REPORT TO THE SUPERVISORS OF THE MAJOR OTC DERIVATIVES DEALERS ON THE PROPOSALS OF CENTRALIZED CDS CLEARING SOLUTIONS FOR THE SEGREGATION AND PORTABILITY OF CUSTOMER CDS POSITIONS AND RELATED MARGIN

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This Report to the Supervisors of the Major OTC Derivatives Dealers[1] (the "Report") has been prepared by an ad hoc group comprising both buy-side and sell-side constituents ("we" or the "Group").[2] The Group was formed in the middle of May 2009 to explore the rights of "customers"—e.g., buy-side and other market participants proposing to clear CDS through clearing members ("CMs") of a central CDS counterparty ("CCP")[3]—in regard to the

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[1] Such supervisors consist of the Board of Governors of the Federal Reserve System, Connecticut State Banking Department, Federal Deposit Insurance Corporation, Federal Reserve Bank of New York, Federal Reserve Bank of Richmond, French Secrétariat Général de la Commission Bancaire, German Federal Financial Supervisory Authority, Japan Financial Services Agency, New York State Banking Department, Office of the Comptroller of the Currency, Securities and Exchange Commission, Swiss Financial Market Supervisory Authority and United Kingdom Financial Services Authority.

[2] The Group was formed at the behest of the Federal Reserve Bank of New York, and consists of buy-side members AllianceBernstein, Barclays Global Investors, BlueMountain Capital Management LLC, Brevan Howard, D. E. Shaw Group, Goldman Sachs Asset Management, King Street Capital Management, L.P. and PIMCO, and sell-side members Barclays Capital, Citigroup, Credit Suisse, Deutsche Bank, The Goldman Sachs Group, Inc., J.P. Morgan, Morgan Stanley and UBS. The International Swaps and Derivatives Association (ISDA), the Asset Managers Group of SIFMA, and Managed Funds Association (collectively, the "Trade Associations") are facilitating and observing the Group's activities. Cleary Gottlieb Steen & Hamilton LLP acted as legal counsel to the Group and Lenz & Staehelin advised on Swiss law matters. For questions or further information about this Report, please contact the Trade Associations. See Appendix C for a list of attorneys that worked on this Report.

This Report is part of ongoing industry efforts to enable customer access to CDS clearing solutions, an initiative described in the letter delivered to the Federal Reserve Bank of New York on June 2, 2009 from certain sell-side and buy-side institutions:

> It is our goal to achieve buy-side access to CDS clearing (through either direct CCP membership or customer clearing) with customer initial margin segregation and portability of customer transactions no later than December 15, 2009. The legal and regulatory analysis to achieve buy-side access will be completed and delivered to supervisors by June 30, 2009. A joint buy- and sell-side group coordinated through IBOC initiated the analysis. If through the analysis we confirm or determine that regulatory and/or legislative changes are required to accomplish buy-side access to CDS clearing with customer initial margin segregation and portability of customer transactions, we will seek assistance from supervisors. In connection with the foregoing, strategic commercial review will be performed by individual institutions which will consider, among other things, tax, legal, regulatory, risk management, interoperability among existing CCPs, implementation, and ongoing operational costs, capital, margining and compliance implications. Subject to the strategic commercial review, dealers who provide customer clearing services in the ordinary course of their businesses, agree to provide clearing services through CCPs that have (i) broad buy-side and dealer support and (ii) a commitment to develop viable direct and indirect buy-side clearing models. In addition, the market needs to accomplish several work streams including the roll out of Restructuring Credit Event Protocol (small bang) and of single name and index clearing for the U.S./Europe and build out of operational infrastructures industry-wide.

[3] This Report does not discuss "self-clearing" market participants—i.e., buy-side and other participants in the CDS market that themselves become CMs in one or more of the CCPs. Participants which satisfy a CCP's requirements for CMs and choose to become self-clearing will not have the issues discussed in this Report,

segregation and portability of CDS positions and associated initial margin ("margin"). To this end, we solicited responses from CME Clearing and ICE Trust U.S. LLC (collectively, the "U.S. CCPs") and Eurex Clearing AG, ICE Clear Europe, LCH.Clearnet Limited/NYSE Liffe and LCH.Clearnet SA (collectively, the "European CCPs") on various matters relating to the protection of customer positions and related margin in the event of a CM default.[4] Copies of our final questionnaire and each CCP's final response are included in Appendix A to this Report.

Even though this Report is detailed as to matters within its limited scope—customer protection of margin (and issues relating to segregation, portability and the sharing of any shortfalls)—it is not an exhaustive analysis of all potential legal issues.[5] In addition, there are a host of business, operational and other legal considerations relevant to the determination of which clearing structure is optimal for any particular CM or customer. Our Report deals with only one facet of that analysis. Expressly excluded from the scope of this Report are, among other matters, issues relating to: (i) the governance structure of the CCPs, (ii) the calculation of required margin amounts, (iii) variation margin (or mark-to-market margin), (iv) the creditworthiness of the CCPs and the adequacy of margin and other funding arrangements, (v) the creditworthiness of the CMs and other matters affecting the likelihood, rather than the consequences, of a CM default, (vi) restrictions on setoff of cleared positions against non-cleared positions[6] and (vii) the consequences of expanding or restricting the range of permitted CM and customer entity types and jurisdictions. Other examples of matters excluded from the scope of this Report are analyses of (a) the consequences of the CCP's insolvency or the

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although they may be subject to a different set of exposures to the CCP and the other CMs (e.g., provisions for mutualization of losses among CMs, guarantee fund contributions and contingent assessment powers by the CCP). In addition, we assume that customers will not opt out of any segregation and portability protections offered by the CCPs through agreement with the CM.

4 The Group circulated the first draft of its questionnaire to the CCPs in late May 2009. The CCPs were given one week to provide initial responses to the questionnaire. In early June 2009, the Group conducted in-person meetings with each of the various CCPs (except for LCH.Clearnet SA). Subsequent to the initial meetings, the Group circulated a revised draft of its questionnaire to the CCPs, which were again provided with a period of one week to provide revised responses. The Group conducted a second round of in-person meetings or conference calls with each of the various CCPs (and its first meeting with LCH.Clearnet SA) in mid-June 2009. On June 24, 2009, a draft of this Report was submitted for review and comment to regulators, as well as each of the CCPs (with information pertaining to the other CCP solutions redacted in the drafts circulated to the CCPs). After taking into account the comments of the regulators and CCPs, the Group submitted this Report on June 30, 2009.

The Group has not generally conducted any independent factual investigations into the matters discussed in this Report (other than through the questionnaire and the discussions described above), and has generally relied upon the accuracy of the materials and information provided to it by the various CCPs.

5 Individual CCPs, CMs and customers should also consult with counsel on the matters discussed herein. No person or entity should rely upon this Report as definitive legal advice.

6 While beneficial from a customer protection perspective, we note that restrictions imposed by CCPs on the ability of affiliates of a CM to obtain liens in or rights of setoff against margin securing cleared CDS positions may preclude the netting of cleared trades against non-cleared trades, for purposes of determining margin requirements and close-out amounts.

insolvency of a third-party custodian at which the margin is held,[7] and (b) the rights of the CCP and CM against customers in the event of a customer's insolvency.[8] This Report does not address the risk of fraud, and assumes that the relevant CM has complied with its segregation and other obligations in respect of customer margin.

Many of the issues discussed below would only arise in a "worst-case" scenario of a liquidation of the CM and no transfer of customer positions and related margin to a successor. There is reason to believe that the failure of a CM might result in an orderly transfer of customer positions and related margin to another financial institution. For instance, the failure of any U.S. bank insured by the Federal Deposit Insurance Corporation ("FDIC") or U.S. futures commission merchant ("FCM") might well result in an orderly transfer of CDS positions (and related margin) to another financial institution or FCM.[9] However, recent historical experience (e.g., the administration of Lehman Brothers International (Europe) ("LBIE")) suggests the need to understand in greater detail the consequences of a "worst-case" scenario on customer rights to positions and related margin at a failed intermediary.

We do not principally focus on timing issues in this Report—e.g., when customers will be able to recover their margin. Although we note certain instances in which timing concerns may be particularly relevant, our primary focus is on whether customers will be able to recover their margin. Timing issues are critical to the analysis of any CCP's customer protection framework. However, we do not focus on them in this Report because of their inherently complex and unpredictable nature. If margin is held at or through an insolvent CM, the insolvency representative[10] of the CM may not release the margin until all custodial claims have been processed and the entitlements of various claimants have been fully resolved. Even if margin is held away from the insolvent CM, absent a contractual relationship directly between customers of the CM and the CCP or third-party custodian (as applicable), the CCP or third-party custodian would almost certainly return the margin to the CM's insolvency representative, rather than directly to the customers.[11] Especially in a worst-case scenario, it is

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7 Generally, a similar inquiry into how margin is posted and held (such as that which follows below with respect to CMs) would be relevant to the analysis of the insolvency of the CCP or a third-party custodian.

8 We note that some of these matters are discussed by certain CCPs in their responses to our questionnaire.

9 To our knowledge, in every case in which a large U.S. bank has become the subject of an FDIC receivership proceeding, all qualified financial contracts (e.g., CDS positions) and associated margin of the failed bank were transferred in their entirety to a single bridge bank or third-party acquiror. Customers would therefore continue to deal with the acquiror, with little or no systemic disruption. And with respect to FCMs, recent history suggests that bulk transfers of customer positions and margin from a failing FCM are likely to occur. For example, in the case of Lehman Brothers Inc. (an FCM), customers were able to transfer their positions and associated margin to other FCMs, even after the parent company (Lehman Brothers Holdings Inc.) had filed for bankruptcy. Customer accounts and associated margin remaining when Lehman Brothers Inc. entered liquidation were transferred in bulk to Barclays Capital Inc. (also an FCM). The transfers were generally conducted in an expedited fashion without any material issues.

