

20th July 2011

David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Dear Mr. Stawick,

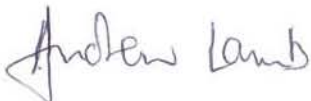
**Re: CME Clearing Europe Limited – Application for Registration as a Derivatives
Clearing Organization Pursuant to Part 39 of the Regulations of the Commission**

On November 26, 2010, CME Clearing Europe Limited (“CMECE”) submitted an Application for Registration as a Derivatives Clearing Organization (the “Application”) pursuant to Section 5b of the Commodity Exchange Act (the “Act”) and Part 39 of the Regulations promulgated under the Act by the Commodity Futures Trading Commission (the “Commission”).

In connection with the Application, CMECE filed Exhibit FF, a memorandum on ring fencing arrangements dated November 24, 2010. After consultation with Commission staff, the memorandum on ring fencing arrangements was revised. CMECE is submitting herewith the revised version of Exhibit FF, dated July 19, 2011 and requests that the previous version be withdrawn.

Should you have any questions regarding this application, please feel free to contact me at +44 20 7796 7170.

Yours sincerely,



Andrew Lamb
Chief Executive Officer

cc: Heidi Rauh, Special Counsel, Division of Clearing & Intermediary Oversight

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memorandum

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To **Andrew Lamb**
CME Clearing Europe Limited

Memorandum on ring fencing arrangements

1 Executive summary

Background

- 1.1 CME Clearing Europe Limited (**CMECE**) is incorporated in England and is a **recognised clearing house** for the purpose of the Financial Services and Markets Act 2000 (**FSMA**).
- 1.2 We understand that:
- (a) CMECE has submitted an application to the Commodity Futures Trading Commission (**CFTC**) for registration as a derivatives clearing organisation (**DCO**) pursuant to Section 5b of the Commodity Exchange Act (**CEA**) and Part 39 of the Regulations adopted under the CEA by the CFTC.
 - (b) the CFTC has requested a reasoned memorandum as to the effectiveness under English law of the arrangements to be put in place by CMECE to ring fence accounts maintained in relation to OTC derivatives contracts cleared by its Cleared OTC Derivatives Clearing Members (as defined below) on behalf of their clients (i.e. sequestered client accounts). Our understanding of this **ring-fencing** requirement is that:
 - (i) CMECE should be able to take discrete default action against each Cleared OTC Derivatives Clearing Member in respect of any sequestered client account; and
 - (ii) the balance on a sequestered client account should not be set-off against the balance on any other account; and

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- (c) CMECE proposes to adopt a new version of its Clearing Rules in substantially the June 1 2011 version and Clearing Procedures in substantially the July 4 2011 version delivered to the CFTC. That new version of the Clearing Rules and Clearing Procedures will have effect from the date on which CMECE is registered, and commences operation, as a DCO (and is referred to in this memorandum as the **Rules**).
- 1.3 Once CMECE is designated as a recognised clearing house and registered as a DCO, the relationship between CMECE and each of its clearing members will be governed by (once they have been adopted) the Rules, a Clearing Membership Agreement entered into by CMECE and the clearing member and individual Contracts entered into pursuant to the Rules (together, the **Clearing Arrangements**¹).

Definitions in this memorandum

- 1.4 Some of the key definitions for the purpose of this memorandum are:
- (a) **Cleared OTC Derivatives Client** means a Client of a Cleared OTC Derivatives Clearing Member in respect of which the Cleared OTC Derivatives Clearing Member has entered into Cleared OTC Derivatives Contracts;
- (b) **Cleared OTC Derivatives Clearing Member** means a Clearing Member which is registered with the Commission as a futures commission merchant under the CEA and qualifies as an eligible contract participant as defined in the CEA, which has entered into Cleared OTC Derivatives Contracts on behalf of a Cleared OTC Derivatives Client;
- (c) **Cleared OTC Derivatives Contracts** means all Contracts in cleared OTC derivatives as that term is defined in Commission Regulation 190.01(o);
- (d) **House Account** means the proprietary account of the Cleared OTC Derivatives Clearing Member;
- (e) **House Contract** means a Contract recorded in the House Account;
- (f) **Other Account** means an Account of a Cleared OTC Derivatives Clearing Member other than its Sequestered Client Account; and
- (g) **Sequestered Client Account** means an account opened for a Cleared OTC Derivatives Clearing Member on the books and records of the Clearing House in accordance with Rule 4.2.1 in respect of all Cleared OTC Derivatives Contracts entered into by the Cleared OTC Derivatives Clearing Member on behalf of its Cleared OTC Derivatives Clients in relation to which money received by the Cleared OTC Derivatives Clearing Member is sequestered in accordance with the CEA and the Commission Regulation.
- 1.5 Other words and expressions defined in the Rules shall have the same meaning when used in this memorandum, unless otherwise defined.

Summary analysis

- 1.6 Most of the risk in terms of ring-fencing arises when a Cleared OTC Derivatives Clearing Member becomes insolvent. The position in respect of an English Cleared OTC Derivatives Clearing Member is summarised in paragraph 1.8 below.

¹ For the purposes of this memorandum, **Clearing Arrangements** includes the amendments referred to in paragraph 2.9.

