SHEARMAN & STERLING LLP

23 July 2009

Memorandum To: ICE Clear Europe Limited **("ICE Clear")**

From: Shearman & Sterling (London) LLP

'Ring-fencing' of US Accounts

1. INTRODUCTION

1.1 ICE Clear is a recognised clearing house ("**RCH**") in the United Kingdom for the purposes of the Financial Services and Markets Act 2000 (the "**FSMA**").[1] It has also been designated by the Financial Services Authority ("**FSA**") as the operator of a designated system for the purposes of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (S.I. 1999/2979) (the "**Settlement Finality Regulations**"), which implement the Settlement Finality Directive[2] in the United Kingdom.[3]

1.2 ICE Clear is submitting an application to the Commodity Futures Trading Commission ("**CFTC**") to be registered as a derivatives clearing organisation ("**DCO**"). This Memorandum is provided to ICE Clear in connection with this application.

1.3 The CFTC has requested that ICE Clear obtain written legal advice as to whether, under currently applicable English law, in the event of the insolvency of either ICE Clear or a clearing member of ICE Clear (as defined in ICE Clear's rules, "**Clearing Member**") to which ICE Clear provides clearing services for a US market (each a "**US Member**"):

(a) the segregation (or 'ring-fencing') of US customer accounts would be effective;

(b) default action could be taken discretely, under ICE Clear's rules (the "**Rules**"), with respect to any account segregated pursuant to section 4d of the Commodity Exchange Act (i.e. an account for positions on a designated contract market and associated property) (a "**4d Account**"), without interference from an insolvency officer (English or European); and

(c) balances in 4d Accounts could be commingled with, or be offset against, balances in any other accounts that ICE Clear maintains.

1.4 This Memorandum has been prepared on the basis of the following assumptions:

---

1 Pursuant to a recognition order of the Financial Services Authority (the "**FSA**") dated 12 May 2008.

2 Council Directive 98/26/EC, (the "**Settlement Finality Directive**").

3 Pursuant to a designation order of the FSA (as the relevant designating authority under the Settlement Finality Regulations) dated 18 December 2008.

(a) that a membership agreement on terms identical to the standard form included as an annex to the DCO application ("**Membership Agreement**") has been executed between ICE Clear and each Clearing Member, and has not been modified or varied, and is legal, valid, binding and enforceable in each instance;

(b) that all Contracts entered into by Clearing Members with ICE Clear are legal, valid, binding and enforceable (and we note that certain transactions may be void or voidable pursuant to Rules 403 and 404);

(c) that all the Clearing Members will act in accordance with the Rules and the relevant Membership Agreements (unless any instance of breach is specifically discussed in this Memorandum);

(d) that Clearing Members and ICE Clear are in compliance with and will at all times comply with the terms of the Membership Agreement, the Rules and the Procedures and, without prejudice to the generality of the foregoing, each Clearing Member will, in compliance with Rule 207(d), establish a Customer Account (as defined in the Rules) as its 4d Account with respect to all transactions and assets that are required to be segregated pursuant to section 4d of the United States Commodity Exchange Act and will, in accordance with Rule 207(d), record correctly and in a timely manner in that Customer Account:

(i) all Contracts (as defined in the Rules) to which that Clearing Member is party as a result of it providing clearing services to its customers (each, a "**Customer Contract**"); and

(ii) all Margin (as defined in the Rules) held by ICE Clear for that Clearing Member's account in respect of that Clearing Member's Customer Contracts ("**Customer Margin**"); and

(e) that any non-cash Customer Margin (other than letters of credit) is provided by Clearing Members in the form of "financial instruments" as defined in the Financial Collateral Arrangements (No 2) Regulations 2003 (S.I. 2003/3226) (the "**Financial Collateral Regulations**").[4]

1.5 This Memorandum relates solely to matters of English law in force at the date of this Memorandum. This Memorandum does not consider the impact of any other laws (including insolvency laws) other than English law, even where, under English law, any foreign law falls to be applied. As discussed in section 12 below, English law will not always apply to the situations discussed in this Memorandum. This Memorandum is itself governed by English law.

[4] All non-cash collateral (other than letters of credit) allowed as Permitted Cover pursuant to ICE Clear's Circular dated August 2008 amount to "financial instruments" for the purposes of this provision: https://www.theice.com/publicdocs/clear_europe/circulars/C08011%20att.%20List%20of%20Permitted%20Cover.pdf

1.6 Where we refer to any European directive or other legal instrument, we assume that the directive or instrument has been implemented in all applicable member states on time and in an identical fashion to the implementation of that directive or instrument in English law.

1.7 All matters of fact stated in this Memorandum are based on information provided by or on behalf of ICE Clear and are assumed to be accurate. Capitalised terms used in this Memorandum shall (if not separately defined herein or if the context does not require otherwise) bear the meanings given to them in the Rules.

1.8 We do not undertake to update this Memorandum in the event of a change in law or practice. This Memorandum is given for the sole benefit of ICE Clear. We accept no responsibility or liability to any person other than ICE Clear as a result of this Memorandum. This Memorandum may not be relied upon by any person other than ICE Clear without our prior written consent. However, a copy of this Memorandum may be shown to the CFTC for information purposes only and a complete copy of this Memorandum may be posted on the CFTC's website in connection with ICE Clear's application to become a DCO. A copy of this Memorandum may also be provided to the FSA.

2. EXECUTIVE SUMMARY

2.1 Rules 102(p) and 905 provide for the "ring-fencing" of assets and liabilities relating to a US Member's Customer Account (including Customer Contracts and Customer Margin) from assets and liabilities relating to a US Member's Proprietary Account. As a consequence of the Settlement Finality Regulations, the Companies Act 1989 and the Financial Collateral Regulations[5], such provisions of the Rules:

(a) will be effective under English law in the event of the insolvency of ICE Clear or a US Member (a "**relevant insolvency**"); and

(b) require default action to be taken discretely under the Rules with respect to any such Customer Account without interference from any English insolvency officer appointed in respect of ICE Clear or a US Member; and

(c) require that the balance on such a Customer Account is not commingled or offset against the balance on any Proprietary Account maintained by ICE Clear.

2.2 Any non-cash Customer Margin provided by a US Member to ICE Clear could be sold by ICE Clear in accordance with the terms of the Clearing Membership Agreement and Rules in the event of that US Member's insolvency. The cash amount derived from this sale is required to be taken into account in determining the net sum payable in relation to the US Member's Customer Account, in accordance with Part 9 of the Rules (and could therefore be used to offset any amounts owing to ICE Clear in respect of that Customer Account but not in respect of any Proprietary Account).

---

[5] The Financial Collateral Regulations implement Directive 2002/47/EC (the "**Financial Collateral Directive**").

2.3 Pursuant to Rule 902(a)(i), following a relevant insolvency affecting the US Member, ICE Clear would be able to effect a transfer or sale of Contracts entered into by a US Member for its Customers from the US Member to a solvent Clearing Member. If the proposed amendments shown in the Annex are made to Rule 902(a), ICE Clear would be able to cause the transfer to a solvent Clearing Member of any Margin transferred by a US Member in respect of Contracts recorded in its Customer Account .

3. RECOGNITION REQUIREMENTS REGULATIONS

3.1 In order to remain an RCH, ICE Clear must comply with the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001[6] (the "**Recognition Requirements Regulations**").

3.2 The Recognition Requirements Regulations previously required that "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".[7] As a result of amendments effected by the Financial Markets and Insolvency Regulations 2009[8] (the "**2009 Regulations**"), this requirement no longer applies. Instead, the Recognition Requirements Regulations now require that "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 other than a client account of the defaulter."[9] This requirement is met by Rule 102(p) of the Rules (set out in paragraph 5.5 below).

3.3 Consequently, clearing houses are now able to apply the net 'house' surplus of a defaulting member to cover a net deficit on that member's 'client' account before the balance is returned to the defaulter. However, it remains prohibited for a surplus on a 'client' account to be used to meet any deficit on a 'house' account.

3.4 The Recognition Requirements Regulations include the following requirements relevant to the ring-fencing of customer assets and the default rules of an RCH:

(a) 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.[10]

---

6 S.I. 2001/995.

7 The previous paragraph 28(1) of the Schedule to the Recognition Requirements Regulations.

8 SI 2009/853

9 The new paragraph 28(1) of the Schedule to the Recognition Requirements Regulations.

10 Paragraph 24(1) of the Schedule to the Recognition Requirements Regulations.

(b) The default 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.[11]

(c) The rules must provide—

(i) for all rights and liabilities of the defaulter[12] 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;

(ii) for the sums so payable by or to the defaulter in respect of different contracts entered into by the defaulter in one capacity for the purposes of section 187 of the Companies Act 1989 to be aggregated or set off so as to produce a net sum;

(iii) for that net sum:

(A) if payable by the defaulter to the clearing house, to be set off against—

(1) any property provided by or on behalf of the defaulter as cover for margin (or the proceeds of realisation of such property);

(2) to the extent (if any) that any sum remains after set off under sub-paragraph (1), any default fund contribution provided by the defaulter remaining after any application of such contribution;

(B) to the extent (if any) that any sum remains after set off under paragraph (A), to be paid from such other funds, including the default

---

11 Paragraph 24(2) of the Schedule to the Recognition Requirements Regulations.

12 Pursuant to paragraph 25(2) of the Schedule to the Recognition Requirements Regulations, 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. 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. Pursuant to the paragraph 25(5)of the Schedule to the Recognition Requirements Regulations, the rights and liabilities of a defaulter under or in respect of an unsettled market contract do not include, where he acts as agent, rights or liabilities of his arising out of the relationship of principal and agent.

fund, or resources as the clearing house may apply under its default rules;

(C) if payable by the clearing house to the defaulter, to be aggregated with—

(1) any property provided by or on behalf of the defaulter as cover for margin (or the proceeds of realisation of such property);

(2) any default fund contribution provided by the defaulter remaining after any application of such contribution; and

(iv) 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.[13]

3.5 The margin cover, default fund contribution, or other funds or resources referred to in paragraph 3.4(c)(iii) against which the net sum is to be set off (or with which it is to be aggregated) are subject to any unsatisfied claims arising out of the default of a defaulter before the default in relation to which the calculation is being made.[14] The rules of the clearing house must also provide that in the event of a default, any default fund contribution provided by the defaulter shall only be used for the purposes and in the manner described in paragraph 3.4(c)(iii)(A) and (B) above.[15]

3.6 ICE Clear's Rules were assessed by the FSA in connection with its recognition as an RCH (and also in connection with its Settlement Finality Designation application) and were found to satisfy all the requirements of the old paragraph 25(1) of the Schedule to the Recognition Requirements Regulations.

4. FSA CLIENT ASSET RULES

4.1 The requirements on clearing houses to ring-fence customer assets from proprietary assets of a Clearing Member on a default do not fall within the scope of the FSA's client asset rules (the "**Client Asset Rules**").[16]

4.2 The Client Asset Rules apply to Clearing Members that are regulated by the FSA, including when they deposit client assets or money with a third party such as ICE Clear.[17] The Client

---

[13] Paragraph 25(1) of the Schedule to the Recognition Requirements Regulations, as amended by the 2009 Regulations.

[14] Paragraph 25(1C) of the Schedule to the Recognition Requirements Regulations, as inserted by the 2009 Regulations.