10 We refer in this Report to liquidators, administrators, trustees, receivers, conservators, debtors-in-possession and the like as "insolvency representatives".

11 In the case of LBIE, margin securing futures and options traded on non-U.S. exchanges was promptly released by the exchanges to LBIE's administrators. As of the date of this Report, such margin generally has not

not possible to have a customer protection regime that ensures prompt return of customer margin while also providing for the holding of such margin in omnibus customer accounts (as is the case for all but one of the CCPs discussed in this Report). Certain regimes, such as those applicable to U.S. FDIC-insured banks and U.S. FCMs, provide mechanisms that, although they do not ensure prompt return, promote such a result.

This Report is organized as follows: We first set forth a brief "executive summary" of the Group's analysis of the U.S. CCPs and the European CCPs. In the executive summary, we summarize our views of each CCP's proposal and highlight particular issues that may need to be resolved. (The summary is subject in its entirety to the more detailed analysis that follows it.) Next, we discuss legislative and regulatory proposals that may help to enhance the customer protection regime for CDS clearing customers. We then set out a general framework for the analysis of customer protection issues, with a particular focus on issues relating to the segregation and portability of positions and related margin. With that framework in place, we consider the specifics of each CCP's response, summarizing the CCP's proposals and highlighting what we perceive to be some of the advantages and disadvantages, as well as any unresolved legal, regulatory and operational issues, surrounding each CCP's customer protection framework, in each case to the extent within the scope of this Report.[12]

As will become apparent, no proposal is perfect in its current form, especially given the imperfect or unclear state of relevant law, but in many respects, the proposals represent significant improvements over the current OTC CDS market in protecting customer margin and enhancing portability. Even with changes in law, the creditworthiness of CMs will be a critical consideration under any customer protection framework. There is no substitute for diligence on the part of customers in carefully choosing a CM with which to do business.

We are grateful to the CCPs for their cooperation, and encourage the CCPs to continue working with existing and potential CMs and customers in this endeavor.

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been released by LBIE's administrators. The administrators have stated that this delay has arisen due to the complexities of the case, and in particular, because margin was commingled with client funds associated with other activities of LBIE (such as stock lending and OTC trading) and also because a large number of LBIE clients consented to having their money held outside of segregation. As LBIE's administrators are required to treat all creditors equally and to avoid returning any assets until they have ascertained each claimant's exact position, they have yet to release such margin.

[12] We note that in the analysis of each CCP, we do not cross-refer to the analysis of any other CCP. Although that results in a fair amount of repetition of the analysis for those that read the entire Report, it allows readers to focus on individual CCPs.

I. Executive Summary and Recommendations for Legislative and Regulatory Reform

The analysis of customer rights in a CM insolvency largely depends upon the law applicable to the defaulting CM, which in turn varies by the entity type and jurisdiction of the CM. This Report analyzes CMs that are U.S. banks, U.S. FCMs, U.S. federal and New York branches of non-U.S. banks, U.S. unregulated entities, English FSA-regulated entities, French financial institutions,[13] German financial institutions[14] and Swiss financial institutions,[15] and English branches of French, German and Swiss banks.[16]

A. Executive Summary—U.S. CCPs

1. CME Clearing ("CME")

The CME's clearing framework requires that customer CDS positions be cleared through FCMs. Dealers generally do not currently conduct their CDS business through FCMs. An analysis of the advantages or disadvantages of this requirement is beyond the scope of this Report (other than to the extent relevant to the legal analysis contained herein).

We believe that the CME's proposals for the segregation of CDS customer positions and related margin are generally quite strong, from the perspective of customers' legal rights to ultimately recover their margin, although questions may arise as to the range of custodial claimants with whom customers would be required to share in any shortfalls in a worst-case scenario. The portability analysis is also generally quite strong (although portability will ultimately depend upon the existence of a willing transferee).

In spite of the foregoing, there are some uncertainties surrounding the insolvency treatment of a defaulted FCM's CDS clearing customers. The primary issue revolves around whether CDS cleared through a derivatives clearing organization ("DCO") registered under the

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13 In referring to "French financial institutions", we mean French regulated financial institutions (i.e., licensed credit institutions, including banks, and investment firms licensed to provide investment services, including broker dealers) incorporated in France.

14 In referring to "German financial institutions", we mean German entities engaging in the business of banking and being licensed in Germany as a "credit institution" (*Kreditinsitut*) within the meaning of Section 1(1) of the German Banking Act (*Kreditwesengesetz*) and German entities engaging in the business of financial services (*Finanzdienstleistungen*) and being licensed in Germany as a "financial services institution" (*Finanzdienstleistungsinstitut*) within the meaning of Section 1(1a) of the German Banking Act. Throughout this Report, we use the terms "German credit institutions" and "German banks" interchangeably.

15 In referring to "Swiss financial institutions", we mean banks incorporated and licensed in Switzerland and Swiss branches of foreign banks licensed in Switzerland.

16 Although this Report focuses on these entities, if entities with different organizational types or from different jurisdictions will serve as CMs, additional analysis will be needed in respect of such entities. CMs and customers should focus on any risks that may arise to them from a CCP accepting additional types of CMs from additional jurisdictions.

U.S. Commodity Exchange Act ("CEA"), such as the CME, constitute "commodity contracts" within the meaning of the U.S. Bankruptcy Code ("Bankruptcy Code"), as the Commodity Futures Trading Commission ("CFTC") has stated in a recent interpretive statement. Although reasonable arguments exist that CDS should be viewed as "commodity contracts" for purposes of the Bankruptcy Code, the risk of a contrary conclusion is not insignificant. Any challenge to the proposition that CDS constitute "commodity contracts" (whether from commodity futures and options customers of the FCM or others) may significantly delay the return of margin to customers.

In the event (i) a court does not view the CDS as "commodity contracts" within the meaning of the Bankruptcy Code or (ii) the Bankruptcy Code framework for commodity broker liquidation is otherwise inapplicable (e.g., because the FCM is liquidated under a federal equity receivership),[17] the rights of CDS customers to recover margin would be unclear, relative to other customers of the FCM and to unsecured creditors of the FCM's estate. These uncertainties would be exacerbated if the FCM being liquidated were a joint broker-dealer/FCM ("BD/FCM"), given the lack of clarity over how shortfalls in customer property would be apportioned as between CDS customers and other customers of a joint BD/FCM. The robustness of the segregation and portability analysis would, in our view, be significantly enhanced if the legislative amendment that the CME suggested (at our request)[18] were enacted. These proposals are briefly described below, and are set forth in greater detail in Annex A.

Finally, in the event customer positions and margin are not transferred,[19] even if customer margin is adequately segregated, a potential challenge for a customer of an insolvent CM is the practical difficulty of obtaining the timely return to it of assets to which it is entitled as a matter of law, but which (as a matter of practice) may not be released to the customer in a timely manner. These concerns would be largely resolved if customer margin could be returned directly to a defaulting CM's customers and not to its insolvency representative, or if a legal regime could be instituted that would provide for a mechanism for the prompt return of customer margin (even if held in omnibus accounts). The CME's omnibus structure of holding

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[17] Bankruptcy Code proceedings may be commenced in respect of an insolvent FCM either by (i) voluntary petition of the FCM, or (ii) involuntary petition by three creditors of the FCM with qualifying claims. See 11 U.S.C. § 303. Because the CFTC does not have the plenary authority to initiate Bankruptcy Code proceedings in respect of an FCM, if the FCM has not initiated voluntary proceedings and the requisite number of qualifying creditors have not filed a Bankruptcy Code petition in respect of the FCM, it is possible that the FCM may be liquidated by means of a federal equity receivership. In such a circumstance, the Bankruptcy Code would not be directly applicable.

[18] Although the CME expressed a high degree of confidence that its segregation and portability framework for customers is, under existing U.S. law, generally sufficient to protect customer positions and related margin, it provided suggested legislative amendments at our request.

[19] As noted above, in the case of Lehman Brothers Inc. (an FCM), customers were able to transfer their positions and associated margin to other FCMs, even after the parent company (Lehman Brothers Holdings Inc.) had filed for bankruptcy. Customer accounts and associated margin remaining when Lehman Brothers Inc. entered liquidation were transferred in bulk to Barclays Capital Inc. (also an FCM). The transfers were generally conducted in an expedited fashion without any material issues.

customer margin significantly complicates efforts in this regard.[20] In addition, consideration would have to be given to how customer liabilities to the CM are satisfied prior to the return of margin to the customer.

These and other matters relating to the CME's proposed clearing framework are discussed in greater detail in Part III.A.1. below.

2. ICE Trust U.S. LLC ("ICE Trust")

ICE Trust's clearing framework does not require that customer CDS positions be cleared through a particular CM entity type or jurisdiction. This allows dealers to clear CDS through the entities in which they currently conduct their CDS business. An analysis of the advantages or disadvantages of this arrangement is beyond the scope of this Report (other than to the extent relevant to the legal analysis contained herein).

The flexibility that ICE Trust has afforded to its CMs has presented it with the challenge of accommodating CMs of differing organizational types across multiple jurisdictions—e.g., U.S. banks, U.S. federal and New York branches of non-U.S. banks, U.S. unregulated entities, English FSA-regulated entities, French, German and Swiss financial institutions and English branches of French, German and Swiss banks. Particularly in the context of our inquiry into segregation and portability of customer positions and related margin upon a CM default, this flexibility has rendered the analysis especially lengthy.