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- 1.7 There are only limited cases in which English courts would take jurisdiction over non-English insolvent entities. It is only in those limited cases when English legal analysis (and therefore, this memorandum) will be relevant in respect of those non-English entities.
- 1.8 This paragraph applies in respect of an English² Cleared OTC Derivatives Clearing Member or in the cases when the English courts take jurisdiction in respect of the subject matter of this memorandum over a non-English Cleared OTC Derivatives Clearing Member. In those cases, Rule 8.4 is the main Rule which provides for the **ring fencing** of assets and liabilities relating to Sequestered Client Accounts (including Cleared OTC Derivatives Contracts). The main safe-harbour legislation applicable in this analysis is Part VII of the Companies Act 1989 (**Part VII**) and the Financial Collateral Arrangements (No 2) Regulations (the **Collateral Regs**).³ As a result of Part VII and the Collateral Regs, Rule 8.4:
- (a) will be effective under English law in the event of the liquidation or administration of a Cleared OTC Derivatives Clearing Member;
 - (b) requires default action to be taken discretely with respect to any Sequestered Client Account without interference from any English insolvency officer appointed in respect of a Cleared OTC Derivatives Clearing Member; and
 - (c) means that the balance of any Sequestered Client Account will not be set-off against or commingled with the balance on any Other Account.
- 1.9 Any non-cash Collateral provided by a Cleared OTC Derivatives Clearing Member to CMECE could be sold by CMECE in accordance with the terms of the Clearing Membership Agreement and the Rules in the event of the insolvency of that Cleared OTC Derivatives Clearing Member. The cash amount derived from this sale is required to be taken into account in determining the net sum payable in relation to the Sequestered Client Account, in accordance with Rule 8.3. It could therefore be used to offset any amounts owing to CMECE in respect of the Sequestered Client Account(s) of that Cleared OTC Derivatives Clearing Member but not in respect of any Other Account.
- 1.10 The rest of this memorandum discusses the relevant provisions of the Rules which deal with ring-fencing (Section 2) and the types of risks to its effectiveness under English insolvency law (Section 3); and protections under Part VII (Section 4).

2 Ring-fencing - relevant provisions of the Rules

- 2.1 The Rules contain a number of provisions relating to the ring-fencing of the Sequestered Client Account of a Cleared OTC Derivatives Clearing Member from its Other Accounts. This Section summarises the main Rules.
- 2.2 Rule 3.3.3 establishes the framework for dealing with Sequestered Client Accounts:

Where a Clearing Member submits a Transaction to the Clearing House on behalf of a Cleared OTC Derivatives Client:

- (a) *the Clearing Member must be registered with the Commission as a futures commission merchant;*

² To be **English** in this context requires the relevant Cleared OTC Derivatives Clearing Member to have its **centre of main interests** in England. In turn, this means mainly that the entity should be incorporated in England.

³ Please note that CMECE does not benefit from protection under the Settlement Finality Regulations as it is not currently a designated entity for this purpose. However, this does not affect the view in this memorandum.

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- (b) *the Clearing Member must hold Collateral of each Cleared OTC Derivatives Client in a sequestered account in accordance with the CEA and the Commission Regulation; and*
 - (c) *the Clearing Member must obtain a satisfactory sequestered account acknowledgement letter identifying the segregated account as such.*
- 2.3 Rules 5.1.2 and 6.1.2 then require Transactions and related Collateral to be identified properly by a Clearing Member so that Transactions and Collateral for a Cleared OTC Derivatives Client should be designated to the Sequestered Client Account of the relevant Cleared OTC Derivatives Clearing Member:
- (Rule 5.1.2) Each Transaction must be designated as relating to either the Clearing Member's House Account, Non-Segregated Client Account, Segregated Client Account or Sequestered Client Account and any relevant sub-account of the Non-Segregated Client Account or Segregated Client Account.*
- (Rule 6.1.2) The Clearing Member shall designate whether Collateral is deposited in respect of its House Account, Non-Segregated Client Account, Segregated Client Account, Sequestered Client Account and any relevant sub-account of the Non-Segregated Client Account or Segregated Client Account.*
- 2.4 There is a set-off provision in the Rules (Rule 4.3.1) which allows all rights and obligations between CMECE and any Clearing Member to be set-off. This Rule does not distinguish between the Sequestered Client Account and any Other Account of a Cleared OTC Derivatives Clearing Member. However, it is subject to Rule 8.4.3 which provides that:
- Notwithstanding any law, regulation (including, without limitation, the Insolvency Rules 1986) or otherwise:*
- (a) *no Liability of the Clearing House to a Clearing Member shall be set-off against or netted with any Liability of a Clearing Member to the Clearing House except in accordance with these Rules, the relevant Clearing Membership Agreement and as otherwise agreed by the Clearing House and the Clearing Member;*
 - (b) *no Liability of the Clearing House to a Clearing Member under or in connection with a Segregated Client Account (and any related Contract and Collateral) shall be set-off against or netted with any Liability of the Clearing Member to the Clearing House in relation to any other Account; and*
 - (c) *no Liability of the Clearing House to a Clearing Member under or in connection with a Sequestered Client Account (and any related Contract and Collateral) shall be set-off against or netted with any Liability of the Clearing Member to the Clearing House in relation to any other Account.*
- 2.5 This Rule 8.4.3 is one of the key Rules in relation to the ring-fencing of Sequestered Client Accounts. Should a Cleared OTC Derivatives Clearing Member become insolvent, the Part VII safe harbour will apply to this Rule 8.4.3 as it forms part of CMECE's **default rules** for the purpose of Part VII (please see Section 4 for more commentary in this respect).
- 2.6 In addition to Rule 8.4.3, Chapter 8 contains the remainder of CMECE's default rules. After CMECE has served a Declaration of Default (i.e. after the occurrence of an Event of Default) in relation to a Cleared OTC Derivatives Clearing Member, the main process (contained for the most part in Rule 8.3) is that:
- (a) CMECE will seek to discharge the rights and obligations of the Cleared OTC Derivatives Clearing Member (e.g. by closing out or settling the relevant Transaction(s)) and set-off the