[15] Paragraph 25(A) of the Schedule to the Recognition Requirements Regulations, as inserted by the 2009 Regulations.

[16] Set out in CASS of the FSA Handbook and made pursuant to sections 138 and 139 of the FSMA.

[17] We have assumed that the "MiFID" part of CASS applies as a result of relevant Clearing Members carrying on "MiFID Business" in relation to their services and activities involving ICE Clear.

Asset Rules are only relevant to Clearing Members regulated by the FSA. However, they are based upon the Markets in Financial Instruments Directive (Directive 2004/39/EC) ("**MiFID**"), so similar rules should apply to Clearing Members that are regulated elsewhere in the EEA.

4.3 The Client Asset Rules apply whenever assets are transferred by a customer to an FSA regulated Clearing Member in circumstances in which the Clearing Member does not obtain full beneficial interest in the assets at the point of deposit with the Clearing Member. Assets or money that are received by the Clearing Member from clients on the basis of "title transfer" collateral from the customer are not covered by the Client Asset Rules.[18]

4.4 A Clearing Member to which the Client Asset Rules apply, that transfers client assets as Margin to ICE Clear, is required, before a client transaction account is first opened with ICE Clear, to: (a) notify ICE Clear that the Clearing Member is under an obligation to keep client assets separate from the Clearing Member's own assets, by placing client assets in a client account; (b) instruct ICE Clear that any assets paid to ICE Clear in respect of client transactions are to be credited to the Clearing Member's client transaction account; and (c) require ICE Clear to acknowledge in writing within twenty business days that the Clearing Member's client transaction account is not to be combined with any other account, nor is any right of set-off to be exercised by ICE Clear against money credited to the Client transaction account in respect of any sum owed to ICE Clear on any other account.[19] A written acknowledgement of the requirement of Clearing Members to segregate client assets must be given by ICE Clear and has indeed been given on these terms to all Clearing Members.[20]

4.5 ICE Clear's acknowledgement, together with the segregation by the Clearing Member of assets held in a Customer Account from those held in the Proprietary Account is, in our view, sufficient to constitute the Clearing Member a trustee of the right to return or repayment of assets held in the Customer Account (enforceable against ICE Clear). Given this trust relationship and ICE Clear's acknowledgement, there will be no mutuality between the right to return or repayment in respect of the Customer Account and any rights ICE Clear may have against the Clearing Member in respect of its Proprietary Account or otherwise not arising from the Customer Account. The absence of mutuality should ensure protection of the Customer Account right of return or repayment from mandatory set-off in the event of ICE Clear's insolvency.

5. RELEVANT PROVISIONS OF THE RULES

5.1 The Rules contain a number of provisions requiring the ring-fencing of a Clearing Member's Customer Account from its Proprietary Account, including in the context of an Event of Default (as defined in the Rules, which includes the occurrence of an insolvency).

---

18 CASS 7.2.3R. FSA Consultation Paper CP 06/14 and FSA Policy Statement PS 07/2.

19 CASS 7.8.2R(1).

20 Clause 5.3 of the Clearing Membership Agreement. In addition, ICE Clear gave such an acknowledgement in a circular to all its Clearing Members immediately prior to launch. See: https://www.theice.com/publicdocs/clear_europe/circulars/C08032%20ICE%20Clear%20Europe_Client%20Assets.pdf.

5.2 The term "Customer Account" is defined as follows: "*an account (if any) with the Clearing House opened in the name of a Clearing Member relating to Contracts to which the Clearing Member is a party as a result of it acting for one or more Customers (whose transactions the Clearing Member requests be recorded in the Customer Account) and in which such Contracts are recorded and to which monies in respect of such Contracts are debited and credited, which may be divided for administrative convenience only into sub-accounts relating to different Customers or groups of Customers or may be designated for Energy Contracts only or for CDS Contracts only*".[21]

5.3 The term "Proprietary Account" is defined as follows: "*an account with the Clearing House, which is not a Customer Account, opened in the name of a Clearing Member in which Contracts made by the Clearing Member are recorded (whether directly or indirectly) and to which monies in respect of such Contracts are credited and debited, which may be divided for administrative convenience only into sub-accounts or may be designated for Energy Contracts only or for CDS Contracts only*".[22]

5.4 Pursuant to Rule 207(d): "*It is the responsibility of the Clearing Member (and not the Clearing House) to ensure that its Nominated Proprietary Accounts and Nominated Customer Accounts are linked appropriately to its Proprietary Accounts and Customer Accounts and to ensure its own compliance with Applicable Laws relating to conduct of business, client money and segregation of client assets.*"

5.5 Rule 102(p) provides that: "*Without prejudice to the requirements of any Applicable Laws relating to clients' money made by the FSA under sections 138 and 139 of the FSMA and notwithstanding any other provision of these Rules, nothing in these Rules shall have the effect of enabling, requiring or implying, that any Margin or other amounts deposited in relation to a Clearing Member's or Defaulter's Customer Account be used to meet a shortfall on that Clearing Member's or Defaulter's Proprietary Account (which restriction, for the avoidance of doubt, shall not apply to any Guaranty Fund Contribution or Assessment Contribution).*"

5.6 Rule 905(a) sets out the process for the calculation of amounts due following the occurrence of an Event of Default. Rule 905(b) provides that:

"*Where the Defaulter has one or more Customer Accounts, the process set out in Rule 905(a) shall, subject to Part 11, be completed separately in respect of:*

(i) the Defaulter's Customer Accounts and Contracts, rights, obligations and liabilities relating to the Defaulter's Customers; and

(ii) the Defaulter's Proprietary Accounts and other Contracts, rights, obligations and liabilities not falling under Rule 905(b)(i).

The Defaulter's Guaranty Fund Contributions, amounts under a Controller Guarantee or amounts payable under a letter of credit, may be used for the purpose of calculating either or

---

21 Rule 101.

22 Rule 101.

both net sums (provided that any such amounts are not double counted) subject to the restrictions in Rule 1103 and to Rule 102(p). The aggregate sums finally payable shall be separately certified under Rule 905(d) ..."

5.7 Rules 102(p) and 905(b) have now been amended to comply with the changes brought about by the 2009 Regulations (as discussed in paragraphs 3.2 and 3.3 above), such that a Proprietary Account surplus may be applied to meet a Customer Account shortfall but not *vice versa*.

5.8 Relevant to Customer Account positions following a default, Rule 902(a)(i) enables the Clearing House to deal with the Contracts of a Defaulter by facilitating such contracts being "*transferred or sold to and accepted by one or more other Clearing Members, with the prior consent of the Clearing House and at a price agreed between the Clearing House and the Clearing Member that is the transferee or purchaser*". We understand that various amendments, shown in the Annex, are proposed to be made to Rule 902(a) in order to enable Customer Account Margin to be transferred to a non-defaulting Clearing Member alongside Customer Account Contracts in such a situation.

6. ENGLISH INSOLVENCY PROCEDURES: AN OVERVIEW

6.1 In this section, we briefly outline the various types of insolvency procedures that could apply to a Clearing Member incorporated or registered in England & Wales. The six main English law proceedings which are potentially relevant are:

(a) *Liquidation*: This involves the appointment of a liquidator by the court or by the creditors of a company who collects in and distributes the company's assets and dissolves the company.[23]

(b) *Administration*: A procedure whereby a company may be rescued or reorganised or its assets realised under the protection of a statutory moratorium on certain creditor enforcement action.[24]

(c) *Administrative receivership*: This procedure is essentially a security enforcement procedure available to certain classes of secured creditor. It has effectively been abolished except for a few limited exceptional circumstances, none of which are likely to be relevant in these circumstances.[25]

(d) *Scheme of arrangement*: A procedure whereby a compromise or other arrangement is reached with the applicable majority within each class of creditors/members, and is then sanctioned by the court.[26]

---

[23] Part IV, Chapters IV and VI of the Insolvency Act 1986.

[24] Schedule B1 to the Insolvency Act 1986.

[25] Sections 72A and 42 to 49 of the Insolvency Act 1986.

[26] Part 26 of the Companies Act 2006.

(e) *Company voluntary arrangement*: Where a company comes to an agreement with the applicable majority within each class of its creditors thereby binding all creditors, including any dissenting minority, and which is implemented and supervised by an insolvency practitioner. This procedure is normally used to avoid or supplement the other types of procedures.[27]

(f) *Bank Insolvency*: The Banking Act 2009 modifies the ordinary liquidation and administration procedures that apply to companies generally. The modified procedures apply to banks, i.e. institutions which are incorporated in, or formed under the law of any part of, the United Kingdom and which have permission under Part 4 of the FSMA to carry on the regulated activity of accepting deposits. The new regime for banks enables the Bank of England (the "**BoE**"), the FSA or the Secretary of State to apply for a "bank insolvency order" if certain conditions are satisfied.[28] A key aim of the procedure is to enable eligible depositors of an insolvent bank to have their accounts transferred to another financial institution or to receive compensation.[29]

(g) *Bank Administration*: Part 3 of the Banking Act 2009 establishes a new bank administration procedure, based largely on the existing administration procedure. The modified procedure is to be used where there has been a transfer of part of a failing bank's business, assets or liabilities to a bridge bank or a private sector purchaser under the Special Resolution Regime (discussed below in section 11), leaving a residual entity. It is designed to ensure that essential services and facilities that cannot be immediately transferred to the bridge bank or private purchaser continue to be provided to such bank or purchaser by the residual bank for a period of time to enable the bridge bank or private purchaser to operate effectively.

6.2 In the context of an insolvency of a Clearing Member, the most likely scenario is a liquidation, administration,[30] bank insolvency, bank administration or subjection to the Special Resolution Regime. These processes are discussed further in the following sections.

6.3 A clearing house's default proceedings in relation to English law insolvency proceedings can be, and typically are, completed expeditiously. The most recent example of a default affecting a UK based derivatives clearing house was the administration of Lehman Brothers International (Europe). LCH.Clearnet Limited issued a default notice on 15 September 2008 in respect of this entity.[31] On 19 September 2008 (four days after the default) LCH.Clearnet announced that "*the vast majority of client requests to transfer futures positions from both segregated and house accounts have now been processed*".[32] On 23 September 2008 (eight

---

27 Part I of the Insolvency Act 1986.

28 Banking Act 2009, Part II.

29 Banking Act 2009, section 99.

30 This is the procedure that Lehman Brothers International (Europe) is currently undergoing.

31 LCH.Clearnet member circular and default notice dated 15 September 2008 entitled " Default Notice - Lehman Brothers International Europe".