For U.S. CMs,[21] the segregation analysis is generally quite strong, from the perspective of customers' legal rights to ultimately recover their margin,[22] although questions may arise as to the range of custodial claimants with whom customers would be required to share in any shortfalls in a worst-case scenario. The portability analysis is not as strong, in light of certain issues arising from the back-to-back principal trade structure, and questions surrounding the enforceability of ICE Trust's portability framework in a CM's insolvency. These considerations may also influence the likelihood of ICE Trust being able to find a willing transferee of positions (and related margin). However, there are good arguments that ICE Trust's portability framework would be enforceable in respect of U.S. CMs. Further, ICE Trust is currently developing contractual mechanisms that may mitigate these enforceability concerns. The robustness of the segregation and portability analysis would be significantly enhanced for U.S. entities if the legislative and regulatory proposals that ICE Trust suggested

[20] We note that these concerns are not unique to the CME, but rather arise under any structure in which custodial property is held in an omnibus account.

[21] Note that ICE Trust does not currently have any FCMs as CMs.

[22] For U.S. CMs that are FDIC-insured banks, there may be more practical comfort as to a prompt transfer of custodial property than in the case of a U.S. federal or New York state branch of a non-U.S. bank or an unregulated U.S. entity, in light of the transfer procedures typically employed by the FDIC that do not exist for the other types of U.S. CMs.

(at our request)[23] were enacted. These proposals are briefly described below, and are set forth in greater detail in Annex B.

For English CMs, the segregation analysis is generally clear as a legal matter and should not, of itself, be a cause for concern for customers as to their right to recover their margin eventually. However, because ICE Trust has not received approval as a "recognised overseas clearing house", its ability to port open positions of an insolvent English CM may be significantly curtailed due to the application of certain mandatory rules under English insolvency law. ICE Trust is currently in the process of applying for this status, which, once obtained, will protect ICE Trust's contracts with its CMs from many of the English insolvency rules that would hamper the operation of clearing house rules as currently envisaged. Even prior to ICE Trust obtaining this status, close-out and netting rights (but less so mandatory portability rules) would generally be protected under the U.K. Financial Collateral Arrangements (No. 2) Regulations 2003. The porting of margin is not an established practice for clearing houses regulated in England and legal certainty with respect to that aspect of the operation of the ICE Trust default rules (even after obtaining approval of "recognised overseas clearing house" status) might be enhanced by specific legislative amendments (particularly if it is intended that CM excess margin will be included in the customer margin that would be ported by the CCP to the new CM).

If any CMs are French financial institutions (or English branches of French banks),[24] the analysis regarding segregation is relatively weak if the margin is deposited with the French CM (i.e., deposited in an account opened in the name of the customer with the French CM or in an account opened in the name of the CM with itself, its custodian or the CCP) since, in case of insolvency, French law requires customers who have deposited cash margin (whether via security interest or title transfer) or security margin (via title transfer) with the French CM to share in any shortfall on a pro rata basis with all other unsecured claimants of the French CM and those who have deposited security margin via security interest to share any shortfall pro rata on a CUSIP per CUSIP basis with all other claimants of the French CM (whether or not they have allowed rehypothecation of the deposited securities). However, in the case of CMs that are French banks acting through their English branch and securities margin is held in an account opened in England, the rights and effect of the French CM's insolvency on such securities should, under certain conditions, be determined under English law. The analysis regarding portability of positions and related margin is subject to considerable uncertainty due to mandatory rules of French insolvency law (i.e., the porting of positions and margin would require the consent of the French insolvency court).

For CMs that are German financial institutions (including English branches of German banks), a customer should ultimately be allowed to segregate margin from the insolvency

23 Although ICE Trust expressed a high degree of confidence that its segregation and portability framework for customers is, under existing U.S. law, generally sufficient to protect customer positions and related margin, it provided suggested legislative amendments at our request.

24 ICE Trust does not currently have any CMs that are French financial institutions (or English branches of French banks).

estate of an insolvent CM if the margin was posted in accordance with ICE Trust's clearing rules. Although there are good arguments that ICE Trust's portability procedures would be given effect in German insolvency proceedings opened with respect to a CM that is a German financial institution, this is a topic for further legal analysis.

For CMs that are Swiss financial institutions (including English branches of Swiss banks), although there is no Swiss statutory duty to segregate client money and assets, such CMs would, as ICE Trust mandates such segregation, have a contractual obligation to do so. Client assets (i.e., securities margin) held by the CM or a sub-custodian will by law be segregated upon the bankruptcy of the CM, while there is no such segregation upon bankruptcy in respect of client money (i.e., cash margin). The analysis regarding portability of positions and related margin is subject to considerable uncertainty due to mandatory rules of Swiss regulatory and insolvency law.

Finally, in the event customer positions and margin are not transferred,[25] even if customer margin is adequately segregated, a potential challenge for a customer of an insolvent CM is the practical difficulty of obtaining the timely return to it of assets to which it is entitled as a matter of law, but which (as a matter of practice) may not be released to the customer in a timely manner. These concerns would be largely resolved if customer margin could be returned directly to a defaulting CM's customers and not to its insolvency representative, or if a legal regime could be instituted that would provide for a mechanism for the prompt return of customer margin (even if held in omnibus accounts). ICE Trust's omnibus structure of holding customer margin significantly complicates efforts in this regard.[26] In addition, consideration would have to be given to how customer liabilities to the CM secured by the customer margin are satisfied prior to the return of margin to the customer.

These and other matters relating to ICE Trust's proposed clearing framework are discussed in greater detail in Part III.A.2. below.

B. Executive Summary—European CCPs

1. Eurex Clearing AG ("Eurex")

Eurex's clearing framework does not require that customer CDS positions be cleared through a particular CM entity type or jurisdiction beyond Eurex's standard requirements applicable to CMs. This generally allows dealers to clear CDS through the entities in which they currently conduct their CDS business, provided they meet these standard requirements.

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[25] As noted above, in every case in which a large U.S. bank has become the subject of an FDIC receivership proceeding, all qualified financial contracts (e.g., CDS positions) and associated margin of the failed bank were transferred in their entirety to a single bridge bank or third-party acquiror. Customers would therefore continue to deal with the acquiror, with little or no systemic disruption.

[26] We note that these concerns are not unique to ICE Trust, but rather arise under any structure in which custodial property is held in an omnibus account.

An analysis of the advantages or disadvantages of this arrangement is beyond the scope of this Report (other than to the extent relevant to the legal analysis contained herein).

The flexibility that Eurex has afforded to its CMs has presented it with the challenge of accommodating CMs of differing organizational types across multiple jurisdictions—e.g., U.S. FCMs, U.S. banks, English FSA-regulated entities, French, German and Swiss banks and English branches of French, German and Swiss banks. Particularly in the context of our inquiry into segregation and portability of customer positions and related margin upon a CM default, this flexibility has rendered the analysis especially lengthy.

The Eurex structure, for U.S. CMs and U.S. customers of non-U.S. CMs, requires that customer margin be segregated by the CM and in certain circumstances requires that the margin be pledged to the customer by the CM. The effectiveness of such pledges and the effect of such an arrangement in the event of the default or insolvency of a customer would have to be examined in each relevant jurisdiction on a customer-by-customer basis; the CMs will need to have clear rights in the margin in a customer default. For non-U.S. customers of non-U.S. CMs, segregation of customer margin is currently not required by the Eurex structure beyond what may be mandated by the laws applicable to the customer's relationship with the relevant CM. However, Eurex is in the process of considering segregation structures for non-U.S. CMs and customers generally. Accordingly, segregation requirements contained in Eurex's clearing conditions might be subject to significant change in the near future.

In regard to portability, Eurex's clearing conditions currently provide for automatic early termination of all CM-Eurex positions upon the opening of formal insolvency proceedings in respect of a CM, which effectively limits the time during which customer positions can be ported, unless all parties concerned (including the CM's insolvency representative) agree to reinstate the positions. Prior to that time, customer positions (i.e., both the customer-CM positions and the related CM-Eurex positions) may be transferred with the consent of all parties concerned (including the customer). In such a case, Eurex would release to the CM any margin no longer required to cover the transferred CM-Eurex positions. It would depend on the transfer arrangements between the customer and its CM whether the CM would release to the customer any customer margin no longer required to cover the transferred customer-CM position. In LBIE, Eurex was able to successfully port customer positions prior to formal insolvency proceedings being opened.[27]

Customers that clear CDS with Eurex through CMs that are U.S. banks might well benefit from a very strong segregation analysis. Under Eurex clearing conditions, CMs that are U.S banks will be required to (i) segregate margin posted by the customers in connection with the Eurex-cleared CDS, (ii) grant those customers a security interest in the segregated assets and (iii) arrange for such security interest to be perfected through control (it is yet to be determined whether and how perfection would be ensured in all relevant jurisdictions). Eurex, at the time of this Report, has not finally decided on the operational details for providing customers with control over the segregated assets (or the impact of such control on the CMs).

[27] With respect to customer margin, see footnote 11 above.

However, if the U.S. CM complies with the segregation requirement and the Eurex-cleared CDS customers obtain a security interest in the segregated assets perfected through control, the Eurex-cleared CDS customers should have an interest in the segregated assets superior to the interest of any other claimant.

If any U.S. FCMs became CMs, the segregation analysis would be complicated. The status of cleared CDS under the U.S. commodities laws and regulations is generally unclear (as discussed below) and the status of Eurex-cleared CDS has its own complications; accordingly, the application of legal segregation requirements thereunder and the status of the Eurex-cleared CDS customers in a bankruptcy of the FCM is unclear. (Eurex is currently exploring the possibility of FCMs being required to hold customer margin in the same manner as CMs that are U.S. banks. We do not analyze such an arrangement here, as it would require further study.) If Eurex-cleared CDS are treated as "commodity contracts" under the Bankruptcy Code, then the assets segregated for the Eurex-cleared CDS customers and all other "customer property" for customers of the same "account class" should be distributed to the Eurex-cleared CDS customers, with all such Eurex-cleared CDS customers sharing pro rata in any shortfall with other customers of the same "account class". If these CDS are not treated as commodity contracts under the Bankruptcy Code, then the treatment of such segregated assets is unclear, but may depend on whether the assets segregated for the Eurex-cleared CDS customers are commingled with the assets segregated for commodities customers (among other relevant factors).