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resulting obligations to produce a single net sum due from the Cleared OTC Derivatives Clearing Member to CMECE or vice versa (Rules 8.3.1 and 8.3.2); and

- (b) that net sum will be set-off against or (if it is due from CMECE to the Cleared OTC Derivatives Clearing Member) aggregated with the Collateral of the defaulting Cleared OTC Derivatives Clearing Member and its contribution to the Guarantee Fund (Rule 8.3.3).
- 2.7 Against the background of this general Rule 8.3 process, Rules 8.4.1 and 8.4.2 support the ring-fencing of the Sequestered Client Account. These Rules provide that:
- (Rule 8.4.1) The process set out at Rule 8.3 shall be applied separately in respect of..... (c) Contracts which relate to the Defaulting Clearing Member's Sequestered Client Account and related rights and liabilities.*
- (Rule 8.4.2) To the extent that the Clearing House sets-off an amount pursuant to Rule 8.3.3.... (c) Collateral credited to the Sequestered Client Account of the Defaulting Clearing Member will only be applied against the sum certified pursuant to Rules 8.3.1 and 8.3.4 in respect of Contracts credited to the Defaulting Clearing Member's Sequestered Client Account.*
- 2.8 The over-riding Rule in 8.4.3 (i.e. no set-off between the Sequestered Client Account and Other Accounts) has already been described in paragraph 2.4 above.
- 2.9 We understand that CMECE proposes to make amendments to the Clearing Membership Agreement for Cleared OTC Derivatives Clearing Members substantially in the form set out in the Appendix to this memorandum.

3 English insolvency law

Overview

- 3.1 The main English insolvency statute is the Insolvency Act 1986 and upon the insolvency of a Cleared OTC Derivatives Clearing Member the most common insolvency proceedings are likely to be administration and liquidation. In 2009, England supplemented the insolvency regime to deal more specifically with banks. The primary legislation in this area is the Banking Act 2009 (the Banking Act) which applies to UK banks, UK holding companies of UK banks and certain other financial institutions. It introduces three regimes. The first is a special resolution regime intended for use when failure of a bank is imminent and other government powers are insufficient. The two other regimes - bank liquidation and bank administration - apply after the bank has become insolvent.
- 3.2 As mentioned above, this memorandum applies primarily when a Cleared OTC Derivatives Clearing Member is an English limited company or a bank (two common legal forms for clearing members). On the assumption that Cleared OTC Derivatives Clearing Members are non-English persons, it may be that this portion of the memorandum is less relevant. However, it is included for completeness. Please also note that the Banking Act does not regulate investment banks if they are not deposit-takers, although HM Treasury is currently consulting on a proposed special regime for them.⁴
- 3.3 The rest of this section provides a little more detail on these insolvency regimes.

⁴ *Establishing resolution arrangements for investment banks*, HM Treasury (16 September 2010)

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Liquidation

- 3.4 Liquidation⁵ is an insolvency process leading to the end of the company's existence⁶. An insolvency official, the liquidator, is appointed over the company. Its principal role is to collect in and realise the assets, ascertain claims and distribute the net proceeds to creditors.

Administration

- 3.5 By contrast to liquidation, the object of administration is normally either to rescue the business as a going concern or to achieve a higher recovery for creditors than would be achieved through a liquidation. One of the main, immediate effects of a company going into administration is that there is an automatic moratorium on enforcement of security and commencement of legal proceedings (amongst others) without court or administrator consent. Partially for this reason, it is common for complex businesses like financial institutions to enter administration, rather than go straight into liquidation. By way of example, Lehman Brothers International (Europe) is in an English administration.

Special resolution regime

- 3.6 Part 1 of the Banking Act creates a special resolution regime for dealing with UK banks in financial difficulty. The regime is operated primarily by the Financial Services Authority, the Bank of England and HM Treasury and gives them three broad options in respect of a failing bank:
- (a) to sell all or part of the business of the bank to a private sector purchaser;⁷
 - (b) to transfer all or part of the bank to a bridge bank (i.e. a bank wholly-owned by the Bank of England), normally with the intention of restructuring the bank and then to sell-on to the private sector;⁸ and
 - (c) to nationalise the bank, although only HM Treasury can exercise this power.⁹
- 3.7 The objectives for using this regime are broad, socio-economic measures, rather than strict, legal tests. By way of example, they include the protection and enhancement of the stability of the financial systems of the UK; to protect and enhance public confidence in the stability of the banking system of the UK; and to protect depositors.¹⁰
- 3.8 In operational terms, the Banking Act gives the authorities very strong powers to transfer ownership of failing banks and/or all or part of their assets to themselves or to the private sector. Broadly speaking, the powers operate regardless of any restrictions or limitations (e.g. prohibitions on transfer in underlying contracts). It is also possible to transfer part (as opposed to all) of the shares or assets/liabilities of a failing bank. Whilst this has been one of the most controversial issues to date in relation to the Banking Act, the position has been largely remedied in respect of the rights of clearing houses in these circumstances (please see paragraph 3.23 below).