32 LCH.Clearnet member circular dated 19 September 2008 entitled: "Lehman default – update Friday 19 September 2008". http://www.lchclearnet.com/member_notices/circulars/2008-09-19.asp.

days after the default), LCH.Clearnet announced that it had successfully managed the default. By that time "*The equity and energy portfolios of Lehman exchange traded derivative positions [had] been sold through a sealed bid process*".[33]

7. ADMINISTRATION

7.1 The primary purpose of an administration is to save a company as a going concern.[34] The secondary objective of an administration is to achieve a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration).[35] The administrator may only move to the secondary objective if he thinks that it is not reasonably practicable to achieve the primary objective or that the secondary objective would achieve a better result for the creditors as a whole.[36] If the administrator does not think that it is reasonably practicable to achieve either the primary or secondary objectives and he does not unnecessarily harm the interests of the creditors as a whole, he may perform his functions with the objective of realising property in order to make a distribution to one or more secured or preferential creditors.[37] As a result, an administration is often a precursor to liquidation (see section 8 below) or other arrangement such as a scheme of arrangement or compromise with creditors. The key effect of administration is that it triggers a statutory moratorium on creditors taking action against the company.[38] This means that, except in certain limited circumstances,[39] no step can be taken to bring legal process against the company, or enforce security over the company's property, without the consent of the administrator or the court.[40]

7.2 Where an administrator gives notice that he proposes to make a distribution to creditors or puts the company into liquidation,[41] mandatory insolvency set-off will apply (in effect, retrospectively).[42] The mandatory insolvency set-off rules may not yield the best outcome for the non-defaulting counterparty (such as a clearing house) due to certain limitations of the regime and may also render any contractual set-off and netting arrangements which are inconsistent with the mandatory insolvency set-off rules unenforceable.

---

33 LCH.Clearnet press release dated 23 September 2008 entitled: "LCH.Clearnet successfully manages Lehman default." http://www.lchclearnet.com/media_centre/press_releases/2008-09-23.asp.

34 Schedule B1, para 3(1)(a) of the Insolvency Act 1986.

35 Schedule B1, para 3(1)(b) of the Insolvency Act 1986.

36 Schedule B1, para 3(3) of the Insolvency Act 1986.

37 Schedule B1, para 3(4) and para 3(1)(c) of the Insolvency Act 1986

38 Schedule B1, para 43(1) to the Insolvency Act 1986.

39 Being where Part VII of the Companies Act 1989 or the Financial Collateral Regulations apply (see below).

40 Schedule B1, paras 43(2) and (6) of the Insolvency Act 1986.

41 Insolvency Rules 1986 r.2.95.

42 Insolvency Rules 1986 r.2.85.

7.3 In addition, the administrator has a number of statutory powers which could impact a creditor's right to recover amounts due. Among other things, the administrator has the power to apply to the court to set aside:

(a) *Transactions at an undervalue*. This applies to transactions where the company received no consideration or consideration that is worth significantly less than the consideration provided by the company. To be capable of being avoided, transactions must have taken place when the company was technically insolvent, i.e. unable to pay its debts as they fell due (or the company became technically insolvent as a result of the transaction). Set aside powers may apply to transactions made up to two years prior to the onset of formal insolvency or administration.[43]

(b) *Preferences*. This applies to transactions with a creditor or guarantor which put that creditor or guarantor in a better position on a liquidation. As above, the company must have been technically insolvent at the time of the transaction (or have become technically insolvent as a result of the transaction) and a two year time limit applies.[44]

(c) *Transactions defrauding creditors*. This applies to transactions entered into at an undervalue for the purpose of putting assets beyond the reach of creditors or which otherwise prejudice the interests of creditors.[45]

7.4 These powers and provisions, to the extent that they are not disapplied by statute for clearing houses, could otherwise potentially be used by an administrator to restrict or prevent ICE Clear from taking steps pursuant to its default rules.

7.5 An administrator's appointment ceases to have effect one year after the date of its commencement.[46] The administrator's term of office may be extended by (a) court order, for a specified period, or (b) consent of the creditors, for a period not exceeding six months.[47] A court order extending the administrator's term of office can be made even if the term has already been extended either by order or consent but not if the term of office has expired.[48]

7.6 An administrator has a duty to perform his function as quickly and efficiently as is reasonably practicable.[49] A creditor or member of a company in administration may apply to the court claiming that an administrator is not performing his functions as quickly or as efficiently as

---

43 Sections 238 and 240 of the Insolvency Act 1986.

44 Sections 239 and 240 of the Insolvency Act 1986.

45 Section 423 of the Insolvency Act 1986.

46 Schedule B1, para 76(1) of the Insolvency Act 1986.

47 Schedule B1, para 76(2) of the Insolvency Act 1986. The term may only be extended once by consent, may not be extended by consent after extension by court order and may not be extended by consent after expiry.

48 Schedule B1, para 77(1) of the Insolvency Act 1986.

49 Schedule B1, para 4 of the Insolvency Act 1986.

reasonably possible.[50] A court has wide powers to deal with such an application including regulating the administrator's exercise of his functions, requiring the administrator to do or not to do a specified thing, requiring a creditors meeting to be held for a specified purpose, providing for the administrator's appointment to cease to have effect and making consequential provision.[51]

7.7 Following the appointment of an administrator, the creditors of a company, at the initial creditor's meeting or in further creditor's meetings, may appoint between three and five creditors to form a creditors committee.[52] The creditors committee is formed to assist the administrator in the discharge of his duties[53] but does not have any specific powers in the conduct of the administration. The creditors committee may require the administrator (a) to attend on the committee at any reasonable time upon due notice; and (b) to provide the committee with information about the exercise of his functions.[54] The creditors committee, if constituted, would provide a degree of oversight which can be used to encourage expeditious resolution of an administration.[55]

7.8 An administrator may apply to the court for an order requiring a person who has any property, papers or records of the company in his possession or control to pay, deliver, convey, surrender or transfer such items to the administrator.[56] The courts have a duty to ensure that cases are dealt with expeditiously and fairly.[57] The courts also have extensive case management powers to use in order to further the overall objective which include fixing timetables or otherwise controlling the progress of cases and giving directions to ensure that the trial of a case proceeds quickly and efficiently.[58] These powers can be used to ensure that the realisation of property for the purposes of an administration is not unduly delayed.

8. LIQUIDATION

8.1 The commencement of liquidation (or winding up) proceedings has a number of effects on the subject company, the most important of which is that, following presentation of a petition for winding up (and provided that an order for winding up is duly made), any disposition of the company's property by anyone other than the liquidator will be void without an order of the

---

50 Schedule B1, para 74(2) of the Insolvency Act 1986.

51 Schedule B1, para 74(3) and (4) of the Insolvency Act 1986.

52 Schedule B1, para 57(1) of the Insolvency Act; Insolvency Rules 1986 r.2.50(1).

53 Insolvency Rules 1986 r.2.52(1).

54 Section 57(3) of the Insolvency Act 1986.

55 Although, to date, English creditor committees have not had the same degree of influence which creditor committees typically have in US bankruptcy proceedings.

56 Section 234 of the Insolvency Act 1986.

57 CPR rule 1.1.

58 CPR rule 1.4.

court.[59] There is no freeze on enforcement of security, but there is a stay on commencing or continuing with proceedings by or against the company after a winding up order has been made without the court's permission.[60]

8.2 The liquidator has the same power to review past transactions as an administrator (described in paragraph 7.3 above), as well as the ability to disclaim 'onerous property'.[61] Onerous property consists of unprofitable contracts and any other property which is unsaleable or not readily saleable, or which may give rise to a liability to pay money or perform another onerous act.[62] The effect of the right of disclaimer is that it determines the rights, interests and liabilities of the company in, or in respect of, the property disclaimed but does not affect the rights of third parties (except to the extent that it is necessary to release the company).

8.3 Mandatory insolvency set-off rules will also apply when a company goes into liquidation.[63] Not unlike mandatory insolvency set-off under an administration, this may not yield the best outcome for the non-defaulting counterparty due to certain limitations of the regime and may also render any contractual set-off arrangements unenforceable to the extent they are inconsistent with mandatory insolvency set-off.[64]

8.4 As in the context of administration, these powers and provisions, to the extent that they are not disapplied by statute for clearing houses, could otherwise potentially be used by a liquidator to restrict or prevent ICE Clear from taking steps pursuant to its default rules.

8.5 There is no statutory time limit for the completion of a liquidation. However, if the winding up takes longer than a year to complete the liquidator must report on the liquidation to the registrar of companies.[65]

8.6 Some of a liquidator's powers are controlled by the court and any contributory or creditor may apply to the court in respect of a liquidator's exercise of such powers.[66] These powers are the powers to pay creditors, to bring legal proceedings, to carry on the business of the company in so far as it may be necessary for its beneficial winding up and powers relating to compromise calls.[67] A court has the power to confirm, reverse or modify any act or decision

---

59 Section 127 of the Insolvency Act 1986.

60 Section 130(2) of the Insolvency Act 1986.

61 Although note that this power does not apply to financial collateral subject to a financial collateral arrangement (see below).

62 See section 178(3) of the Insolvency Act 1986.

63 Insolvency Rules 1986 r.4.90.

64 Insolvency Rules 1986 r.4.90(2).

65 Section 192 of the Insolvency Act 1986.

66 Section 167(3) of the Insolvency Act 1986.

67 Schedule 4, Parts I and II, of the Insolvency Act 1986. The liquidator does not require sanction in order to exercise powers such as the power to realise property or to appoint an agent. The full list and

of a liquidator or make any order it deems just, on the application of a person aggrieved by such act or decision.[68]

8.7 Following the appointment of a liquidator, the liquidator must advertise his appointment by notice which must include an indication of whether the liquidator intends to summon meetings of both creditors and contributories, or of creditors alone, for the purpose of establishing a liquidation committee or if he does not intend to summon any such meeting.[69] A liquidation committee is composed of three to five members.[70]

8.8 If a liquidation committee has been formed,[71] the liquidator is obliged to comply with certain requests of such committee. In particular, the liquidator must:

(a) report on all matters which the committee has indicated are of concern to it in the winding up;[72]

(b) provide the committee with access to his records of the liquidation;[73]

(c) provide an explanation of any matter within the committee's responsibility;[74]

(d) call meetings where this is required by a creditor member or where it has previously been resolved upon by the committee;[75] and

---

details of the liquidator's powers which do not require court sanction are set out in Schedule 4, Part III, of the Insolvency Act 1986.

68 Section 168(5) of the Insolvency Act 1986. The applicant must have an interest or right in law which has been prejudiced by the act or decision of the liquidator: *Re ACLI Metals (London) Limited* (1989) 5 BCC 749. A court will only intervene where it is demonstrated that the liquidator acted in a way in which no reasonable liquidator, properly advised, could have acted: *Re Edennote Limited* [1996] 2 BCLC 389.

69 Section 141 of the Insolvency Act 1986.

70 Insolvency Rules 1986 r.4.152(1). The Insolvency rules 1986 provide conditions that creditors and contributories must meet in order to become members of the liquidation committee – see r.4.152 (2) to (7).

71 Section 141 of the Insolvency Act 1986; Insolvency Rules 1986 r.102(6).

72 Insolvency Rules 1986 r.4.155(1). However a liquidator may refuse if it appears to him that the request is frivolous or unreasonable, too expensive to comply with or there are insufficient assets to enable him to comply – r.155(2).

73 Insolvency Rules 1986 r.4.155(5).

74 Insolvency Rules 1986 r.4.155(5).

75 Insolvency Rules 1986 r.4.156(2).

(e) provide reports on the progress of the winding up to each committee member, where the committee so directs but not more frequently than once every two months or in the absence of such directions, at least once every six months.[76]

8.9 Under the Insolvency Rules 1986, a court is entitled to extend or shorten the time for compliance with anything required or authorised to be done by the Insolvency Rules 1986 by the application of rule 3.1(2)(a) of the Civil Procedure Rules ("**CPR**").[77] The CPR expressly do not apply to insolvency proceedings.[78] However, under the Insolvency Rules 1986, the rules of the CPR and the practice and procedures of the High Court and country courts are expressly applied to insolvency proceedings except in so far as those rules, practices and procedures are inconsistent with the Insolvency Rules 1986.[79]

8.10 The Court case management powers relevant to administrations discussed in paragraph 7.8 would apply equally in relation to an insolvency.