In this regard, the application of U.S. law may enhance the portability analysis with respect to Eurex. When an FDIC-insured bank enters insolvency proceedings, the automatic termination of CDS under Eurex's rules (which would otherwise prevent any post-insolvency transfers of cleared CDS) is stayed (at least temporarily) and the bank's insolvency representative has the ability to transfer the CDS with any counterparty, provided that the insolvency representative also transfers all other "qualified financial contracts" with that counterparty and any of that counterparty's affiliates, along with all margin and other credit support for such contracts, to a single entity (including to certain existing financial institutions or to a newly-created "bridge bank".

For English CMs, Eurex's clearing conditions generally leave it to CMs and their customers to implement measures for the protection of customer margin (subject to certain special rules for U.S. customers). Protection of a customer's margin will depend on the manner in which such margin is posted to the CM. If posted under an "outright transfer" arrangement or custodial arrangement pursuant to which the CM has exercised a right of reuse or rehypothecation, the customer will have only an unsecured claim against the CM for the return of the margin. If posted by way of a security interest granted over a customer's assets held in a third party account away from the CM, the customer should have a proprietary claim to the assets posted as margin. Although the details of Eurex's portability procedure are being developed, it is likely that any such portability procedure will be respected under English law because Eurex is a "recognised overseas clearing house" and therefore English insolvency law could not be used to challenge or restrict actions taken under its default rules to the extent within the protections provided to market contracts of regulated clearing houses.

For CMs that are French financial institutions (including English branches of French banks), the analysis regarding segregation is unclear because the scope and applicability of certain regimes overriding general principles of French insolvency law are uncertain. If such overriding regimes are not applicable, the protection of a customer's margin will depend on the manner in which such margin is posted to the CM. If posted to the CM under a title transfer arrangement, customers would likely be left with an unsecured claim for the return of margin. If posted to the CM by way of a security interest, customers would share any shortfall pro rata on a CUSIP per CUSIP basis with all other claimants of the French CM (whether or not they have allowed rehypothecation of the deposited securities). However, in the case of CMs that are French banks acting through their English branch and securities margin is held in an account opened in England, the rights and effect of the French CM's insolvency on such securities would, under certain conditions, be determined under English law. If posted by way of a security interest granted over a customer's assets held in a third party account held away from the CM, the customer should have a proprietary claim to the assets posted as margin. Eurex's special rules on the segregation of margin for U.S. customers (as described above) would offer U.S. customers protection that they would otherwise not have, provided in particular that all relevant aspects are governed by the law of a U.S. jurisdiction. With respect to portability of positions and related margin, French insolvency law should defer to and respect any portability procedures applicable to CM-Eurex positions and related margin available under German law, although this result is more uncertain with respect to customer-CM positions and related margin.

For CMs that are German financial institutions (including English branches of German banks), Eurex's clearing conditions generally leave it to CMs and their customers to implement measures for the protection of customer margin, with the consequences described above. CMs would only be required to segregate margin for U.S. customers (as described above), which would offer U.S. customers a certain degree of protection. In regard to portability, as noted above, Eurex's clearing conditions currently provide for automatic early termination of all CM-Eurex positions upon the opening of formal insolvency proceedings in respect of a CM. Prior to that time, customer positions (i.e., both the customer-CM positions and the related CM-Eurex positions) may be transferred with the consent of all parties concerned (including the customer). (Again, in LBIE, Eurex was able to successfully port customer positions prior to formal insolvency proceedings being opened.[28])

For CMs that are Swiss financial institutions (including English branches of Swiss banks), there is no Swiss statutory duty to segregate client money and assets. Client assets held by the CM or a sub-custodian will by law be segregated upon the bankruptcy of the CM, while there is no such segregation upon bankruptcy in respect of client money. The analysis regarding portability of positions and related margin is subject to considerable uncertainty due to mandatory rules of Swiss regulatory and insolvency law.

[28] With respect to customer margin, see footnote 11 above.

These and other matters relating to Eurex's proposed clearing framework are discussed in greater detail in Part III.B.1. below.

2. ICE Clear Europe Limited ("ICE Clear Europe")

ICE Clear Europe's clearing framework does not require that customer CDS positions be cleared through a particular CM entity type or jurisdiction. This allows dealers to clear CDS through the same entities in which they currently conduct their CDS business. An analysis of the advantages or disadvantages of this arrangement is beyond the scope of this Report (other than to the extent relevant to the legal analysis contained herein).

The flexibility that ICE Clear Europe has afforded to its CMs has presented it with the challenge of accommodating CMs of differing organizational types across multiple jurisdictions—e.g., U.S. banks, English FSA-regulated entities, French, German and Swiss financial institutions and English branches of French, German and Swiss banks. Particularly in the context of our inquiry into segregation and portability of customer positions and related margin upon a CM default, this flexibility has rendered the analysis especially lengthy.

Although the legal framework of ICE Clear Europe is still under development, its general proposals for the segregation and portability of customer positions and related margin have the potential to provide customers with substantial protections that they may not otherwise have had. One of the primary structural protections offered by ICE Clear Europe is that CMs will be required to hold "on trust", for the benefit of customers, any margin to which CMs may be entitled after positions have been closed out or ported. However, one of the key concerns is that, because margin is transferred from the customer to the CM pursuant to a "title transfer collateral arrangement", any margin that is posted by the customer, but not transferred on by the CM to ICE Clear Europe, might be absorbed into the CM's general estate in the event of the CM's insolvency. Diligence will also need to be done on a jurisdiction-by-jurisdiction basis as to whether the trust in favor of the customer in the title transfer collateral will affect the CM's rights on a default or insolvency of the customer; the CMs will need to have clear rights in the margin in a customer default.

For U.S. CMs (other than FCMs, of which there are currently none for ICE Clear Europe), the segregation analysis is unclear due to the title transfer/trust arrangement, although this initial conclusion merits further study. In addition, questions may arise as to the range of custodial claimants with whom customers would be required to share in any shortfalls in a worst-case scenario. The portability analysis is also unclear, in light of certain issues arising from the back-to-back principal trade structure, and questions surrounding the enforceability of ICE Clear Europe's portability framework. The robustness of the segregation and portability analysis would be significantly enhanced if the legislative changes suggested by ICE Trust were enacted.

For English CMs, the segregation analysis is generally clear as a legal matter and should not, of itself, be a cause for concern for customers as to their right to recover their margin eventually. Although the legal framework of ICE Clear Europe is still under development, its general proposals for the segregation and portability of CDS customer positions and related margin have the potential to provide customers with substantial protections that they may not otherwise have had (for example, if the framework had not included the trust (in favor of customers) over the CM's right to the return of customer margin after customer positions have been closed out or ported). The porting of margin is not an established practice for clearing houses regulated in the U.K. and legal certainty with respect to that aspect of the operation of the ICE Clear Europe default rules might be enhanced by specific legislative amendments (particularly if it is intended that CM excess margin will be included in the customer margin that would be ported by the CCP to the new CM).

For CMs that are French financial institutions (including English branches of French banks), the analysis regarding segregation is unclear because the scope and applicability of certain regimes overriding general principles of French insolvency law are uncertain. However, the envisaged trust over the CM's right to the return of the margin posted with ICE Clear Europe in favor of customers, although subject to some legal uncertainty with respect to its treatment by French insolvency courts, would offer customers protection that they would otherwise not have, provided that all relevant aspects are governed by English law. In the case of CMs that are French banks acting through their English branch and securities margin is held in an account opened in England, the rights and effect of the French CM's insolvency on such securities should, under certain conditions, be determined under English law. With respect to the portability of positions and related margin, French insolvency law should defer to and respect any portability procedures applicable to CM-ICE Clear Europe positions and related margin available under English law, although this result is more uncertain with respect to customer-CM positions and related margin.

For CMs that are German financial institutions (including English branches of German banks), the envisaged structure of holding the CM's retransfer claim in relation to customer margin at the ICE Clear Europe level "on trust", although subject to some legal uncertainty, offers customers protection that they would otherwise not have, provided that all relevant aspects including the claim for the retransfer of customer margin are governed by English law. Although there are also good arguments that ICE Clear Europe's portability procedures would be given effect in German insolvency proceedings opened with respect to a CM that is a German financial institution, this is a topic for further legal analysis.

For CMs that are Swiss financial institutions (including English branches of Swiss banks), while there is no Swiss statutory duty to segregate client money and assets, such CM would, as ICE Clear Europe mandates such segregation, have a contractual obligation to do so. Client assets held by the CM or a sub-custodian will by law be segregated upon the bankruptcy of the CM, while there is no such segregation upon bankruptcy in respect of client money. The analysis regarding portability of positions and related margin is subject to considerable uncertainty due to mandatory rules of Swiss regulatory and insolvency law. It should be noted that Art. 27 para. 2 of the Swiss Federal Banking Act ("BA") provides that payment and security transaction orders which were entered into a system before the Swiss Financial Market Supervisory Authority ("FINMA") has ordered measures or before the system operator has or should have knowledge of these measures, may only be revoked if they are not irrevocable according to the rules of the system. The provision of Art. 27 para. 2 BA applies irrespective whether the system is Swiss or foreign.

These and other matters relating to ICE Clear Europe's proposed clearing framework are discussed in greater detail in Part III.B.2. below.

3. LCH.Clearnet Limited/NYSE Liffe ("LCH.C")

LCH.C's clearing framework does not require that customer CDS positions be cleared through a particular CM entity type or jurisdiction. This allows dealers to clear CDS through the same entities in which they currently conduct their CDS business. An analysis of the advantages or disadvantages of this arrangement is beyond the scope of this Report (other than to the extent relevant to the legal analysis contained herein).