⁵ A company goes into liquidation if it passes a resolution for voluntary winding up or an order for its winding up is made by the court (Insolvency Act 1986, s247(2)).

⁶ In this memorandum, the terms liquidation and winding-up will be used interchangeably.

⁷ Banking Act 2009, s11

⁸ Banking Act 2009, s12

⁹ Banking Act 2009, s13

¹⁰ Banking Act 2009, s4

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Bank liquidation

- 3.9 Part 2 of the Banking Act establishes a new, bank liquidation procedure which is based largely on the existing corporate liquidation procedure under the Insolvency Act 1986. The main differences to the existing regime are that:
- (a) only the Bank of England, the Financial Services Authority (**FSA**) or HM Treasury may apply for the order to commence bank liquidation;
 - (b) an application by the Bank of England or the FSA must be on the grounds that the bank is unable or likely to become unable to pay its debts and that it would be fair to wind up the bank;
 - (c) an application by HM Treasury must be made on the grounds that the winding up of the bank is in the public interest; and
 - (d) the liquidator must prioritise (this means in terms of process and speed, rather than statutory ranking) the interests of bank depositors - particularly by giving precedence to the transfer of their deposits to another financial institution or arranging compensation for the depositor from the Financial Services Compensation Scheme.

Bank administration

- 3.10 Part 3 of the Banking Act establishes the new, bank administration regime. As with bank liquidation, it is largely based on the existing administration regime under the Insolvency Act 1986. The main features of the bank administration regime are:¹¹
- (a) bank administration is used specifically when part of a bank is sold to a commercial purchaser (please see paragraph 3.6(a) above) or transferred to a bridge bank (please see paragraph 3.6(b) above); and
 - (b) in that case, the bank administrator is able and required to ensure that the remaining part of the bank (the **residual bank**) provides the services or facilities required to enable the commercial purchaser or bridge bank to be operated effectively.

Non English companies

- 3.11 This section summarises the jurisdiction of the English courts to wind-up a foreign company or to put it into administration.
- 3.12 The jurisdiction of the English courts to wind up foreign companies is contained in sections 220 to 228 of the Insolvency Act 1986, which deal with the winding-up of unregistered companies. The expression **unregistered company** includes any association and any company other than companies incorporated under the companies legislation of the United Kingdom.
- 3.13 Section 221(1) provides:
- Subject to the provisions of this Part, any unregistered company may be wound up under [the Insolvency Act 1986]; and all the provisions of this Act about winding up apply to an unregistered company with the exceptions and additions mentioned in the following subsections.*
- 3.14 Whilst this is a rather broad starting point, the power of the English courts to wind up foreign companies is discretionary and the courts tend to exercise this discretion more restrictively than with English companies. The tests for exercising discretion are drawn from case law and have changed

¹¹ Banking Act s136

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over time. However a reasonably good characterisation is found in *Stocznia Gdanska v Latreefers (No 2)*.¹² Morritt LJ, giving the judgment of the court, described the requirements as follows:

- (1) *There must be a sufficient connection with England and Wales which may, but does not necessarily have to, consist of assets within the jurisdiction.*
- (2) *There must be a reasonable possibility, if a winding-up order is made, of benefit to those applying for the winding-up order.*
- (3) *One or more persons interested in the distribution of assets of the company must be persons over whom the court can exercise a jurisdiction.*

3.15 The jurisdiction of the English courts to put foreign companies into administration is narrower than in respect of winding-up. The position was clarified in the Insolvency Act 1986 (Amendment) Regulations 2005 which gives the English courts jurisdiction in cases primarily when the company is incorporated or has its centre of main interests in the European Union.

3.16 It may therefore be that the English courts would not take jurisdiction to wind-up a non-English Cleared OTC Derivatives Clearing Member without assets or a material connection with the United Kingdom; and they are unlikely to put a Cleared OTC Derivatives Clearing Member which is incorporated and managed outside of the EU into administration.

Example risks to ring-fencing

3.17 If the English courts do take jurisdiction, then the effectiveness of the ring-fencing may be challenged by an insolvency official under ordinary insolvency law. Examples of such potential challenges are below.

3.18 **Automatic set-off** - if a company goes into liquidation all sums due from it to each counterparty are set off automatically against all sums due from each counterparty to the insolvent company. This provision cannot be contracted out of or varied. This means for example that debts from the Cleared OTC Derivatives Clearing Member to CMECE under Contracts relating to its House Account would be set-off automatically against debts from CMECE under Cleared OTC Derivatives Contracts so that ring-fencing would not be effective.¹³ This is the position under ordinary English insolvency law and is included by way of illustration of normal insolvency risks without consideration of the protection provided by the Part VII safe-harbour. For that analysis, please see Section 4 below and paragraphs 4.3(b), 4.7, 4.12 and 4.13 in particular.