9. BANK INSOLVENCY

9.1 An application for a bank insolvency order may be made by the BoE, the FSA or the Secretary of State on a number of grounds and subject to the satisfaction of certain conditions. The grounds upon which an order is made are[80]:

(a) the bank is unable to pay its debts, or is likely to become unable to pay its debts;

(b) the winding up of the bank would be in the public interest; or

(c) the winding up of the bank would be fair.[81]

9.2 Where the closure of a failing bank is considered to be the most appropriate option, a court may make an insolvency order and appoint a bank liquidator.[82]

9.3 A bank liquidator would have the powers available to other liquidators, discussed in section 8. The objectives of the bank liquidator would be:

---

76 Insolvency Rules 1986 r.4.168. As stated above, English creditor committees do not usually enjoy the same degree of influence which creditor committees typically have in US bankruptcy proceedings.

77 Insolvency Rules 1986 r.12.9(2).

78 CPR rule 2.1(2).

79 Insolvency Rules 1986 r.7.51.

80 Although there are certain other conditions that must be satisfied before an order is made: Section 96 of the Banking Act 2009.

81 Section 96 of the Banking Act 2009.

82 Section 96(4) of the Banking Act 2009.

(a) to work with the Financial Services Compensation Scheme (the "**FSCS**") to ensure that each eligible depositor has its account transferred to another financial institution, or receives compensation under the FSCS as soon as reasonably possible; and

(b) to wind up the affairs of the failing bank so as to achieve the best result for the bank's creditors as a whole.[83]

9.4 Subject to the specific adaptations and modifications made by the Banking Act 2009, the legal effects, timings and powers of relevant insolvency practitioners under a bank insolvency would be essentially the same as apply to an ordinary liquidation (described in section 8).

10. BANK ADMINISTRATION

10.1 A bank administration was two objectives (with the first one taking priority over the second one):

(a) support for a commercial purchaser or bridge bank to which part of the failed bank's business has been transferred; and

(b) normal administration.[84]

10.2 The BoE can apply for a bank administration order in respect of a bank if:

(a) it has made or intends to transfer the business of the bank to a private purchaser or to a bridge bank;

(b) it is satisfied that the residual bank is unable to pay its debts, or is likely to become unable to pay its debts as a result of the transfer which the BoE intends to make.[85]

10.3 Subject to the special objectives that a bank administration must achieve, the special grounds upon which it is ordered and certain other modifications, a bank administration operates as a normal administration would under the Insolvency Act 1986.[86] It should be noted that the bank administrator of the residual bank is required to co-operate with any request of the BoE to enter into an agreement for the residual bank to provide services or facilities to the private sector purchaser or to the bridge bank.[87]

11. BANKING ACT 2009: SPECIAL RESOLUTION REGIME

11.1 The Banking Act 2009 introduces a permanent special resolution regime ("**SRR**") for dealing with banks that get into financial difficulties. HM Treasury, the FSA and the BoE all play a

---

83 Section 99 of the Banking Act 2009.

84 Section 137 of the Banking Act 2009.

85 Section 143 of the Banking Act 2009.

86 Section 136(2)(d) of the Banking Act 2009.

87 Section 138(3) and (4) of the Banking Act 2009.

role. The BoE has the power to transfer a failing bank's business or its shares to a "bridge bank" (i.e., a company wholly owned by the BoE), with a view to restructuring it for onward sale to the private sector. It can also order a direct transfer to a private sector purchaser. The United Kingdom Treasury is in addition given the power to nationalise a failing bank.

11.2 The BoE has the power to make partial transfers, i.e., to transfer only some of the property, rights or liabilities of a failing bank to another entity. This may enable the BoE to transfer healthy assets out of a failing bank and into a bridge bank, potentially causing prejudice to those creditors whose claims are not transferred to the bridge bank but remain with the residual bank. One of the objectives of the special resolution regime is to "protect depositors" and satisfaction of this objective could lead the authorities to prefer the interests of depositors to those of wholesale creditors.

11.3 However, there are safeguards for certain parties and situations where partial property transfers are made. The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 grants protection from partial transfers to, *inter alia*, clearing houses, set-off and netting provisions, title transfer collateral arrangements, and security interests. Thus, the authorities cannot exercise their powers in such a way as would have the effect of modifying, modifying the operation of, or rendering unenforceable, a market contract, the default rules of a recognised clearing house[88], or the rules of a recognised clearing house as to the settlement of market contracts not dealt with under its default rules.[89] Nor can the authorities transfer some, but not all, of the protected rights and liabilities between a particular person and a banking institution under a particular set-off arrangement, netting arrangement or title transfer financial collateral arrangement.[90] A partial property transfer cannot transfer the property or rights against which a liability of a United Kingdom bank is secured unless that liability and the benefit of the security are also transferred, nor can it transfer a secured liability unless the benefit of the security is also transferred.[91]

11.4 It should be noted that under the Banking Act 2009, if a Clearing Member which is a bank is subject to the SRR the authorities have the power to remove or vary the terms of any trust affecting property held by such Member.[92] Although a right to compensation exists under the Act, it is only mandatory for the authorities to compensate persons such as beneficiaries whose rights are interfered with where the authorities have made a partial transfer of a bank's property, rights or liabilities. Although extremely unlikely, it is conceivable that this power could result in any assets held in trust by a Member which is a bank being transferred from

---

88 Including an ROCH.

89 The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009, Article 7.

90 The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009, Article 3.

91 The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009, Article 5.

92 Banking Act 2009, Section 34(7). In relation to a partial property transfer, the authorities may remove or alter the terms of a trust only to the extent necessary or expedient for the purpose of transferring from the banking institution to the transferee (a) the legal or beneficial interest of the banking institution in the property held on trust; and (b) any powers, rights or obligations of the banking institution in respect of the property held on trust: The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009, Article 7A.

that Member to a bridge bank without the beneficial interest of Clients being transferred with the trust property so as to bind the bridge bank and without any compensation being available to the Clients beneficially entitled to the assets. The validity of these powers under the Human Rights Act 1998 has yet to be tested.

11.5 There are no explicit time limits within which the BoE, FSA or HM Treasury are required to exercise their powers under the Banking Act 2009 and few explicit time limits exist for the taking of action under the Banking Act 2009 or subordinate legislation. Where no express time limit is required by legislation, as a matter of law, such bodies would be required to exercise their powers within a reasonable period of time.[93] The BoE, FSA and HM Treasury are each potentially subject to judicial review in relation to the carrying out of their duties under the Banking Act 2009.[94] Judicial review would be potentially available to affected parties such as creditors, *inter alia*, if there has been an actual breach of the Banking Act 2009 by the regulators or if any delay is unreasonable.[95] Remedies potentially available under judicial review include a quashing, prohibition or mandatory order, a declaration, a stay or injunction and damages.[96]

12. CONFLICTS OF LAW ISSUES

12.1 A series of different conflicts of law rules under English law apply to determine the governing law of a Clearing Member's insolvency. It is necessary to distinguish the following classes of Clearing Member:

(a) companies which are incorporated under the Companies Act 1985 or 2006 under the laws of England and Wales and which are authorised and regulated by the FSA under the FSMA ("**English Financial Institutions**");

(b) companies incorporated elsewhere in the EEA which are banks or investment firms authorised and regulated by an EEA regulator other than the FSA as home state regulator and which have no registered branch in the UK ("**EU Financial Institutions**");

---

93 *R v Gloucestershire County Council, ex p P* [1994] ELR 334.

94 For example, see *Griggs (R on the application of) v Financial Services Authority* [2008] EWHC 2587 (Admin); *SRM Global Master Fund LP & Ors, R. (On the Applications of) v The Commissioners of Her Majesty's Treasury* [2009] EWHC 227 (Admin)*; R v Bank of England, ex parte Mellstrom* (1995) CLC 232.

95 *Associated Provincial Picture Houses v Wednesbury Corp* [1948] 1 KB 223; *R (M) v Criminal Injuries Compensation Authority* [2002] EWHC 2646 (Admin) The Times 11th November 2002; *R v Secretary of State for the Home Department, ex p Rofathullah* [1989] QB 219; *Fisher v Minister of Public Safety and Immigration (No.2)* [2000] 1 AC 434; *R v Gloucestershire County Council, ex p P* [1994] ELR 334.

96 Civil Procedure Rules, 54.2 and 3.

(c) English branches[97] of companies incorporated elsewhere in the EEA which branches are registered in England and Wales under the Companies Act 1985 or 2006 and which are banks or investment firms authorised and regulated by an EEA regulator other than the FSA as home state regulator and regulated for the conduct of UK business by the FSA ("**English EU Branches**");

(d) English branches of companies incorporated and regulated in non-EEA jurisdictions such as the United States which branches are registered in England and Wales under the Companies Act 1985 or 2006 and which branches are authorised and regulated as banks or investment firms by the FSA ("**English Non-EU Branches**"); and

(e) Companies incorporated and regulated in non-EEA jurisdictions such as the United States which have no branch registered in England and Wales under the Companies Act 1985 or 2006 ("**Non-EU Financial Institutions**").

12.2 In summary, as a matter of English law:

(a) English Financial Institutions, English EU Branches and EU Financial Institutions that are regulated as 'credit institutions' (with a deposit-taking authorisation from the relevant regulator such as the FSA) or insurers will be subject to insolvency rules and proceedings of their 'home' member state.[98] Regulated banks and insurers are required to have their 'home member' state as their state of registration.[99] For English Financial Institutions, this will usually be England and Wales. For English EU Branches and EU Financial Institutions, this is likely to be elsewhere in Europe.

(b) For English Financial Institutions, entities having English EU Branches and EU Financial Institutions that are not regulated as credit institutions or insurers, insolvency proceedings would take place in their 'centre of main interests'.[100] For English Financial Institutions, this is likely to be England and Wales. For entities having English EU Branches and EU Financial Institutions, this is likely to be

---

97 Where the branch meets the test of being 'a place of business which forms a legally dependent part of a credit institution and which carries out directly all or some of the transactions inherent in the business of credit institutions'. Regulation 2 of the Credit Institutions (Reorganisation and Winding Up) Regulations 2004 (S.I. 2004/1045) (the "**Credit Institutions Regulations**"); Article 4 of the Banking Consolidation Directive (Directive 2006/48/EC); Regulation 2 of the Insurers (Reorganisation and Winding Up) Regulations 2004, as amended (S.I. 2004/353) (the "**Insurers Regulations**").

98 Regulation 3 of the Credit Institutions Regulations; Article 10 of the Credit Institutions Directive (Directive 2001/24/EC); Regulation 4 of the Insurers Regulations; Article 4 of the Insurers Directive (Directive 2001/17/EC).

99 Article 11(2) of the Banking Consolidation Directive (Directive 2006/48/EC); Article 6 of the Taking-up and Pursuit of the Business of Non-Life Insurance Directive (Directive 73/239/EC).