The flexibility that LCH.C has afforded to its CMs has presented it with the challenge of accommodating CMs of differing organizational types across multiple jurisdictions—e.g., U.S. banks, English FSA-regulated entities, French, German and Swiss financial institutions and English branches of French, German and Swiss banks. Particularly in the context of our inquiry into segregation and portability of customer CDS positions and related margin upon a CM default, this flexibility has rendered the analysis especially lengthy.

In addition, LCH.C's clearing conditions provide for customer margin to be posted by CMs to LCH.C by way of outright transfer and do not mandate protection of margin posted by the customer to the CMs. Where customers seek to obtain protection for the margin posted to their CM through a dependable form of customer protection (such as a custody arrangement or security interest), the CM generally will not be able to post such margin to LCH.C under a title transfer arrangement.

For U.S. CMs, the protection of a customer's margin will depend on the manner in which such margin is posted to the CM. If posted under a "title transfer" arrangement, the customer will likely have only an unsecured claim. If posted by way of a security interest granted over a customer's assets held in a third party account held away from the CM, the customer should have a proprietary claim to the assets posted as margin. We can analyze LCH.C's portability procedures if and when developed.

For English CMs, the protection of a customer's margin will depend on the manner in which such margin is posted to the CM. If posted under a "title transfer" arrangement or custodial arrangement under which the right to use or rehypothecate has been exercised, the customer will have only an unsecured claim. If posted by way of a security interest granted over a customer's assets held in a third party account held away from the CM, the customer should have a proprietary claim to the assets posted as margin. Should LCH.C decide to implement a portability procedure that includes margin, its portability procedure should be respected under English law because LCH.C is a "recognised clearing house" and therefore English insolvency law could not be used to challenge or restrict actions taken under its default rules to the extent within the provisions that protect clearing house default rules from mandatory insolvency laws. However, the porting of margin is not an established practice for "recognised clearing houses" regulated in the U.K. and legal certainty with respect to portability of margin might be enhanced by specific legislative amendments (particularly if it is intended that CM excess margin will be included in the customer margin that would be ported by the CCP to the new CM).

For CMs that are French financial institutions (including English branches of French banks), the analysis regarding segregation is unclear because the scope and applicability of certain regimes overriding general principles of French insolvency law are uncertain. If such overriding regimes are not applicable, the protection of a customer's margin will depend on the manner in which such margin is posted to the CM. If posted to the CM under a title transfer arrangement, customers would likely be left with an unsecured claim for the return of margin. If posted to the CM by way of a security interest, customers would share any shortfall pro rata on a CUSIP per CUSIP basis with all other claimants of the French CM (whether or not they have allowed rehypothecation of the deposited securities). However, in the case of CMs that are French banks acting through their English branch and securities margin is held in an account opened in England, the rights and effect of the French CM's insolvency on such securities would, under certain conditions, be determined under English law. If posted by way of a security interest granted over a customer's assets held in a third party account held away from the CM, the customer should have a proprietary claim to the assets posted as margin. With respect to portability of positions and related margin, French insolvency law would defer to and respect any portability procedures applicable to CM-LCH.C positions and related margin available under English law, although this result is more uncertain with respect to customer-CM positions and related margin.

For CMs that are German financial institutions (including English branches of German banks), LCH.C's clearing conditions generally leave it to CMs and their customers to implement measures for the protection of customer margin, which would leave customers generally with an unsecured claim for the return of margin, unless agreed otherwise. Although there are good arguments that LCH.C's portability procedures would be given effect in German insolvency proceedings opened with respect to a CM that is a German financial institution, this is a topic for further legal analysis.

For CMs that are Swiss financial institutions (including English branches of Swiss banks), there is no Swiss statutory duty to segregate client money and assets. Client assets held by the CM or a sub-custodian will by law be segregated upon the bankruptcy of the CM, while there is no such segregation upon bankruptcy in respect of client money. The analysis regarding portability of positions and related margin is subject to considerable uncertainty due to mandatory rules of Swiss regulatory and insolvency law.

These and other matters relating to LCH.C's proposed clearing framework are discussed in greater detail in Part III.B.3. below.

4. LCH.Clearnet SA[29]

LCH.Clearnet SA is targeting the start of its CDS clearing activities by the end of 2009 and its CDS clearing infrastructure is currently still being developed. Additional issues may be identified once its CDS clearing infrastructure takes on a more settled and detailed form.

LCH.Clearnet SA's current clearing framework does not require that customer CDS positions be cleared through a particular CM entity type or jurisdiction. This allows dealers to clear CDS through the same entities in which they currently conduct their CDS business. An analysis of the advantages or disadvantages of this arrangement is beyond the scope of this Report (other than to the extent relevant to the legal analysis contained herein).

The flexibility that LCH.Clearnet SA has afforded to its CMs has presented it with the challenge of accommodating CMs of differing organizational types across multiple jurisdictions—e.g., U.S. banks, English FSA-regulated entities, French, German and Swiss financial institutions and English branches of French, German and Swiss banks. Particularly in the context of our inquiry into segregation and portability of customer CDS positions and related margin upon a CM default, this flexibility has rendered the analysis especially lengthy.

LCH.Clearnet SA's clearing conditions do not mandate protection of margin posted by the customer to the CMs, nor do they allow for posting of customer margin directly with it. Where customers seek to obtain protection for the margin posted to their CM through a dependable form of customer protection (such as a custody arrangement or security interest), the CM generally will not be able to post such margin to LCH.Clearnet SA under a title transfer arrangement.

From a portability perspective, LCH.Clearnet SA is entitled by law to transfer the positions and related margin of an insolvent CM to another solvent CM, with the customer's and the new CM's prior consent.

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29 LCH.Clearnet SA requested that we add the following Disclaimer to this Report:

> This document is solely for information purposes to the attention of the members of the trade associations and the regulatory community or others who are interested in the clearing and settlement process operated by LCH.Clearnet SA. It is an overall presentation of the services provided by LCH.Clearnet SA and not a binding commercial offer for the clearing of the credit default swaps. Although all reasonable care has been taken in the preparation of this document, LCH.Clearnet SA disclaims liability of the information and for the uses to which it is put. LCH.Clearnet SA is currently designing the project consisting in the clearing of credit default swaps and is not, in any event, implementing the project; as a consequence, this document may be amended from time to time and LCH.Clearnet SA shall not be held liable for making such amendments. All intellectual property rights associated with any part of this document are vested in LCH.Clearnet SA. This work is issued in confidence for the purpose for which it is supplied. It must not be reproduced in whole or in part or used for other purposes except with the consent in writing of LCH.Clearnet SA and then only on the condition that this notice is included in any such reproduction. The information contained in this document is solely for educational purposes and is not to be construed as technical specification.

For U.S. CMs, the protection of a customer's margin will depend on the manner in which such margin is posted to the CM. If posted under a "title transfer" arrangement, the customer will likely have only an unsecured claim. If posted by way of a security interest granted over a customer's assets held in a third party account held away from the CM, the customer should have a proprietary claim to the assets posted as margin. We can analyze LCH.Clearnet SA's portability procedures if and when developed.

For English CMs, the protection of a customer's margin will depend on the manner in which such margin is posted to the CM. If posted under an "outright transfer" arrangement or custodial arrangement under which the right to use or rehypothecate which has been exercised, the customer will have only an unsecured claim. If posted by way of a security interest granted over a customer's assets held in a third party account held away from the CM, the customer should have a proprietary claim to the assets posted as margin. However, because LCH.Clearnet SA has not received approval as a "recognised overseas clearing house", its ability to port open positions of an insolvent English CM may be significantly curtailed due to the application of certain mandatory rules under English insolvency law. LCH.Clearnet SA is currently in the process of applying for this status, which, once obtained, will protect LCH.Clearnet SA's contracts with its CMs from many of the English insolvency rules that would hamper the operation of clearing house rules as currently envisaged. Even prior to LCH.Clearnet SA obtaining this status, to the extent LCH.Clearnet SA is also a "designated system" within the meaning of The Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "Settlement Finality Regulations"), depending on the details of its default procedures, its portability procedures may be protected because Regulation 14 of the Settlement Finality Regulations provides that LCH.Clearnet SA's default arrangements are to take precedence over general insolvency proceedings of the English CM. In addition, close-out and netting rights (but less so mandatory portability rules) would generally be protected under the U.K. Financial Collateral Arrangements (No. 2) Regulations 2003. However, the porting of margin is not an established practice for "recognised overseas clearing houses" regulated in the U.K. and legal certainty with respect to portability of margin might be enhanced by specific legislative amendments (particularly if it is intended that CM excess margin will be included in the customer margin that would be ported by the CCP to the new CM).

For CMs that are French financial institutions, the analysis regarding segregation is generally relatively strong, since any customer margin must be posted by way of title transfer with the French CM but, in this case, is segregated from the French CM's estate so that in the event of insolvency, the customer is entitled to recover such margin (less any losses in case of liquidation of the customer's positions and payment of any outstanding sums due to the French CM) ahead of any other creditor of the French CM. The analysis regarding portability of positions and related margin is generally relatively strong since if LCH.Clearnet SA is entitled to transfer open positions and related margin at both the CM-LCH.Clearnet SA and the customer-CM levels. Any such transfer is, however, subject to the prior consent of both the customer and the new CM.

For CMs that are German financial institutions (including English branches of German banks), LCH.Clearnet SA's clearing conditions generally leave it to CMs and their customers to implement measures for the protection of customer margin, which would leave customers generally with an unsecured claim for the return of margin, unless agreed otherwise. Although there are good arguments that LCH.Clearnet SA's portability procedures would be given effect in German insolvency proceedings opened with respect to a CM that is a German financial institution, this is a topic for further legal analysis.

