a Clearing Member. The Clearing House will not have any category of “non-clearing membership”.
- 4.4 Data in relation to matched trades will automatically pass to TRS, the post-trade administration system owned and operated by Atos Euronext Market Solutions (“AEMS”). TRS receives details of transactions in real-time from the ICE Platform and provides functions to Clearing Members and authorized parties to perform the following functions:
- (a) account allocation;
 - (b) splitting between accounts;
 - (c) the allocation of transactions or split transactions between one or more Clearing Member(s) or trading participants of Clearing Members (trade allocation); and
 - (d) the entry of position settlement instructions.
- 4.5 In accordance with the Contract Terms for ICE Futures and ICE OTC contracts, open positions will be settled to market at least daily using prices taken from relevant markets and validated by the Clearing House. The Clearing House may, at its discretion, make further settlements-to-markets whether on a routine or *ad hoc* basis.

- 4.6 The Clearing House will maintain at various banks a cash deposit account and a securities custodian account separately in respect of each Customer Account and Proprietary Account that its Clearing Members hold with the Clearing House and each Guaranty Fund contribution of each Clearing Member. Each Clearing Member is further required to maintain accounts with a financial institution approved by the Clearing House (an “Approved Financial Institution”).
- 4.7 The settlement and delivery requirements arising after contract expiry are detailed in the ICE Futures and ICE OTC Contract specifications and the Clearing House’s delivery procedures. Settlement and delivery will occur as follows for Contracts which remain open at contract expiry:
- (a) cash-settled products will be settled by payment or receipt of the difference between the price at which the position is recorded at the Clearing House and the applicable reference settlement price at ICE Futures or for ICE OTC products in accordance with relevant procedures calculated in accordance with the Rules. Following payment, all contract obligations will be deemed to have been met and contract performance will be final;
 - (b) contracts that result in the physical delivery of a commodity (or title to a commodity), will be settled by the delivery of the commodity or title to that commodity against the payment of an amount being the difference between the price at which the position is recorded at the Clearing House and the reference settlement price.
- 4.8 Clearing Members may provide collateral to the Clearing House as margin and Guaranty Fund contributions. All collateral deposited with the Clearing House will be held at regulated custodian and deposit-taking banks who themselves are regulated in the conduct of such activities by the FSA or other regulators.
- 4.9 Clearing Members are obliged to contribute to a Guaranty Fund which may be used in the event of default. The value of the Guaranty Fund at launch in 2008 is estimated to be in the region of US\$450 million.