100 Article 3(1) of Council Regulation (EC) No 1346/2000 on insolvency proceedings (the "**European Insolvency Regulation**"). The European Insolvency Regulation is implemented in the UK by the Insolvency Act 1986 (Amendments) Regulations (S.I. 2002/1037) and the Insolvency Act 1986 (Amendments) (No.2) Regulations (S.I. 2002/1240).

elsewhere in Europe. Ancillary insolvency proceedings relating to English EU Branches and EU Financial Institutions could be commenced in the English courts.[101]

(c) For English Non-EU Branches and Non-EU Financial Institutions, the English courts would in principle have jurisdiction in relation to insolvency proceedings but this jurisdiction is rarely exercised, except to deal with assets located in England.[102]

12.3 Insolvency proceedings under the jurisdiction of the English courts would generally be governed by English law, subject to a small number of exceptions.[103] As detailed in section 1, this Memorandum is only relevant to the extent that English law applies.

13. PROTECTIONS FROM INSOLVENCY LAW

13.1 In order to ensure that English insolvency laws do not unduly restrict the extent to which a clearing house is able to take action under its default rules, three separate pieces of legislation provide clearing houses with a series of protections:

(a) Part VII of the Companies Act 1989 (as recently amended), which provides protections for 'market contracts' to which a clearing house is party, certain collateral taken by a clearing house and the default rules and default procedures of a clearing house;

(b) Settlement Finality Directive as implemented in the UK by the Settlement Finality Regulations, which provides protections for payment transfer orders, securities transfer orders, collateral security and the default rules of 'designated systems'; and

(c) Financial Collateral Directive as implemented in the UK by the Financial Collateral Regulations, which provides protections to persons who take certain kinds of financial collateral.

13.2 ICE Clear's "default rules" for the purposes of the Companies Act 1989 and Settlement Finality Regulations would include Parts 9 and 11 of the Rules, as well as Rule 102(p) (as applicable in relation to a default).

---

101 Article 3(2) of the European Insolvency Regulation.

102 Some English insolvency procedures are potentially applicable to overseas companies incorporated in jurisdictions outside the UK. In particular, an English court may exercise jurisdiction to wind-up any such overseas company as an unregistered company under section 221 of the Insolvency Act 1986. In general, this is dependent upon the overseas company having a branch or other place of business in England, assets in England or some other identifiable connection with England. As a result, an English court is unlikely to assert jurisdiction to wind-up a US Member which is an overseas company where it has no presence in England or other connection with England.

103 Regulation 22 of the Credit Institutions Regulations, Article 10 of the Credit Institutions Directive; Article 4(1) of the European Insolvency Regulation.

14. PART VII OF THE COMPANIES ACT 1989

14.1 The Companies Act 1989 applies to "market contracts" and the default rules and default proceedings of recognised clearing houses in respect of such contracts.[104] ICE Clear is a recognised clearing house for these purposes. The term "market contracts" is defined to include:

(a) Contracts entered into by the recognised clearing house, in its capacity as such, with a member of the clearing house or with a recognised investment exchange or with another recognised clearing house for the purpose of enabling the rights and liabilities of that member or investment exchange or other clearing house under a transaction to be settled; and

(b) Contracts entered into by the clearing house with a member of the clearing house or with a recognised investment exchange or with another recognised clearing house for the purpose of providing central counterparty clearing services to that member or investment exchange or other clearing house.[105]

14.2 The definition of "market contract" in Part VII of the Companies Act 1989 was amended pursuant to the 2009 Regulations, which came into force on 15th June 2009. Previously, the definition of "market contract" was confined to "contracts entered into by a recognised clearing house with a member of the clearing house for the purpose of enabling the rights and liabilities of that member under transactions in investments to be settled". As a result, not all Contracts cleared by ICE Clear came within the definition of "market contract". This is because ICE Clear's clearing business embraced certain over-the-counter products that were likely to be characterised as unregulated forwards or spreads and hence as non-investment products.[106] As a result of the 2009 Regulations, which deleted the reference to "investments" in the definition of market contracts, all Contracts arising under Part 4 of the Rules (including Customer Contracts) will be "market contracts" and the protections of the Companies Act 1989 will be available to ICE Clear in respect of its default rules and default proceedings under those rules. It follows that any Customer Contract which is concluded between ICE Clear and a US Member will be a market contract for these purposes.

14.3 The various protections afforded to ICE Clear by the Companies Act 1989 apply in the event of liquidation or administration (including a bank insolvency or a bank administration[107]). The protections include the following:

---

104 Sections 155, 158(1) and 188 of the Companies Act 1989.

105 Section 155(3) of the Companies Act 1989.

106 Under English law, it is possible for a person to enter into a forward or spread contract as principal with a clearing house in a situation in which the relevant contract is not an investment, for example if the contract is entered into for commercial purposes: Annex IC of MiFID, section 7; article 38 of Commission Regulation (EC) 1287/2006; FSA Handbook, Perimeter Guidance, section 13.4 and "MiFID Survival Guide" prepared by MiFID Connect.

107 Article 3 and the Schedule to The Banking Act 2009 (Parts 2 and 3 Consequential Amendments) Order 2009.

(a) None of the following are to be regarded to any extent as invalid on the ground of inconsistency with insolvency law:[108]

(i) market contracts entered into by ICE Clear;

(ii) ICE Clear's default rules; and

(iii) ICE Clear's rules as to the settlement of market contracts not dealt with under its default rules.

(b) Duties are imposed on third parties to give assistance to a recognised clearing house to carry out its default proceedings.[109]

(c) The courts are given the power to make orders against a person who is a party to a market contract with a defaulter to prevent the dissipation of assets by such person where the court is satisfied that such person intends to dissipate or apply his assets so as to prevent the recovery of such sums as may become due upon the completion of the default proceedings.[110]

(d) Insolvency office-holders (such as the liquidator, administrator, bank liquidator, bank administrator or other insolvency practitioner) or the court cannot exercise their powers under the Insolvency Act 1986 in such a way as to prevent or interfere with:

(i) the settlement in accordance with the rules of a recognised clearing house of a market contract not dealt with under its default rules; or

(ii) any action taken under the default rules of a recognised clearing house.[111]

(e) The operation of various insolvency law procedures and restrictions is expressly excluded as regards market contracts and the default rules of a clearing house, including the following:

(i) Powers to disclaim onerous property and to order rescission of contracts and related powers pursuant to sections 178, 186, 315 and 345 of the Insolvency Act 1986 do not apply in relation to market contracts or to contracts effected by a clearing house for the purpose of realising property provided as margin in relation to market contracts or as a default fund contribution.[112] There are some limited exceptions to this protection (discussed in paragraph 16.4 below).

---

108 Section 159(1) of the Companies Act 1989.

109 Section 160 of the Companies Act 1989.

110 Section 161 of the Companies Act 1989. Default proceedings here means proceedings taken by a clearing house pursuant to its default rules: section 188(3).

111 Section 159(2) of the Companies Act 1989.

112 Section 164 of the Companies Act 1989.

(ii) Provisions of the Insolvency Act 1986 enabling the avoidance of property dispositions effected after commencement of insolvency proceedings,[113] or for transactions at an undervalue, preferences or transactions defrauding creditors[114] are disapplied to market contracts, margin provided in relation to such contracts or default fund contributions.

(f) Margin held by ICE Clear in relation to a market contract or any default fund contribution held by ICE Clear can be applied in accordance with the Rules notwithstanding any prior equitable interest or right, or any right or remedy arising from a breach of fiduciary duty, unless ICE Clear had notice of the interest, right or breach of duty at the time the property was provided as margin or as a default fund contribution.[115] Any third party who acquires property from ICE Clear pursuant to this process will take free from any interest, right or remedy. Such property is also immune from any execution or other legal process for the enforcement of a judgment or related actions by unsecured creditors.[116]

14.4 The protections available under the Companies Act 1989 would apply even if the Clearing Member is a foreign entity[117], insolvency proceedings are opened against it in a foreign jurisdiction, and the assistance of the English courts is sought by foreign creditors, courts or insolvency office-holders. Such assistance is available under section 426 of the Insolvency Act 1986 or the Cross-Border Insolvency Regulations 2006[118]. Thus, section 183 of the Companies Act 1989 prevents an English court from recognising or giving effect to:

(a) any order of a court exercising insolvency law jurisdiction in relation to a Clearing Member outside the UK; or

(b) any act of a person appointed in such a jurisdiction to discharge any insolvency law functions;

where the making of the order or the doing of the act would itself be prohibited under the provisions of Part VII of the Companies Act 1989.[119]

---

113 Section 164 of the Companies Act 1989.

114 Section 165 of the Companies Act 1989.

115 Section 177(2) of the Companies Act 1989.

116 Section 180(1) of the Companies Act 1989.

117 Or an entity incorporated in England that is amenable to foreign jurisdiction in insolvency matters (such as by having a branch or assets located in such foreign jurisdiction).

118 SI 2006/1030.

119 Section 183 of the Companies Act 1989 is the equivalent provision to regulation 25 of the Settlement Finality Regulations. Section 183 does not prevent the English court from recognising or giving effect to an overseas court order where it is required to do so under the Civil Jurisdiction and Judgments Act 1982 (the "**1982 Act**") or EU Council Regulation No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (the "**EU Jurisdiction Regulation**"). The EU Jurisdiction Regulation applies to all civil and commercial matters, however,

14.5 Furthermore, the English court must not grant any relief, or modify any relief already granted, or provide any co-operation or coordination, under or by virtue of any of the provisions of the Cross-Border Insolvency Regulations if and to the extent that such relief or modified relief or cooperation or coordination would be prohibited under or by virtue of Part VII of the Companies Act 1989 in the case of a proceeding under English insolvency law.[120]

14.6 The cumulative effect of the provisions discussed above is to enable ICE Clear to deal with the default of a Clearing Member in accordance with ICE Clear's default rules, unrestricted by any English insolvency law provision or process. These protections would extend to ICE Clear facilitating sales and transfers of Customer Contracts to solvent Clearing Members under Rule 902(a)(i), which are "default rules" for such purposes. ICE Clear can, for example, sell or close out Contracts to which a defaulting Clearing Member is party. If the amendments shown in the Annex are made, these protections would also extend to transfers of Margin enabled by the amended Rule 902(a). The final step of default proceedings is to declare a net sum as payable to or from the defaulting Clearing Member.[121] The net sum certified by ICE Clear (following completion of proceedings under its default rules) and (if payable by the Defaulter) is provable in English insolvency proceedings in respect of the Defaulter in the same way as if it was a debt which had become due prior to the onset of insolvency and can also be taken into account for set-off purposes.[122] ICE Clear is therefore able to apply the provisions of its Default Rules in the event of insolvency of a US Member (assuming it is subject to insolvency proceedings in England or assistance is sought from the English courts in respect of foreign insolvency proceedings) without fear of challenge by an English insolvency officer appointed in respect of that US Member or an English court. As a result, the desired "ring-fencing" and discrete default action would also be protected under Part VII of the Companies Act 1989 in the event of the insolvency of any US Member.

14.7 There is a requirement on ICE Clear to report to the FSA on the completion of default proceedings as to the net amount payable to or from a defaulter.[123]

14.8 The Companies Act 1989 also provides protections for "market charges"[124] but these are not relevant to ICE Clear because it receives all its collateral by way of title transfer of cash or non-cash Collateral rather than a charge.

---

certain matters are expressly excluded including bankruptcy. In order for proceedings to be excluded on the basis that they are concerned with bankruptcy they must derive directly from the insolvency or winding up and be closely connected with the insolvency proceedings. An action by a liquidator to recover amounts due to an insolvent company would not be excluded: *Re Hayward* [1997] Ch. 45.