3.19 **Void dispositions of property** - if the company is subject to a winding up by the court, any disposition of its property made after the commencement of the winding up is, unless the court orders otherwise, void.¹⁴

3.20 **Moratorium** - as mentioned above, if a company is in administration, no security may be enforced and no legal process (including legal proceedings, execution and distress) may be instituted or continued against the company without the consent of the court or the administrator.¹⁵

3.21 **Preferences and transactions at undervalue** - in certain cases, payments or deliveries (e.g. in relation to Cleared OTC Derivatives Contracts) may be set aside if they improve the position of one

¹² [2001] 2 BCLC 116 at 120

¹³ Insolvency Rules 1986 (r4.90). A similar provision exists in the administration regime but the automatic set-off only occurs when the administrator proposes to make a distribution (r2.85).

¹⁴ Insolvency Act 1986, s127

¹⁵ Insolvency Act 1986, Schedule B1, paragraph 43

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creditor ahead of others¹⁶ or if they are made in circumstances in which the Cleared OTC Derivatives Clearing Member receives significantly less than the value of the payment or delivery that it makes.¹⁷

- 3.22 **Failure to register security** - this is an important requirement of English law. In summary, many types of security created by an English company should be registered at UK Companies House within 21 days of creation or they will be void against a liquidator, administrator or creditor of that Company.¹⁸ However, at the date of this memorandum, the form of Clearing Membership Agreement contemplates that CMECE will take Collateral on a so-called title transfer basis which does not require registration.

Banking Act 2009

- 3.23 The Banking Act itself is not a traditional “insolvency risk” under English law. There has however been some concern with the speed of its implementation and it is expected that it will not be widely used unless or until there is a future banking crisis. This suggests that there will be little case law or commentary to guide when the regime is next used. The market has already required modification of certain unclear provisions in the original form of the Banking Act. For example:

- (a) **Bank liquidator and bank administrator** - the Banking Act broadly says that, where ordinary insolvency law (i.e. the Insolvency Act 1986 mainly) refers to **liquidator** and **administrator**, those terms should include **bank liquidator** and **bank administrator**. However, the Banking Act overlooked the fact that over 20 other UK Acts and a further 20+ pieces of secondary legislation also use the term **liquidator** and **administrator**. Most importantly for this memorandum, that list includes the safe harbour under Part VII of the Companies Act 1989. It was therefore not clear that Part VII protection did apply against the actions of bank liquidators or bank administrators appointed over clearing members. This has now been rectified by The Banking Act 2009 (Parts 2 and 3 Consequential Amendments) Order 2009 which confirms that references to liquidator and administrator in the Companies Act 1989, also include references to bank liquidator and bank administrator: and
- (b) **Property and securities transfers** - as mentioned above (please see paragraph 3.6), one of the powers of the UK authorities under the special resolution regime is to sell/transfer the assets of or securities issued by a relevant bank. In this respect, there has been discussion about partial transfers - where the UK authorities transfer some, but not all, of the business of a failing bank to a third party; and whether they could, for example, transfer assets to the third party but leave liabilities (e.g. obligations to CMECE) in the residual bank. There is still some discussion on this topic but the situation has been substantially remedied by The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009. Regulation 7(1) of that Order provides:

A property transfer order to which this Order applies may not transfer property, rights or liabilities or include provision under the continuity powers to the extent that to do so would have the effect of modifying, modifying the operation of or rendering unenforceable -

- (a) *a market contract;*
- (b) *the default rules of a recognised clearing house; or*

¹⁶ Insolvency Act 1986, s239

¹⁷ Insolvency Act 1986, s238

¹⁸ Companies Act 2006, s874. This requirement for registration also applies to non-English companies but only if both the relevant collateral is situated in England at the time of the security and if the company has an establishment registered in England.

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- (b) *the rules of a ... recognised clearing house as to the settlement of market contracts not dealt with under its default rules.*¹⁹

4 Part VII

Summary

- 4.1 Against this background of the normal corporate insolvency law, CMECE is given protection by Part VII, which is comprised of sections 154 to 191 of the Companies Act 1989.
- 4.2 The regime and accompanying secondary legislation²⁰ is designed to safeguard the operation of financial markets. It does this by modifying English insolvency law to protect the actions of recognised clearing houses and recognised investment exchanges in the event that one of their members defaults on the obligations he has entered into in the course of buying or selling financial instruments. The intention of the regime is to “enable [a recognised clearing house] to take action to close out a defaulter’s unsettled market contracts in accordance with [its] default rules.”²¹
- 4.3 Whether or not the Part VII safe-harbour applies to Sequestered Client Accounts and the ring-fencing provisions of Rule 8.4 depends on satisfying a number of requirements. The main ones are whether a Cleared OTC Derivatives Contract qualifies as a **market contract**; and does Rule 8.4 form part of CMECE’s **default rules**? Subject to the further discussion below:
- (a) both of these requirements are satisfied; and
- (b) therefore Rule 8.4 will be effective even in the administration or liquidation of a Cleared OTC Derivatives Clearing Member. This means that Cleared OTC Derivatives Contracts will be closed-out separately from Contracts in relation to Other Accounts; that CMECE could only net proceeds from the close-out of Cleared OTC Derivatives Contracts with those from the close-out of other Cleared OTC Derivatives Contracts and not its Other Accounts; and that CMECE could not apply Collateral credited to the Sequestered Client Account against a shortfall on an Other Account of the Cleared OTC Derivatives Clearing Member.
- 4.4 The remainder of this Section of the memorandum will summarise the key provision (section 159) and the main supporting sections in Part VII.