For Swiss CMs that are Swiss financial institutions (including English branches of German banks), there is no Swiss statutory duty to segregate client money and assets. Client assets held by the CM or a sub-custodian will by law be segregated upon the bankruptcy of the CM, while there is no such segregation upon bankruptcy in respect of client money. The analysis regarding portability of positions and related margin is subject to considerable uncertainty due to mandatory rules of Swiss regulatory and insolvency law.

These and other matters relating to LCH.Clearnet SA's proposed clearing framework are discussed in greater detail in Part III.B.4. below.

C. Legislative and Regulatory Reforms

The foregoing executive summary and the remainder of this Report is based upon current insolvency law. However, it is important to recognize that change is being considered generally, as is evident from recent financial modernization proposals and ongoing global efforts for legislative and regulatory reform in this area. In both the U.S. and Europe, a wide range of legislative reforms could be implemented to enhance the protection of customer margin, and increase the likelihood that such margin will be successfully transferred (in connection with a porting of positions) or returned to customers. The extent of these reforms should be discussed with market participants and regulators in conjunction with consultations on reforms already underway,[30] as the reforms may have some disadvantages, such as reduced

[30] For example, in the U.S., in its White Paper, "Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation," released on March 26, 2009, the U.S. Treasury proposes a resolution authority for systemically significant financial companies that is modeled on the Federal Deposit Insurance Act ("FDIA") insolvency provisions for insured depository institutions. Under such a regime, regulators would have the power to, among other things, place a failed financial company into conservatorship or receivership and transfer its "derivatives" to a "bridge" institution.

With respect to the UK, various reports have been prepared in relation to legal reforms in response to the financial crisis, including: (a) "The Turner Review" (18 March 2009)—The FSA's review on the UK and international approaches to the way banks are regulated. The FSA's Discussion Paper 09/2, which accompanies the Turner Review, recommends steps that the international community needs to take to enhance regulatory standards, supervisory approaches and international cooperation and coordination. The FSA's Discussion Paper was published in March 2009; (b) "UK international financial services – the future" (May 2009)—A report to the UK Government from UK-based financial services leaders whose remit was to examine the competitiveness of financial services globally and to develop a framework on which to base policy and initiatives to keep UK financial services competitive; and (c) "Developing effective resolution arrangements for investment banks" (May 2009)—a HM Treasury publication on the UK Government's initial thoughts on the main areas where reform could be considered in relation to insolvency law, regulation and market practice.

business flexibility, higher costs of doing business and, in some cases, increased risks for other market participants or custodial claimants.

In recognition of these ongoing reform efforts, we have asked the CCPs to suggest any legislative or regulatory changes that would (in their view) be helpful to the customer protection analysis and have also, as a Group, made our own proposals. These proposals are discussed below.

1. CME

We believe legislative and regulatory reforms could help to resolve the uncertainties briefly noted above (and discussed in further detail below) surrounding the CME's clearing framework. In particular, we believe that the following changes under U.S. law would be helpful to the segregation and portability analysis:

- Provide that a customer clearing CDS (whether through a CFTC-registered derivatives clearing organization or otherwise) through a U.S. FCM is, upon an insolvency of the FCM, a "customer" with a claim on account of "commodity contract" under the Bankruptcy Code.

- Clarify the interaction between the Securities Investor Protection Act ("SIPA") and the commodity broker liquidation provisions in the Bankruptcy Code upon the insolvency of a joint broker-dealer/FCM.[31]

Although the CME agrees that these changes would be helpful, it indicated that it does not believe that the Bankruptcy Code is in need of reform, and maintains that it is "highly confident that the CFTC's Interpretative Statement and the legal analysis contained therein fully and adequately address the range of legal issues in respect of customer property that might arise in the event of a CM insolvency." However, as discussed above, we believe there is a not insignificant degree of uncertainty associated with this issue. In light of our views on this matter, the CME has offered a proposed amendment that would revise Section 761(4)(F) of the Bankruptcy Code to read as follows:

(4) "commodity contract" means— …

Although some uncertainties relating to the rules contained in the FSA's Client Assets Sourcebook (the "CASS Rules"), which govern the treatment of "client money" and "client assets", may be clarified in due course by English court decisions arising out of the LBIE and other administrations, a wider review and revision of the CASS Rules is seen by the Group as a priority. According to the FSA's Handbook Development Newsletter (May 2009), the FSA intends to commence consultation on the review of the CASS Rules (in particular, the distribution rules) in the fourth quarter of 2009.

[31] We believe this change, while important, is significantly less important as a practical matter than the first change. Of still lesser importance, we believe it would also be useful to provide the CFTC with authority to place an FCM into liquidation under the Bankruptcy Code, similar to the authority of the Securities Investor Protection Corporation with respect to its broker-dealer members.

> (F) any other contract, option, agreement or transaction that is similar to a contract, option, agreement or transaction referred to in this paragraph; for this purpose, a similar contract, option, agreement or transaction shall include, without limitation, any contract, option, agreement or transaction cleared by a derivatives clearing organization that is registered with the Commission; …

We support this amendment, and believe its enactment would be very helpful in enhancing the rights of customers under the CME's clearing framework.

The CME did not suggest any proposals to resolve the issues surrounding the interplay between SIPA and the commodity broker liquidation provisions of the Bankruptcy Code upon the insolvency of a joint BD/FCM (or the CFTC's inability to initiate Bankruptcy Code proceedings in respect of a failing FCM). As stated above, we believe these are second-order issues. However, we believe (and the CME agrees in principle) that such changes should be considered, especially in light of other legislative changes being considered in regard to the resolution of systemically important financial institutions.

2. ICE Trust

We believe legislative and regulatory reforms could help to resolve the uncertainties briefly noted above (and discussed in further detail below) surrounding ICE Trust's clearing framework. ICE Trust has expressed a high degree of confidence that its segregation and portability framework for customers is, under existing U.S. law, generally sufficient to protect customer positions and related margin, to the extent U.S. law is applicable. Nevertheless, in response to our request for whether legislative or regulatory reforms would be helpful to the CCP's customer protection framework, ICE Trust has suggested the following changes under U.S. law, which we believe would be helpful to the segregation and portability analysis:

- If relevant statutes applicable to the CM were to be amended to expressly:
    - Cover the enforceability of CCP rights to transfer positions (including customer positions) and related margin, in addition to rights to terminate and net such transactions and apply pledged collateral;
    - Provide the appropriate regulatory authority with the power to create a regulatory framework for the segregation of CDS margin; and
    - Allow the FDIC to transfer cleared positions separately from non-cleared positions.
- If the appropriate regulator of the CM were to provide confirmation that it would:
    - Respect the segregation of, and cooperate with the return of, margin;

- o Not seek to interfere with, and would cooperate with, attempts by the CCP to implement portability rules; and

- o Provide guidance as to the manner in which it would expect to treat cleared transactions in the event of the insolvency of a regulated entity.

ICE Trust has suggested specific legislative amendments in respect of CMs that are U.S. entities (attached in Annex B),[32] which we believe would, if enacted, be very helpful for customers clearing through U.S. CMs and address several of the issues raised above.

ICE Trust has not, at this stage, provided legislative proposals for English, French, German and Swiss CM entity types. Therefore, customers of non-U.S. CMs would continue to face the uncertainties highlighted in this Report to the extent non-U.S. law were applicable, even if ICE Trust's suggested legislative amendments were enacted in the U.S. We would encourage ICE Trust to consider proposing specific legislation for non-U.S. CMs, as it has done for U.S. CMs. In this endeavor, we believe ICE Trust should also consider the legislative and regulatory reforms described below for the European CCPs.

3. European CCPs

With respect to the European CCPs, we would welcome—to a greater or lesser degree, depending on the structure of the relevant CCP's clearing solution, and the law applicable to the CCPs and the CMs—the following legislative and regulatory changes, in order to address our concerns arising from the analysis of the CCP structures detailed in this Report:

- Rules enabling or enhancing the ability of CMs to rehypothecate customer margin to CCPs without customers losing their proprietary interest in that margin on the CM's insolvency;

- Rules enhancing the ability of CCPs to effect the transfer or novation of a CM's customer positions with the CCP and related customer margin posted by that CM to the CCP on that CM's default or insolvency and, where necessary, to effect the transfer or novation of the customer's underlying positions with that CM and related customer margin held by that CM to successor CMs (this could be achieved through relatively simple amendments to existing legislation in the case of Part VII of the U.K. Companies Act 1989, but would require certain changes in Germany and Switzerland, so may be more easily achieved in these jurisdictions by granting powers to regulators to effect such transfers on behalf of CMs);

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[32] One of the amendments suggested by ICE Trust leaves open the applicable federal regulator empowered to make certain determinations. Further consideration needs to be given to the identity of such a regulator for U.S. CMs that are branches of non-U.S. banks or that are unregulated U.S. entities. More generally, in the case of branches of non-U.S. banks, consideration needs to be given to the effect, if any, of non-U.S. law.

- Rules relating to the timely access by customers to their margin after the insolvency of a CM. In the U.K. this would, in our view, mean going beyond what is currently envisaged by the HM Treasury consultation paper,[33] such as providing certainty for customers of financial intermediaries in the CDS market through adoption of a special insolvency regime for investment banks, pursuant to powers established in the Banking Act 2009, providing an alternative to insolvency practitioners in the administration or winding up of an investment bank (the FDIC receivership or SIPA trustee models may be worth considering) or empowering regulators to make orders as to the release of client money and client assets;[34]

- Rules relating to segregation (in particular, segregation of client money in Switzerland and points of detail in other jurisdictions);

- Rules protecting customers against the risk of a CM's failure to segregate money and assets should be considered (although inevitably this protection would have to come at the expense of the unsecured creditors, other custodial claimants or all market participants (if the protection is by way of compensation from a general fund));

- Rules concerning the efficacy of trusts (statutory or otherwise) over assets posted by customers in jurisdictions that do not normally recognize the efficacy of trusts;

- Rules designating that the default rules and proceedings of a clearing house should take precedence over general insolvency proceedings of the insolvent CM whether or not such clearing house is in the same jurisdiction as the insolvent CM;[35]

- Rules reducing the extent to which CDS clearing customers of CMs will have to share in any shortfall in client money and client assets (this could be a special regime to ring fence margin held by the CCPs from pooling/sharing with other client money or client assets); and

- Legislation empowering regulators to develop relevant rules relating to any or all of the above matters.