120 Article 1(4) of the Schedule to the Cross-Border Insolvency Regulations 2006.

121 Section 163 of the Companies Act 1989; Rule 905.

122 Section 163 of the Companies Act 1989.

123 Section 162 of the Companies Act 1989.

124 Sections 174 and 175 of the Companies Act 1989.

14.9 By virtue of section 158 of the Companies Act 1989, the provisions of Part VII of the Companies Act 1989 will also apply in the event of the insolvency of ICE Clear, and it is no longer a requirement that the insolvency proceedings in respect of ICE Clear be commenced after ICE Clear has taken action under its default rules in relation to one of its Clearing Members.[125] The Settlement Finality Regulations (discussed in section 15) would also be applicable in such circumstances.

15. SETTLEMENT FINALITY REGULATIONS

15.1 ICE Clear operates a "designated system" for the purposes of the Settlement Finality Regulations. The effect of Part III of the Settlement Finality Regulations is to modify general English insolvency law with respect to, among others:

(a) transfer orders effected through a designated system;

(b) action taken under the rules of a designated system with respect to such orders;

(c) the default rules and default arrangements of a designated system; and

(d) any realisable assets provided under a collateral arrangement for the purpose of securing rights and obligations potentially arising in connection with a designated system (a "**collateral security**").[126]

15.2 Various protections from insolvency laws are afforded to ICE Clear pursuant to the Settlement Finality Regulations:

(a) A transfer order, the default arrangements and settlement rules of a designated system and contracts for the purpose of realising collateral are not invalid by virtue of being inconsistent with insolvency law;[127]

(b) Insolvency office-holders cannot exercise their powers in such a way as to prevent or interfere with the settlement in accordance with the rules of a designated system of a transfer order not dealt with under its default arrangements or any action taken under its default arrangements or any action taken to realise collateral security in connection with participation in a designated system otherwise than pursuant to its default arrangements;[128]

(c) Debts resulting from a transfer order subject to default arrangements may not be proved in an insolvency until completion of the action taken under default arrangements and any exercise of set-off rights;[129]

---

125 Section 158 of the Companies Act 1989, as amended by the 2009 Regulations.

126 Regulations 13 to 26 of the Settlement Finality Regulations.

127 Regulation 14(1) of the Settlement Finality Regulations.

128 Regulation 14(2) of the Settlement Finality Regulations.

129 Regulation 14(4) of the Settlement Finality Regulations.

(d) Claims of a participant in a designated system to collateral security are given priority over both general and preferred creditors and the expenses of the winding-up;[130]

(e) Amounts owed on completion of action under the default rules can be proved in an insolvency;[131]

(f) Powers of an insolvency office-holder to disclaim onerous property, rescind contracts and to undertake similar acts do not apply in relation to a transfer order, contracts for the purposes of realising collateral security or dispositions of property in accordance with the rules of the designated system;[132]

(g) If insolvency proceedings are brought against a person who participates or has participated in a designated system, any question relating to the rights and obligations arising from or in connection with, that participation and falling to be determined by a court in England and Wales must be determined in accordance with the law governing that system.[133] In the case of ICE Clear, as the law governing the system is English law, any questions relating to the rights and obligations regarding a Clearing Member's participation in ICE Clear's system will be determined in accordance with English law;

(h) An English court cannot use any of its powers to recognise or give effect to any order of a court exercising insolvency jurisdiction outside the UK or any act of an insolvency office-holder from an overseas jurisdiction, in so far as the making of the order or the doing of the act would be prohibited in the case of a court in England and Wales or a relevant office-holder by the Regulations;[134] and

(i) An English court must not grant any relief, or modify any relief already granted, or provide any co-operation or coordination, under or by virtue of any of the provisions of the Cross-Border Insolvency Regulations if and to the extent that such relief or modified relief or cooperation or coordination would be prohibited under or by virtue of Part 3 of the Settlement Finality Regulations[135] in the case of a proceeding under English insolvency law.[136]

---

130 Regulation 14(5), (6) and (7) of the Settlement Finality Regulations.

131 Regulation 15 of the Settlement Finality Regulations.

132 Regulations 16 and 17 of the Settlement Finality Regulations.

133 Regulation 24 of the Settlement Finality Regulations.

134 Regulation 25 of the Settlement Finality Regulations. As discussed above, this does not affect the English court from recognising or giving effect to an overseas court order where it is required to do so under the 1982 Act or the EU Jurisdiction Regulation.

135 Most of which are set out in paragraphs 15.2(a) to (h).

136 Article 1(4) of the Schedule to the Cross-Border Insolvency Regulations 2006.

15.3 ICE Clear's default rules, together with default arrangements established by ICE Clear in connection with such rules, would comprise default arrangements for the purposes of the above provisions. We take the view that the Clearing Membership Agreement and Rules establish "collateral security" as long as the Margin provided to ICE Clear is in the form of cash or investments. As a result, the provisions of Part III of the Settlement Finality Regulations would apply to protect such security. If the register, account or centralised deposit system in which legal entitlements to the assets are recorded is located in England and Wales, then English law would apply to determine the rights of ICE Clear to the collateral security.[137]

15.4 Transfer orders may comprise "securities transfer orders" or "payment transfer orders". Both types of transfer order are relevant in the case of ICE Clear's designated system. In this regard, it should be noted that:

(a) A "securities transfer order" is defined in the Settlement Finality Regulations as "an instruction by a participant to transfer title to, or an interest in, securities by means of a book entry on a register or otherwise".[138] Securities are themselves defined in the Settlement Finality Regulations as any instruments referred to in section C of Annex I to MiFID. The relevant definition includes a broad range of options, futures, swaps, forward rate agreements and other derivatives.[139] However, securities transfer orders are of limited relevance to ICE Clear, only arising in the somewhat unusual context of a transfer of positions between Clearing Members. Any securities transfer orders entered into pursuant to Rule 902(a)(i) in order to transfer or sell Customer Contracts to a solvent Clearing Member following an Event of Default would be subject to the

---

137 Regulation 23 of the Settlement Finality Regulations.

138 Regulation 2 of the Settlement Finality Regulations.

139 The following contracts, among others, are included in this definition: "(4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash; (5) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event); (6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF; (7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in [paragraph] 6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls; (8) Derivative instruments for the transfer of credit risk; (9) Financial contracts for differences; (10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls." "MTF" for these purposes means a multilateral trading facility.

Settlement Finality Regulations vis-à-vis the solvent transferee Clearing Member but not as against the transferring Defaulter (see paragraphs 17.2 and 17.3 below). The primacy given to ICE Clear's default rules by the Settlement Finality Regulation and Part VII of the Companies Act 1989 results in the Clearing House being able to transfer or sell Customer Contracts to other (solvent) Clearing Members pursuant to Rule 902(a)(i) without interference in this process by an insolvency practitioner. A securities transfer order would arise, for example, when a Customer of a Clearing Member decides to change to using a different Clearing Member or following a business sale between Clearing Members;

(b) A "payment transfer order" is defined in the Settlement Finality Regulations as "an instruction by a participant to place at the disposal of a recipient an amount of money by means of a book entry on the accounts of a bank or a settlement agent, or an instruction which results in the assumption or discharge of a payment obligation as defined by the rules of a designated system".[140] Part 12 of the Rules specifies various points at which payment transfer orders arise and become irrevocable as a result of payments both between ICE Clear and its Clearing Members and within ICE Clear's banking system. The commercially most important Payment Transfer Orders from the perspective of Clearing Members arise (i) "*at the point that a Contract arises under Rule 401*";[141] and (ii) upon "*ICE Clear sending an instruction [for payment] pursuant to Rule 302*".[142] Payment instructions are issued by ICE Clear regularly on a daily basis[143] and may also be issued intra-day.[144] Accordingly, a Payment Transfer Order arises each time a trade is reported for clearing in respect of the payment required under the trade. Furthermore, a Payment Transfer Order arises at the end of the day when payment instructions are actually issued. The provisions of Part III of the Settlement Finality Regulations (and, in particular, regulation 14) would allow any Payment Transfer Orders which have arisen prior to an insolvency to be dealt with in accordance with the Settlement Finality Regulations; and

(c) The ICE Clear system designated by the FSA includes the standardised formal arrangements, common rules and procedures, as set out in the Rules and the Procedures, and related functionality which involve ICE Clear, Clearing Members and certain banks participating in ICE Clear's 'Assured Payments System' ("**Approved Financial Institutions**") for the effecting of transfer orders between participants.[145] As a result of the definitions of Payment Transfer Orders in the Rules

---

140 Regulation 2 of the Settlement Finality Regulations.

141 Rule 1202(a)(i).

142 Rule 1202(a)(ii).

143 ICE Clear Finance Procedures, paragraph 5.1(h).

144 Rule 503.

145 Rule 1201(d). Pursuant to regulation 2(1) of the Settlement Finality Regulations, the following persons, whether Approved Financial Institutions or Clearing Members, qualify as "participants" in ICE Clear's designated system: (a) the following "institutions": (i) a credit institution; (ii) an investment firm as defined in Article 4.1.1 of MiFID, other than a person to whom Article 2 of MiFID applies; (iii) a public authority or publicly guaranteed undertaking; (iv) any undertaking whose head office is

and ICE Clear's designation, any instruction by a US Member to transfer money to ICE Clear will comprise a payment transfer order for the purposes of the Settlement Finality Regulations which affects both the US Member and the Approved Financial Institution used by it.[146]

15.5 The Default Rules require the ring-fencing of Customer Contracts and Customer Margin recorded in the Customer Account of a US Member, including following the occurrence of an Event of Default.[147] The application of the Default Rules and the default arrangements of ICE Clear are protected on an insolvency as a result of the Settlement Finality Regulations.

15.6 The Settlement Finality Directive applies in all EEA member states and the deadline for its implementation has passed. In the event of insolvency proceedings being opened against a participant in a designated system, the rights and obligations arising from, or in connection with, the participation of that participant shall be determined by the law governing that system.[148] English law (including Part III of the Settlement Finality Regulations) should therefore apply in the event of insolvency proceedings being opened in any EEA member state in respect of ICE Clear or any US Member in order to determine the rights and obligations arising from, or in connection with, its participation in ICE Clear's designated system.[149] It follows that the "ring fencing" and discrete default action described in section 2 of this Memorandum should be upheld, and given effect to, in all EEA member states that have implemented the Settlement Finality Directive.

16. INTERACTION OF PART III OF THE SETTLEMENT FINALITY REGULATIONS AND PART VII OF THE COMPANIES ACT 1989

16.1 The provisions of the Companies Act 1989 will prevail in relation to the treatment of any net sum determined as being owing under the Default Rules.[150] However, the Settlement Finality

---

outside the European Community and whose functions correspond to those of a credit institution or investment firm as defined in (i) and (ii); or (v) any undertaking which is treated by the FSA as an institution under regulation 8 of the Settlement Finality Regulations (pursuant to which the FSA is given powers to treat an institution as a participant on grounds of systemic risk), in either case which participates in a designated system and is responsible for discharging the financial obligations arising from transfer orders which are effected through the system; (b) a body corporate or unincorporated association which carries out any combination of the functions of a central counterparty, a settlement agent or a clearing house, with respect to a system, or (c) an indirect participant which is treated as a participant, or is a member of a class of indirect participants which are treated as participants, in accordance with regulation 9 (pursuant to which the FSA is given powers to treat indirect participants as participants on the grounds of systemic risk). For any Clearing Members not falling within this definition and for Disclosed Principal Members (as defined in the Rules), the protections under Part VII of the Companies Act 1989 (described in section 12 of this Memorandum) and under the Financial Collateral Regulations (described in section 15 of this Memorandum) still apply.