Section 159

- 4.5 Sub-sections (1) and (2) provide the fundamental insolvency protection under Part VII. They read as follows:²²
- (1) *None of the following shall be regarded as to any extent invalid at law on the ground of inconsistency with the law relating to the distribution of assets of a person on bankruptcy, winding up or sequestration or in the administration of a company or other body or in the administration of an insolvent estate -*
- (a) *a **market contract**;*

¹⁹ The terms **market contract**, **default rules** and **recognised clearing house** are all important and discussed in section 4 of this memorandum.

²⁰ This is mainly the Financial Markets and Insolvency Regulations 1991 and the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (the **Recognition Requirements**)

²¹ Modernising the insolvency protections for the operation of financial markets – proposals to reform Part 7 of the 1989 Companies Act (HM Treasury, July 2008)

²² This extract reflects the current text of Part VII which was updated in 2009 by the Financial Markets and Insolvency Regulations 2009.

- (b) the **default rules** of a ... recognised clearing house;
 - (c) the rules of a recognised clearing house as to the settlement of **market contracts** not dealt with under its **default rules**.
- (2) The powers of a relevant office-holder in his capacity as such, and the powers of the court under the Insolvency Act 1986 shall not be exercised in such a way as to prevent or interfere with -
- (a) the settlement in accordance with the rules of a recognised clearing house of a **market contract** not dealt with under **its default rules**; or
 - (b) any action taken under the **default rules** of such clearing house.

Default rules

- 4.6 Chapter 8 of the Rules constitutes the **default rules** of CMECE for Part VII purposes. This is because they are the:

*rules of a recognised investment exchange or recognised clearing house which provide for the taking of action in the event of a person (including another recognised investment exchange or investment house) appearing to be unable, or likely to become unable, to meet his obligations in respect of one or more **market contracts** connected with the exchange or clearing house*²³

- 4.7 The ring-fencing provisions in Rule 8.4 (i.e. that close-out; netting of positions; and application of Collateral should be undertaken separately in respect of Sequestered Client Accounts) should receive section 159 protection as they form part of CMECE's default rules. As can be seen from the text of s159(2) in paragraph 4.5, this means that a court or an insolvency officer may not exercise its powers to challenge that separate close-out; netting; and application of Collateral.²⁴

Market contracts

- 4.8 In order to obtain Part VII protection, it is also important that a Cleared OTC Derivatives Contract qualifies as a **market contract**. It is the existence and settlement of a market contract that is given direct protection in sub-sections 159(1)(a) and (c) and (2)(a) above. And a market contract is the basis of the defined term **default rules** as used in sub-sections 159(1)(b) and (c) and (2)(b).
- 4.9 **Market contract** is defined in s155(3) of the Companies Act 1989 and was broadened in 2009 following consultation by HM Treasury²⁵ on potential inconsistencies between the previous definition and secondary legislation. The current definition is:

- (3) *In relation to a recognised clearing house this Part applies to -*
- (a) *contracts entered into by the clearing house, in its capacity as such, with a member of the clearing house for the purpose of enabling the rights and liabilities of that member under a **transaction** to be settled; and*
 - (b) *contracts entered into by the clearing house with a member of the clearing house for the purpose of providing central counterparty clearing services to that member...*

²³ Companies Act 1989, s188

²⁴ Whilst section 159 gives broad protection, it is possible for an insolvency official or court to afterwards challenge a step taken. However, broadly speaking, such a challenge will not be successful if the step is taken under the default rules of CMECE.

²⁵ Please see footnote 21

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- 4.10 The word **transaction** is not defined in Part VII but it is clear that this is meant to be a broad term.²⁶ Whilst we are not advising on the individual contracts, our view is that the following classes of contract between CMECE and a Cleared OTC Derivatives Clearing Member and cleared by CMECE will qualify as market contracts - OTC energy, agricultural, freight and metals derivatives. In this respect, it does not matter how the original order is placed or contract with CMECE is created.

Supplemental provisions

- 4.11 In addition to section 159, Part VII provides a number of specific protections and some of the central ones are summarised below. However, the over-riding rule (i.e. that insolvency officers and the courts may not exercise their powers under English insolvency law to prevent or interfere with any action taken under CMECE's default rules) is contained in section 159. The remainder of Part VII should not be construed to limit the generality of section 159.²⁷

No set-off

- 4.12 As mentioned in paragraph 3.18 above, the normal position would be that CMECE could claim against an insolvent Cleared OTC Derivatives Clearing Member for a debt under a market contract (e.g. in respect of a house position) but that such a debt would be set-off automatically against debts outstanding the other way from CMECE to the Cleared OTC Derivatives Clearing Member (e.g. in respect of a Cleared OTC Derivatives Contract). This is a risk to effective ring-fencing.
- 4.13 However, section 159(4) of Part VII provides that, until the completion of CMECE's default proceedings²⁸ in relation to the Cleared OTC Derivatives Clearing Member:
- (a) a debt or other liability arising out of a market contract may not be proved²⁹ in the winding up, bankruptcy or administration of the Cleared OTC Derivatives Clearing Member; and
 - (b) such a debt shall not be taken into account for the purpose of any set-off until the completion of the default-proceedings.