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33 "Developing effective resolution arrangements for investment banks" (HM Treasury, May 2009).

34 In connection with the issue of timely access by customers to their margin following a CM insolvency, consideration would have to be given to how customer liabilities to the CM secured by the customer margin are satisfied prior to the return of margin to the customer.

35 Rules that change applicable conflict rules, such as those discussed with respect to the Settlement Finality Directive which give precedence to the rule of the system over the insolvency rules of the participant or rules like s183(2) of the Companies Act 1989 which limit the discretion of the English courts to give effect to foreign judgments in certain circumstances where they would conflict with the rules of a UK "recognised clearing house", could be used to eliminate difficult conflicts of law issues that can arise where a CCP has CMs from different jurisdictions.

II. Analytical Framework for Customer Protection Issues

In the event of a CM default, the two essential elements of the customer protection analysis are (i) the manner in which margin is provided and held, and particularly, the extent to which margin is segregated from the CM's assets and recoverable by the customers (the "Segregation Analysis") and (ii) the effectiveness of the CCP's procedures for the transfer or novation of customer positions and related margin (the "Portability Analysis").

Both the Segregation Analysis and the Portability Analysis depend in large part upon the law applicable to the defaulting CM, which in turn varies by the entity type and jurisdiction of the CM. For purposes of this Part II, we provide a brief overview of the legal issues that may be relevant across a range of entity types and jurisdictions. In Part III, we discuss in greater detail the issues outlined in Part II, as specifically applied to the types of entities that can be clearing members of each CCP. Attached in Appendix B are schematics illustrating the various manners in which margin posted to the CCPs is provided and held.

A. Segregation Analysis

In this Part II.A., we set forth the various ways in which margin can be provided and held, focusing upon the differing ways in which margin may be segregated, and describing in general terms the consequences resulting therefrom. Inquiry into the manner in which margin is provided and held is important because it affects (i) the likelihood that positions and related margin will be successfully transferred in the event of a CM default and (ii) a customer's ability to ultimately recover its margin in the event its positions and related margin cannot be transferred.

The Segregation Analysis is critical to the Portability Analysis, as it is difficult to envisage a successful framework for full portability if customer margin cannot be accessed or identified,[36] or if there is a significant degree of undersegregation of customer margin.[37] We discuss considerations relating to the Portability Analysis in greater detail in Part II.B.

In the event there is no transfer or novation of customer positions and related margin, the Segregation Analysis is critical to the determination of customers' rights to recover their margin—specifically, to (i) the ability of customers to establish ownership rights in posted margin, (ii) whether and to what extent customers may be required to share with competing

[36] For example, in the case of LBIE, because the margin of LBIE's customers was frozen, customers were required to deposit margin with their new clearing firms to meet margin requirements associated with the transferred positions, resulting in "double margin".

[37] As the CFTC reported in 1978, "[W]here the amount of undersegregation has amounted to only a few thousand dollars, some of the larger futures commission merchants have occasionally accepted a failing futures commission merchant's customers trades and absorbed any resulting loss themselves for the 'good of the industry.'" However, the CFTC also noted that it could be "assumed that no futures commission merchant would be willing to accept customers' trades where the amount of undersegregation is tens or hundreds of thousands of dollars." Bankruptcy Act Revision: Hearings on H.R. 31 and 31 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary, 94th Cong. 2d. Sess. 2377, 2500-01 (1977).

claimants in the event of a shortfall and (iii) the likely length of time required to return margin to customers after their positions have been terminated. We discuss the applicable rules in the event of a shortfall in customer positions and related margin in Part II.C.

1. Posting of Margin

Security Interest and Trust Arrangements vs. Title Transfer Arrangements

The manner by which customers post margin (e.g., security interest or title transfer) may have important effects on the customer protection analysis. If customers were to grant a security interest in their margin, as collateral for their outstanding cleared CDS, the margin would remain property of the customers, subject to the rights of the secured parties. Once any obligations secured by the pledged margin have been discharged, the secured parties generally would maintain no further interest in the margin.

If, on the other hand, customers were to post margin under a title transfer arrangement, they would forfeit their proprietary interests in such margin immediately upon such transfer. Even after any obligations "secured" by the transferred margin have been discharged, the customers in this case would retain only a contractual claim against the transferees for the return of the margin so transferred, not a proprietary interest therein. Notwithstanding the foregoing, where customers have transferred title to their margin, it may nevertheless be possible for CMs to establish trust or security interest arrangements that would allow customers to establish proprietary interests in the margin or the contractual obligation of the holder of margin to return such margin to the CM (as agent or custodian for the customers). These arrangements may be helpful in the event of the CM's insolvency, as they might allow customers to recover any such margin that is returned to the insolvent CM ahead of the claims of unsecured creditors.

The distinction between proprietary and contractual claims may be critical in the event of a CM insolvency. Contractual claimants are generally afforded the status of mere unsecured creditors in an insolvency proceeding. Proprietary claimants, on the other hand, may have the ability (subject to tracing or other requirements) to recover their property ahead of unsecured creditors, on the ground that the property they deposited with the insolvent entity did not form part of the insolvency estate, but was merely held in a safekeeping or custodial capacity.[38]

To the extent CMs and customers decide to change to a security interest arrangement from an existing title transfer arrangement for the posting of margin, the parties should be mindful of any legal, operational, commercial or other issues that may arise in the course of such a transition—in particular, the rights of CMs against the customer upon a customer default or insolvency, and any filing or other requirements to perfect the security interest.

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[38] As discussed above, we do not principally focus on timing issues in this Report—e.g., when customers will be able to recover their margin. Although we note certain instances in which timing concerns may be particularly relevant, our primary focus is on whether customers will be able to recover their margin. This is because timing issues are inherently unpredictable, and depend upon the complexities of each case.

CCP's Collection of Gross vs. Net Margin

CCPs can collect margin from CMs either on a gross basis (i.e., the CCP collects from each CM all margin amounts posted by such CM's customers on account of CCP-imposed margin requirements (the "Gross Amount")) or on a net basis (i.e., the CCP collects from each CM a level of margin sufficient to account for the aggregate risk to the CCP of such CM's customer positions (the "Net Amount"), with offsetting customer positions resulting in a corresponding reduction in the aggregate margin requirement). Any margin collected by CMs in excess of CCP margin requirements is referred to herein as "CM Excess Margin".

Collection by CCPs of the Gross Amount (rather than just the Net Amount) may enhance both the Segregation Analysis and the Portability Analysis. If CCPs collect customer margin from CMs on a net basis, then it is important from a portability standpoint that the excess of the Gross Amount over the Net Amount (the "Excess Amount") be effectively segregated and accessible by the CCP, for transferability (rather than loss mutualization) purposes—ideally without the consent or cooperation of the CM's insolvency representative—upon a CM insolvency. To the extent the Excess Amount remains at the CM at the time of its insolvency, the CCP may only have the ability to transfer the Net Amount, unless the CCP has the cooperation of the CM's insolvency representative (which it may be able to obtain so long as the Excess Amount is segregated from the assets of the CM). If the CCP can only transfer the Net Amount, the associated customer positions are more likely to be undermargined at the transferee CM. Since no CM is likely to willingly accept the transfer of significantly undermargined customer positions (unless the transferee CM is satisfied that the customers will remedy the margin shortfall upon any transfer), collection by the CCP of only the Net Amount may have adverse effects upon portability, absent a separate requirement imposed upon CMs to segregate the Excess Amount in an account that the CCP can access in the event of a CM's insolvency. Portability considerations are discussed in further detail in Part II.B. below.

Securities vs. Cash

The type of property posted as margin may also affect the customer protection analysis. As securities and cash are the most common forms of margin, we discuss them briefly here.

For certain entity types, whether margin is posted in the form of securities or cash is irrelevant (as a legal matter) to the customer protection analysis. For example, so long as a customer has a "net equity" claim under the Bankruptcy Code in an FCM's insolvency proceeding, it is irrelevant whether the net equity claim derives from cash or securities posted by the customer. However, for other entity types (generally speaking), the posting of securities is preferable to cash from a customer protection standpoint. For example, under New York law, if margin consisting of securities has been credited to a "securities account" in the name of the customer by a "securities intermediary", in each case within the meaning of Article 8 of the Uniform Commercial Code, as enacted in the State of New York (the "UCC"), then the customer would retain a proprietary interest in such securities, on a pro rata, CUSIP-by-CUSIP basis with other proprietary claimants of the intermediary that have such securities credited to their securities accounts. Under English law, whether customers can demonstrate a proprietary interest in margin consisting of securities largely depends upon the extent to which (i) the securities are adequately segregated from the assets of the insolvent secured party, (ii) the rights relating to such securities remain free of liens and the securities are not subject to rehypothecation and (iii) the books and records of the insolvent secured party demonstrate the customer's ownership rights. We discuss these factors and other relevant considerations in greater detail in Part II.A.2. below.