146 Rule 1202.

147 Rules 102(p) and 905(b), described in section 3.

148 Regulation 8 of the Settlement Finality Directive.

149 Regulation 24 of the Settlement Finality Regulations; Article 8 of the Settlement Finality Directive.

150 Regulation 15 of the Settlement Finality Regulations.

Regulations prevail in relation to matters concerning the validity of transfer orders occurring at or around the time of an insolvency and clearing house's notice of the same.[151] In other respects, the protections of Part III of the Settlement Finality Regulations and Part VII of the Companies Act 1989 will apply in parallel with respect to transfer orders which are market contracts.

16.2 As regards the timing of insolvency and transfer orders, the Settlement Finality Regulations provide that various protections do not apply if a transfer order is entered into after any of the following events has occurred in relation to the participant:

(a) a court had made an insolvency law order (e.g. bankruptcy, winding-up or administration) in respect of that participant, or

(b) that participant had passed a creditors' voluntary winding-up resolution, or

(c) a trust deed granted by that participant had become a protected trust deed.[152]

16.3 However, the protections still apply if:

(a) the transfer order is carried out on the same day that the relevant insolvency event occurs, and

(b) ICE Clear did not have notice of that event at the time of settlement of the transfer order (and "notice" will be deemed to exist if ICE Clear failed to make enquiries as to a matter in circumstances in which a reasonable and honest person would have done).

16.4 Separately, the Companies Act 1989 is also restricted, for example in cases of market contracts which arise after an insolvency has occurred or been declared:

(a) The first restriction applies to any "creditor" under a net sum determined under the default arrangements of a clearing house. The term "creditor" does not expressly include or exclude clearing houses. We would interpret this expression as potentially including a clearing house where a net sum is due from a Clearing Member. If the net sum payable to the clearing house arises from a market contract entered into at a time when the clearing house had notice that insolvency proceedings were pending against the defaulter, the value of any profit to the clearing house arising from the sum being so taken into account is recoverable by the insolvency office-holder unless the Court directs otherwise.[153] This provision does not apply to a sum arising from a contract effected under the default rules of a recognised clearing house (such as a contract arising from the transfer of a defaulter's positions pursuant to the default rules).[154]

---

151 Regulation 21 of the Settlement Finality Regulations.

152 Regulation 20 of the Settlement Finality Regulations.

153 Section 163(4) of the Companies Act 1989.

154 Section 163(5) of the Companies Act 1989.

(b) Secondly, where a market contract is entered into by a person who has notice that a winding-up petition etc. has been presented against the other party, the value of any profit to him arising from the contract is recoverable from him by an insolvency office-holder unless the court directs otherwise.[155] This restriction does not apply where the person entering into the contract is a RCH acting in accordance with its rules, or where the contract is effected under the default rules of a clearing house, meaning that this restriction is unlikely to affect the clearing house in straightforward default proceedings.[156]

(c) Finally, where margin in relation to a market contract or a default fund contribution is received by a person who has notice that a winding-up petition etc. has been presented against the other party, the amount or value of the margin or default fund contribution is recoverable from him by an insolvency office-holder unless the court directs otherwise.[157] The applicability of the Settlement Finality Directive to payment transfer orders means that this provision is unlikely ever to be relevant to ICE Clear.

16.5 The above restrictions in the Companies Act 1989 do not apply to "market contracts" which are also "transfer orders" to which the Settlement Finality Regulations apply.[158] In light of the interplay between Part III of the Settlement Finality Regulations and Part VII of the Companies Act 1989, it is necessary to distinguish the following situations:

(a) *Market Contracts that are not Transfer Orders*: These would include most futures and options contracts to which ICE Clear is party as a result of open contract positions with its Clearing Members. The provisions of Part VII of the Companies Act 1989 in relation to timing of insolvency and validity of market contracts would apply.

(b) *Market Contracts that are also Transfer Orders*: These would comprise any collateral contractual obligations that may arise in respect of payment obligations or in connection with unfulfilled position transfer orders. The provisions of the Settlement Finality Regulations in relation to timing of insolvency and validity of the payment and any position transfers would apply.

(c) *Transfer Orders that are not Market Contracts*: It is difficult to envisage circumstances in which such a situation would arise. The provisions of the Settlement Finality Regulations in relation to timing of insolvency and validity of the payment and any position transfers would apply.

---

155 Section 164(4) of the Companies Act 1989.

156 Section 164(5) of the Companies Act 1989.

157 Section 164(4) of the Companies Act 1989.

158 Regulation 21(a) of the Settlement Finality Regulations.

16.6 In all three instances above, the default rules and default arrangements of ICE Clear are otherwise subject to the disapplications of insolvency law set out in both Part VII of the Companies Act 1989 and the Settlement Finality Regulations described above.

17. FINANCIAL COLLATERAL REGULATIONS

17.1 The Financial Collateral Regulations establish a separate set of protections for ICE Clear which run in parallel to those under the Companies Act 1989 and the Settlement Finality Regulations, without any exclusion in cases of overlap. The Financial Collateral Regulations apply to the following "financial collateral arrangements":

(a) a title transfer financial collateral arrangement, which involves the transfer of legal or beneficial ownership in financial collateral; and

(b) a security financial collateral arrangement, which involves the creation of a security interest in financial collateral which is delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker.[159]

17.2 Clause 4 of the Clearing Membership Agreement, which contains provisions governing Margin, states that the posting of Margin will take the form of an outright transfer of cash or, as the case may be, title to securities, to or to the order of ICE Clear.[160] ICE Clear acquires a full, unencumbered ownership right in Margin transferred to it pursuant to Clause 4 and not merely a security interest.[161] The cash and securities contemplated to be transferred to ICE Clear all comprise "financial collateral" for purposes of the Financial Collateral Regulations.[162] Rule 505 and Clause 4.9 of the Clearing Membership Agreement each contain express acknowledgements that the Financial Collateral Regulations apply to Margin posted by Clearing Members. As a result of the various provisions mentioned in this paragraph, a title transfer financial collateral arrangement is established by the provision of Margin to ICE Clear.

17.3 In our view, the Collateral provided by a Clearing Member in accordance with the Rules and the Clearing Membership Agreement, including any Customer Margin, will fall within the scope of a "title transfer financial collateral arrangement". In the event that relevant Collateral does not fall within the scope of a "title transfer financial collateral arrangement",

---

159 Regulation 3 of the Financial Collateral Regulations.

160 Clauses 4.1 and 4.7 of the Clearing Membership Agreement.

161 Clause 4.7 of the Clearing Membership Agreement.

162 Financial collateral for these purposes includes cash and financial instruments. The relevant definition of "financial instruments" is: "shares in companies and other securities equivalent to shares in companies and bonds and other forms of debt instruments if these are negotiable on the capital market, and any other securities which are normally dealt in and which give the right to acquire any such shares, bonds or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment), including units in collective investment undertakings, money market instruments and claims relating to or rights in or in respect of any of the foregoing" (Financial Collateral Directive , article 2(1)(e).

for example if it is an *ad hoc* creating of a security interest to secure some obligation, then the arrangement may be capable of constituting a "security financial collateral arrangement" if ICE Clear (including any of its agents) has "control" or "possession" over the relevant Collateral.

17.4 The Clearing Membership Agreement also allows Margin requirements to be satisfied or reduced by delivery of a letter of credit acceptable to ICE Clear.[163] Such arrangements do not establish a financial collateral arrangement, given that ICE Clear would not have the requisite possession or control over the relevant assets. However, ICE Clear would have a claim on the letter of credit issuer in the event of any default affecting a Clearing Member.

17.5 The principal protections conferred by the Financial Collateral Regulations are as follows:

(a) Various rules on formalities and the registration of security are disapplied to financial collateral arrangements.[164]

(b) Insolvency legislation, in as much as it restricts the enforcement of security under financial collateral arrangements, is disapplied. Thus:

(i) Provisions in the Insolvency Act 1986, which contain restrictions on the enforcement of security interests, confer powers on an administrator to deal with charged property and impose a moratorium on enforcement action by creditors do not apply to any security interest created or otherwise arising under a financial collateral arrangement.[165]

(ii) Various other provisions of the Insolvency Act 1986, including those relating to avoidance of property dispositions, avoidance of share transfers after a winding-up resolution, powers to disclaim onerous property and the avoidance of certain floating charges do not apply to a financial collateral arrangement.[166]

(c) Protection is given to financial collateral arrangements that occur on the day of, but after the making of, a winding-up order or the appointment of an administrator where the collateral-taker was not aware, nor should have been aware, of the making of the order or the appointment.[167]

(d) A close-out netting provision[168] takes effect in accordance with its terms and is not subject to the general insolvency rules on mutual set-off even if the collateral-

---

163 Clause 4 of the Clearing Membership Agreement; ICE Clear Finance Procedures, paragraph 9.

164 Regulations 4 to 7 of the Financial Collateral Regulations.

165 Regulation 8 of the Financial Collateral Regulations.

166 Regulation 10 of the Financial Collateral Regulations.

167 Regulation 13 of the Financial Collateral Regulations.

168 A "close-out netting provision" is defined in the Financial Collateral Regulations as, among other things, "a term of a financial collateral arrangement, or of an arrangement of which a financial

provider or the collateral-taker is subject to winding-up proceedings or reorganisation measures (such as administration) unless, at the time that a party to a financial collateral arrangement entered into such an arrangement or that the relevant financial obligations came into existence:

(i) that party was aware or should have been aware that a winding-up order had been made or an administrator had been appointed in relation to the other party;

(ii) that party had notice that a meeting of creditors had been summoned or that a winding-up petition in respect of the other party was pending;

(iii) that party had notice that an application for an administration order was pending or that any person had given notice of an intention to appoint an administrator; or

(iv) that party had notice that an application for an administration order was pending or that any person had given notice of an intention to appoint an administrator and liquidation of the other party to the financial collateral arrangement was immediately preceded by an administration of that party.[169]

(e) The English court must not grant any relief, or modify any relief already granted, or provide any co-operation or coordination, under or by virtue of any of the provisions of the Cross-Border Insolvency Regulations if and to the extent that such relief or modified relief or cooperation or coordination would be prohibited under or by virtue of Part 3 of the Financial Collateral Regulations in the case of a proceeding under English insolvency law or interfere with or be inconsistent with any rights of a collateral taker under Part 4 of the Financial Collateral Regulations which could be exercised in the case of such a proceeding.[170]

17.6 There are a number of provisions in the Rules which would qualify for treatment as "close-out netting provisions", including:

(a) Rule 903(a)(iii), which enables ICE Clear, upon an Event of Default, to close out the defaulting Clearing Member's Contracts where the Contracts are sale and purchase Contracts of the same Set.