Therefore a liability under a Contract which relates to a Cleared OTC Derivative Clearing Member's Other Accounts should not be set-off (other than in accordance with the Clearing Arrangements) until the completion of default proceedings relating to the Cleared OTC Derivatives Clearing Member.

Transaction avoidance

- 4.14 The ability of the courts or an insolvency official to set-aside transactions on the grounds of preference or undervalue³⁰ (amongst others) are also limited by Part VII. For example, by virtue of section 165, no order shall be made under the provisions relating to preferences or transactions at undervalue in

²⁶ The previous version of s155(3) was narrower than the current language, focusing on the settlement of **transactions in investments**. **Investments** itself is however a broad term in this context Schedule 2 of FSMA provides a list of investments. These include futures ("rights under a contract for the sale of a commodity or property of any other description under which delivery is to be made at a future date") and options ("options to acquire or dispose of property"). The overriding definition of investment is also very broad, including "any asset, right or interest" (FSMA 2000, 22(4)). However, as the 2008 consultation acknowledged, there was some question in the market as to whether Part VII protections did not therefore apply to **non-investments**. Whilst HM Treasury intends for the FSA to determine periodically what non-investments might be, the intention is that **transaction** is intended to be a broad concept, beyond the existing definition of investments.

²⁷ Companies Act 1989, s159(3)

²⁸ In this memorandum, **default proceedings** means the proceedings undertaken by CMECE under its default rules, rather than proceedings of a court, insolvency official or other person. Our use of the term default proceedings also matches the meaning in Part VII itself.

²⁹ Under English insolvency law a creditor must notify the insolvency official appointed over the debtor company in order to be recognised in the insolvency and to gain related rights (e.g. in the end, to receive payment of a dividend in respect of its debt). This notice is known as a **proof of debt** and a creditor who submits the notice **proves** in the relevant insolvency proceeding.

³⁰ Please see paragraph 3.21.

relation to a market contract, a disposition of property in pursuance of such market contract, the provision of margin in relation to a market contract, any contract effected by the clearing house in question to realise property provided as margin or any disposition of such property in accordance with the rules of the clearing house.

Payment of net sum on completion of default proceedings

- 4.15 On completion of the default proceedings in relation to a Sequestered Client Account, CMECE should pay the net sum to the insolvency official of the relevant Cleared OTC Derivative Clearing Member. If the Cleared OTC Derivatives Clearing Member is in an English insolvency process (either in addition or alternatively to foreign bankruptcy/insolvency proceedings), then it is most likely that English law will require CMECE to pay the net sum to the English insolvency official. The proposed trust and related provisions contained in the Appendix to this memorandum make it clear that, even in that case, the net sum on the Sequestered Client Account should be applied in accordance with Section 766 of the US Bankruptcy Code. This trust and other provisions of the Appendix are intended to form part of the Clearing Membership Agreement which is governed by English law. Therefore, the trust is also proposed to be governed by English law.

5 Non-cash Collateral

- 5.1 Clause 4 of the Clearing Membership Agreement, which contains provisions governing the Eligible Cash and Eligible Securities which form the Collateral, states that the deposit of Collateral 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 CMECE³¹. CMECE acquires an ownership right in the Collateral transferred to it pursuant to clause 4 and not merely a security interest. The Clearing Membership Agreement also provides that CMECE “shall have the right to deal with any Eligible Cash and Eligible Securities in any manner”.
- 5.2 As a result of these provisions and protection from Part VII and the Collateral Regs, CMECE would be able to sell any non-cash Collateral credited to a Sequestered Client Account for cash, including after making a Declaration of Default (i.e. following an Event of Default) in respect of a Cleared OTC Derivatives Clearing Member. After close-out of its Cleared OTC Derivatives Contracts, the cash from sale of such non-cash Collateral would be applied by CMECE in accordance with Rule 8.3.3 against any net amount owing to CMECE in relation to the Sequestered Client Account but not in relation to the Other Accounts of the Cleared OTC Derivatives Clearing Member.

6 Assumptions

- 6.1 This memorandum has been based on the following assumptions:
- (a) The Clearing Arrangements will be entered into in substantially the versions referred to in paragraph 1.2(c)(including the amendments in the Appendix) or will only be amended from those versions in such a way that does not materially affect the operation of the Rules referred to in this memorandum in relation to any Sequestered Client Account, related Collateral, Cleared OTC Derivatives Clearing Member, Cleared OTC Derivatives Client or Cleared OTC Contract;
 - (b) the Clearing Arrangements will create legal, valid, binding and enforceable obligations; and the parties will comply with their terms;

³¹ Clause 4.1.Clearing Membership Agreement.