---

collateral arrangement forms part, or any legislative provision under which on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise (a) the obligations of the parties are accelerated to become immediately due and expressed as an obligation to pay an amount representing the original obligation's estimated current value or replacement cost, or are terminated and replaced by an obligation to pay such an amount; or (b) an account is taken of what is due from each party to the other in respect of such obligations and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party". Regulation 3 of the Financial Collateral Regulations.

169 Regulation 12 of the Financial Collateral Regulations.

170 Article 1(4) of the Schedule to the Cross-Border Insolvency Regulations 2006.

(b) Rule 903(a)(vi) which entitles ICE Clear to sell, transfer, value or create any interest in any Permitted Cover, Original Margin or other assets that remain credited to the Clearing Member or are otherwise in ICE Clear's possession, subject to an obligation to account to the Defaulter for the net proceeds of such actions after having deducted ICE Clear's reasonable and properly incurred expenses and costs in doing so.

(c) Rule 905(a) to (c), whereby ICE Clear arrives at a net sum by aggregating or setting off sums payable in respect of Contracts between the Defaulter and any other person.

17.7 Those provisions of the Rules that are close-out netting provisions will be subject to the protections in the Financial Collateral Regulations unless ICE Clear had notice of insolvency proceedings when the relevant financial obligation came into existence. Even if there is such notice and hence no protection available under the Financial Collateral Regulations, ICE Clear may still rely upon the additional protections applicable under the Companies Act 1989 and the Settlement Finality Regulations, neither of which are disapplied in the case of any overlap with the Financial Collateral Regulations.

17.8 The Financial Collateral Directive applies in all EEA member states and the deadline for its implementation has passed. The protections for ICE Clear's use of Customer Collateral on an insolvency under the Financial Collateral Directive should be upheld, and given effect to, in all EEA member states that have implemented the Financial Collateral Directive.

18. NON-CASH CUSTOMER MARGIN

18.1 Clause 4 of the Clearing Membership Agreement, which contains provisions governing Margin, states that the posting of Margin will take the form of an outright transfer of cash or, as the case may be, title to securities, to or to the order of ICE Clear.[171] ICE Clear acquires an ownership right in Margin transferred to it pursuant to Clause 4 and not merely a security interest.[172]

18.2 The Clearing Membership Agreement provides that ICE Clear "shall have the right to deal with any amounts or securities transferred or delivered to it as referred to in this Clause 4 in any manner".[173] More specifically ICE Clear may deal with such securities provided it is able, when it has an obligation to do so, to re-deliver to a Clearing Member securities of the same type, nominal value, description and amount, or the proceeds of any securities that have been redeemed.[174] In addition, ICE Clear has an express power of sale under Rule 903(a) in respect of any Permitted Cover, which includes non-cash Customer Margin. This power of sale is exercisable by ICE Clear without prior consent of the relevant US Member in the event of any default on its part in paying or discharging any of the obligations secured thereunder. Finally, ICE Clear has the benefit of a power of attorney executed by all Clearing Members pursuant to which ICE Clear may "take such action in the [Clearing Member's] name for the

---

171 Clause 4.1 of the Clearing Membership Agreement.

172 Clause 4.7 of the Clearing Membership Agreement.

173 Clause 4.4 of the Clearing Membership Agreement.

174 Clause 4.4 of the Clearing Membership Agreement.

purposes of … discharging any of the rights, obligations or liabilities of the [Clearing Member]".[175]

18.3 As a result of these provisions and the protections of the Financial Collateral Regulations, Part VII of the Companies Act 1989 and Settlement Finality Regulations, ICE Clear would be able to convert any non-cash Margin held by it into cash, including following any default of a Clearing Member. The cash amount derived from any such sale would be included in the "net sum" calculation for the Customer Account of the defaulting US Member and would therefore be applied by ICE Clear (as if it were cash Customer Margin), in accordance with the Default Rules, to offset any amounts owing to ICE Clear in relation to the Customer Account (but not the defaulter's Proprietary Account).

19. EFFECT OF CLEARING FOR OTHER MARKETS

19.1 At present, the only US market for which ICE Clear provides clearing services is the exempt commercial market operated by IntercontinentalExchange, Inc. ("**ICE OTC**"). ICE Clear also provides clearing services for the UK recognised investment exchange, ICE Futures Europe. The ICE OTC market is not a recognised overseas investment exchange ("**ROIE**") or a market in respect of which the Secretary of State has extended the protections of Part VII of the Companies Act 1989 by statutory instrument under section 170 of the Companies Act 1989 ("**Designated Market**" and, together with a ROIE, "**Regulated Market**").

19.2 Were ICE Clear to clear any Regulated Market, the protections available to it under the Financial Collateral Regulations and Settlement Finality Regulations would be identical. The protections available to it under the Companies Act 1989 would also be unaffected. However, there would be an additional layer of default protection applying at the level of the Regulated Market.[176] In practice, the default rules of Regulated Markets typically provide that the default rules of the relevant clearing house will apply. Regulated Markets' default rules may also make provision for dealing with exchange-traded contracts which, at the time of a default, were not yet accepted for clearing. Any such provisions would be subject to the same protections as in the Companies Act 1989 were ICE Clear to clear a Regulated Market. Although the default rules of a Regulated Market could in theory conflict with or alter the

---

175 Clause 5.1 of the Clearing Membership Agreement.

176 The Recognition Requirements Regulations mandate that domestic recognised investment exchanges demonstrate compliance with essentially identical requirements to those applicable to RCHs discussed in section 3 (Paragraph 10 of the Schedule to the Recognition Requirements Regulations). An ROIE would similarly need to show that it (or its clearing house) had default rules that afford equivalent investor protection to the Recognition Requirements Regulations. In the past, the FSA has considered the segregation of client assets on a default to be a key element of investor protection and has sought evidence that the legal regime in which an ROIE is established and the default rules of ROIEs comply with this requirement. The United States rules relating to 4d Accounts have been considered equivalent in relation to past applications. A Designated Market would be unable to avail itself of that status unless it had default rules which allowed it to take action to close out market contracts. HM Treasury would be likely as a policy matter to require the same segregation policy as applicable for RIEs or ROIEs were it ever to consider extending the protections of the Companies Act 1989 to an overseas market that is not a ROIE - given that such a step would have the same legal effect as recognition as a ROIE.

scope of the Rules, no such conflict or alteration would be permitted that would affect materially any of the conclusions stated in section 2 of this Memorandum.

19.3 Were ICE Clear to clear any over the counter market or products, the conclusions stated in section 2 of this Memorandum would also be unaffected.

20. AMENDMENTS TO LEGISLATION

20.1 A new Directive[177] (the "**Amending Directive**") has been adopted by the EU to amend the Settlement Finality Directive and the Financial Collateral Directive. Member states are required to adopt and publish the laws and regulations necessary to comply with the Amending Directive by 30 December 2010 and to apply those measures from 30 June 2011.[178]

20.2 In summary, the key changes introduced by the Amending Directive to the Settlement Finality Directive are:

(a) The term "participant" will now be defined to include the "system operator" in order to put it beyond doubt that the protections afforded by the Settlement Finality Directive also apply in the event of the system operator's insolvency;[179]

(b) The term "transfer order" will now be defined to include an instruction by a participant to place at the disposal of a recipient an amount of money by means of a book entry on the accounts of a central counterparty (whereas it is currently confined to book entries on the accounts of a credit institution, a central bank or a settlement agent);**[180]**

(c) Transfer orders and netting will be legally enforceable and binding on third parties even in the event of participant's insolvency. The currently applicable version of the Settlement Finality Directive extends this protection to transfer orders and netting even in relation to transfer orders that are entered into a system after the moment of opening of insolvency proceedings and which are carried out on the day of the opening of such proceedings. However, this protection is conditional upon the settlement agent, central counterparty or clearing house being able to prove that it was not aware, nor should have been aware, of the opening of such proceedings. This condition will now be amended so that the system operator is only required to prove that it was neither aware, nor should have been aware, of the opening of insolvency proceedings at the time that the relevant transfer order became irrevocable;**[181]** and

---

177 Directive 2009/44/EC.

178 Directive 2009/44/EC, Article 3(1).

179 Directive 2009/44/EC, Article 1(5)(c).

180 Directive 2009/44/EC, Article 1(5)(f).

181 Directive 2009/44/EC, Article 1(6)(a).

(d) Article 9 of the Settlement Finality Directive, which, *inter alia*, insulates the rights of a participant to collateral security provided to it in connection with a system from insolvency proceedings against another participant, will now be amended so that the protection is afforded to the system operator as well and also in the event of insolvency proceedings against any third party which provided the collateral security.[182]

20.3 The key amendment to the Financial Collateral Directive is that the definition of "financial collateral" will now be expanded to cover, for the first time, "credit claims".[183] Credit claims are defined as pecuniary claims arising out of an agreement whereby a credit institution (as defined in the Banking Consolidation Directive[184], including the institutions listed in Article 2 of that Directive) grants credit in the form of a loan.

Shearman & Sterling (London) LLP

182 Directive 2009/44/EC, Article 1(10).

183 Directive 2009/44/EC, Article 2(4)(c).

184 Directive 2006/48/EC.

Annex: Proposed Amendments to Rule 902(a)

Rule 902(a)

Where a Person is subject to an Event of Default, the Clearing House may take such steps pursuant to this Part 9 as appear in the circumstances to be necessary or expedient to discharge all the Defaulter's rights and liabilities under or in respect of Contracts to which it is party, to protect the Clearing House and its non-defaulting Clearing Members and to complete the process described in this Part 9. All Contracts to which a Defaulter is party (which are not voidable and voided by the Clearing House pursuant to Rule 902(a)(ii)) shall be liquidated in the manner set out in Rule 903 below unless and to the extent that:

(i) such Contracts are transferred or sold to and accepted by one or more other Clearing Members **(each, a "Transferee Clearing Member")**, with the prior consent of the Clearing House **in the case of each transfer or sale** at a price agreed between the Clearing House and the **relevant Transferee** Clearing Member ~~**that is the transferee or purchaser**~~;

(ii) the Clearing House determines in its discretion that the protection of the financial integrity of the Clearing House does not require such a liquidation; or

(iii) such liquidation is delayed because of the cessation or curtailment of trading on an Exchange which lists such Contracts.

The Clearing House shall be entitled, at its discretion, to take any of the steps described in Rule 902(a)(i), (ii) or (iii) as part of its default proceedings. If any Contracts recorded in a Defaulter's Customer Account are subject to any transfer or sale pursuant to Rule 902(a)(i):

(A) any Margin recorded in the Defaulter's Customer Account may, at the discretion of the Clearing House, be transferred from the Defaulter's Customer Account to the Transferee Clearing Member's Customer Account;

(B) to the extent that any transfer of Margin takes place in accordance with Rule 902(a)(A), the Defaulter shall have no claim against the Clearing House for return of such Margin and the Clearing House shall be released from any liability or obligation to return such Margin (or any property in substitution thereof) to the Defaulter; and

(C) as between the Transferee Clearing Member and the Clearing House, the Clearing House shall have all rights in relation to any Margin transferred pursuant to Rule 902(a)(A) as if the same were Margin transferred to the Clearing House directly from the Transferee Clearing Member.

Any transfer, sale or acceptance of Contracts pursuant to Rule 902(a)(i) may take place pursuant to a termination of Contracts between the Clearing House and a Defaulter and the entry into of new Contracts with the Transferee Clearing Member, rather than as a transfer or sale, at the discretion of the Clearing House.