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- (c) no Cleared OTC Derivatives Clearing Member is insolvent (or in any insolvency proceeding) at the time that it enters into the Clearing Membership Agreement with CMECE or becomes insolvent as a result of entering into the Clearing Membership Agreement;³²
 - (d) CMECE will open a Sequestered Client Account in relation to each Cleared OTC Derivatives Clearing Member and will record in that account all Cleared OTC Derivatives Contracts and all related Collateral;
 - (e) each Cleared OTC Derivatives Clearing Member will:
 - (i) establish a Sequestered Client Account with respect to all transactions and assets required to be segregated pursuant to the CEA and CFTC requirements;
 - (ii) advise CMECE correctly of all contracts and collateral which are to be recorded in relation to the Sequestered Client Account; and
 - (iii) segregate the net sum as contemplated in the provisions contained in the Appendix;
 - (f) any non-cash Collateral is in the form of **financial instruments**³³ or physical gold; and
 - (g) CMECE is a recognised clearing house.
- 6.2 This memorandum is also based on the assumption that Collateral relating to a Sequestered Client Account is not subject to the FSA client money or asset rules. Because such Collateral is provided under a title transfer mechanism, our view is that it is not subject to the FSA client money or asset rules.

7 Scope and interpretation

- 7.1 This memorandum and any non-contractual obligations connected with it are governed by English law and are subject to the exclusive jurisdiction of the English courts.
- 7.2 This memorandum is given only in relation to English law as it is understood at the date of this opinion. We have no duty to keep you informed of subsequent developments which might affect this opinion. There is almost no case law in relation to Part VII.
- 7.3 If a question arises in relation to a cross-border transaction or any agreement or arrangement not governed by English law, it may not be the English courts which decide that question and English law may not be used to settle it.
- 7.4 We express no opinion on, and have taken no account of, the laws of any jurisdiction other than England and Wales.
- 7.5 We express no opinion on matters of fact.
- 7.6 The contents of this memorandum are not to be extended by implication. In particular, we express no opinion on the accuracy of the assumptions contained in paragraph 6.1.

³² The assumption relates only to insolvency occurring as a result of the original establishment of the relationship between the Cleared OTC Derivatives Clearing Member and CMECE. It does not relate, for example, to a Cleared OTC Derivatives Clearing Member that becomes insolvent "as a result of" a Contract that it enters into months or years later.

³³ This is a broad concept which is defined in the Financial Collateral Arrangements (No 2) Regulations 2003 as "(a) shares in companies and other securities equivalent to shares in companies; (b) bonds and other forms of instruments giving rise to or acknowledging indebtedness if these are tradeable on the capital market; and (c) any other securities which are normally dealt in and which give the right to acquire any such shares, bonds, instruments or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment)" (Regulation 3)

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- 7.7 This memorandum is given solely for the benefit of CMECE. It may not be relied on by any other person. It may not be disclosed to any other person apart from the CFTC and the FSA on the basis that those persons will make no further disclosure except that the CFTC may post a complete copy of this memorandum on its website in connection with the application referred to in paragraph 1.2(a). A person, who accesses the memorandum in this way, agrees that it does not rely on the memorandum and will take its own professional advice in connection with the matters contained herein.



Norton Rose LLP

**APPENDIX - PROPOSED AMENDMENTS TO THE CLEARING MEMBERSHIP AGREEMENT
FOR OTC DERIVATIVES CLEARING MEMBERS**

1 Definitions and interpretation

Bankruptcy Code means title 11 of the United States Code

Customer Property has the meaning given to customer property in 11 U.S.C. §761(10) in the Bankruptcy Code and Regulation 190.01 of the Rules of the Commodity Futures Trading Commission

Customer Trust Account means an account in the name of the Clearing Member maintained solely for the purpose of receiving the Net Sum

Net Sum means, in relation to the Clearing Member's Sequestered Client Account, the net sum certified by the Clearing House upon completion of the proceedings under the Default Rules in relation to such Sequestered Client Account

Trust Assets means:

- (a) the Net Sum;
- (b) the Customer Trust Account and any credit balance; and
- (c) any rights (present, future, contingent or otherwise) relating to paragraphs (a) and (b) of this definition,

but excludes any other rights and assets in relation to the Clearing Member's Sequestered Client Account, related Collateral and Cleared OTC Derivatives Contracts

4 Trust and other provisions in relation to Net Sum

4.1 The Clearing Member:

- (a) shall hold the Net Sum in the Customer Trust Account at all times; and
- (b) shall not create or permit to subsist any Encumbrance over or otherwise deal with any Trust Asset,

except as permitted pursuant to this clause 4.

4.2 The Clearing Member declares that it holds the Trust Assets on trust for its Cleared OTC Derivatives Clients as tenants in common on the terms of this clause 4.

4.3 The Trust Assets shall be treated for all purposes as Customer Property in accordance with §766(h), (i) and (j) of the Bankruptcy Code and 17 CFR Part 190 of the Rules of the Commodity Futures Trading Commission. The rights and obligations of the Clearing Member and each Cleared OTC Derivatives Client in relation to the Trust Assets shall be construed accordingly.

4.4 The only obligation of the Clearing House in relation to the Trust Assets is to transfer the Net Sum to the Clearing Member in accordance with the Rules. The Clearing House shall have no obligation to transfer any Trust Assets to or to the order of (or otherwise deal with any Trust Assets in accordance with the instructions of) any Cleared OTC Derivatives Client.

4.5 The perpetuity period for the trust created under this clause 4 is 125 years.