Compared to securities, cash is relatively more fungible. Therefore, it is generally more difficult (or sometimes not possible) for a claimant to demonstrate a proprietary interest in margin consisting of cash. However, in certain instances, applicable law may provide customers with the possibility of demonstrating proprietary rights in cash. For example, under New York law, it may be possible for a customer to establish proprietary rights in cash that has been credited to a securities account in the customer's name by a securities intermediary.[39] And under English law, it may be possible that the cash is held subject to an express trust or would be classified as "client money" under the Client Asset Sourcebook rules, subject to a statutory trust in favor of the customer as beneficial owner. However, under the laws of certain other jurisdictions (e.g., France, Germany and Switzerland), customers holding cash at the secured party do not maintain proprietary interests in such cash, since it is assumed that any such cash was commingled with the estate of the insolvent secured party. In these jurisdictions, the cash must be held away from the secured party in order for customers to possibly demonstrate proprietary interests in such cash.

With respect to both securities and cash, the analysis of whether customers maintain proprietary or contractual rights largely depends upon the manner in which the margin is held. We now discuss several considerations that may be relevant in this regard.

2. Holding of Margin

There are several factors relating to how margin is held that may affect the customer protection analysis, as discussed in further detail below.

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[39] Under limited circumstances, cash not credited to a securities account may be treated as a "special deposit" entitled to custodial treatment under New York law. Key considerations in this regard include: whether interest is paid on the cash; whether there is an express agreement or clear evidence of intent that the parties intended the cash to be held for safekeeping; whether such cash is contractually required to be or was in fact segregated; whether the cash is identified as belonging to custodial claimant. Any payment of interest on the cash by the intermediary would appear to be inconsistent with the notion that the cash is being held in a custodial capacity, as it constitutes strong evidence that title to the cash passed to the securities intermediary. See Peoples Westchester Savings Bank v. FDIC, 961 F.2d 327, 331 (2nd Cir. 1992). But see Merrill Lynch Mortgage Capital v. FDIC, 293 F. Supp. 2d 98, 108 (D.C. 2003). However, to the extent any cash held in custody is commingled with other deposits at an upper-tier intermediary (for instance, the Federal Reserve Bank of New York ("FRBNY")) through which it is held, or subject to any liens at an upper-tier intermediary, it is uncertain what the customer's rights to such cash would ultimately be (even if, as between the customer and the CM, such cash could qualify as a "special deposit").

Where is the margin held?

Margin may be held at a customer's CM, at the CCP or at a third-party custodian (which may be an affiliate of the CM). In certain cases, CMs may be required under applicable law or regulation to hold customer margin separately from their proprietary assets. In the context of a CM insolvency, customers might well benefit from a structure in which margin is held away from the CMs, either at the CCP or at a third-party custodian (assuming the CCP or the third-party custodian is not itself insolvent).[40] Holding margin away from an insolvent CM may be helpful to customers for several reasons: (i) it enhances customers' ability to trace the margin; (ii) it supports the notion that ownership of the margin did not pass to the insolvent CM's estate (particularly helpful in the case of cash); and (iii) it may mitigate the timing burdens associated with the customers' recovery of margin.

If margin is held at multiple entities, the Segregation Analysis should be conducted at each relevant entity. For instance, CCPs may distinguish between (i) margin posted in respect of CCP-imposed requirements and (ii) any margin posted by customers in excess of such requirements. Specifically, CCPs may require the former category of margin to be posted to the CCP (or into an account to which the CCP has access), but allow the latter category of margin to be held elsewhere. Even if margin will ultimately be held at a single entity, customers should consider where the margin is to be held until it is transferred, and who bears any risk of loss throughout this intervening period.

Is margin commingled with other assets?

Where margin is held at the CM, the extent to which it is commingled with other assets in the same account may be relevant to the Segregation Analysis. If the CM holds margin together with its proprietary assets or is able to use the margin, it may be more difficult for customers to demonstrate that the margin was held in a custodial capacity, given the commingling of margin with the CM's proprietary assets or the CM's free use of such margin in its business. (However, for certain entity types—e.g., U.S. FCMs and U.S. banks acting as UCC Article 8 securities intermediaries—any commingling of margin by the CM with its own property does not affect whether customers have proprietary rights in such margin.) Any such commingling of customer assets with proprietary assets may also affect the class of custodial

[40] Judgment as to which of these alternatives is optimal from a customer protection standpoint depends in the first instance upon the allocation of the risk of loss. If margin is held at the CCP or at a third-party custodian, and the CM bears the risk of loss upon the insolvency of the CCP or the third-party custodian, holding away from the CM would clearly enhance customer rights. (We note in this regard that the standard New York law Credit Support Annex and English law Credit Support Deed to the ISDA Master Agreement allocates the risk of a custodian's insolvency to the secured party. However, the parties are free to vary this default risk allocation by agreement.) On the other hand, to the extent the customers are responsible for the risk of loss, judgment as to where the margin should be held is contingent upon a balancing of credit risk, custodial risk, operational risk and other considerations (e.g., additional costs arising from holding at a third-party custodian) for each entity, as customers would effectively be substituting one risk profile for another. This judgment may be affected by whether the third-party custodian is affiliated with the CM, given the possibly heightened risk of a joint insolvency in such a scenario.

claimants with whom customers may be required to share in the event of a shortfall in customer property.

If the CM has commingled a particular CDS customer's margin, not with proprietary assets of the CM, but instead with either (i) other CDS customers' margin or (ii) the custodial property of the CM's other custodial claimants (e.g., trust claimants holding property for safekeeping at the CM), such commingling is not likely to affect the analysis of whether CDS customers have proprietary or contractual rights to the margin—i.e., even if margin is commingled with other custodial property, CDS customers should still have rights to such property superior to those of unsecured creditors of the insolvent CM. However, it may affect the class of custodial claimants with whom the CDS customer may be required to share in the event of a shortfall in custodial property.

Where non-cash margin is held at the CCP or a third-party custodian, it is unlikely to be the case that the margin will be commingled with assets proprietary to the CCP or third-party custodian. However, at least under U.S. law, even if margin were commingled at the CCP or third-party custodian level (as will likely be the case for cash margin) with proprietary or other custodial assets of the CCP or third-party custodian, such commingling should not affect the nature of CDS customers' rights vis-à-vis the CM (i.e., whether the customers have a proprietary interest in the assets or only a contractual right against the CM). In addition, the extent of commingling at the CCP or third-party custodian, and the question of on whose behalf the CCP or third-party custodian is holding the margin—e.g., (a) each CM individually, (b) the CMs collectively, (c) each CDS customer individually, (d) CDS customers collectively or (e) custodial claimants (of the depositing CM) collectively—may affect the class of custodial claimants with whom the CDS customers would have to share in the event of a shortfall in custodial property.

What is the relationship between the CCP, the CM, any custodians and the customers?

Where margin is held at the CCP or a third-party custodian, it is generally the case that, the more direct the contractual relationship between customers and the CCP or third-party custodian, the stronger the corresponding Segregation Analysis becomes. For instance, the notion that ownership of customer margin does not pass to the CM would be buttressed to the extent the CM were acting as agent vis-à-vis the CCP on behalf of customers (rather than as principal). In addition, if the CCP or third-party custodian "knows" customers in this regard, it may be more likely that customers will be able to recover margin directly, rather than from the insolvent CM's insolvency representative.

Is the margin subject to any liens or setoff rights?

To the extent the margin is subject to liens and setoff rights in favor of the CM beyond the rights in respect of cleared transactions, the entity holding such margin may not return the margin to the customer in the event of the CM's insolvency, unless it is absolutely clear that the customer owes no further obligations to the CM. To the extent margin is also subject to liens or setoff rights in favor of affiliates of the CM (e.g., under a cross-margining and netting agreement), the customer's ability to recover the margin may be further complicated. In the event of a dispute regarding entitlement to the margin, the entity holding the margin is likely to either (i) return the margin to the CM's insolvency representatives, or (ii) interplead or deposit the margin with a court and petition the court to require all interested parties to litigate the dispute as between themselves.

Aside from these timing considerations, which are not the primary focus of this Report, it is possible that the imposition of liens on the margin, or the exercise of setoff rights, by CMs or their affiliates could diminish the pool of available margin and result in a shortfall in custodial property. Where margin is held away from the CM, any imposition of liens on the margin, or the exercise of setoff rights, by the CCP, the third-party custodian or other entities (e.g., potential lenders or liquidity providers to the CCP) may also present risks to customers seeking recovery of their margin. The practical import of any such liens should be evaluated on a case-by-case basis.

Is the margin or other custodial property of the CM subject to rehypothecation or on-transfer?

Any rehypothecation or on-transfer of customer margin to third parties (other than to the CCP) may have an adverse effect on customer rights to recover such margin. For certain entity types—e.g., CMs that are acting as UCC Article 8 securities intermediaries who have credited the margin to securities accounts on behalf of customers—the rights of customers who have allowed rehypothecation or on-transfer may, relative to other customers, be adversely affected by rehypothecation or on-transfer. For instance, with respect to such securities intermediaries, if the CM were to transfer control over the margin to a secured creditor, custodial claimants would only have a proprietary claim to the extent of any excess remaining after the CM's obligations to the secured creditor had been fully discharged.

Even if a particular customer does not permit rehypothecation or on-transfer, the customer may be required to share in any shortfalls arising from the claims of other custodial claimants who allowed rehypothecation or on-transfer. Whether this will be the case depends in part upon the applicable sharing rules for a shortfall in custodial property. It may also depend upon certain operational practices that are relevant to the sharing analysis—e.g., whether a securities intermediary debits financial assets from securities accounts upon any rehypothecation or on-transfer, to eliminate such claimants' proprietary rights in the debited financial assets, thereby minimizing the possibility that any resulting shortfall would be shared by CDS customers who did not allow rehypothecation or on-transfer. Considerations relating to a shortfall in custodial property are discussed in further detail in Part II.C. below.

B. Portability Analysis

Portability of positions[41] and related margin is highly desirable, as it reduces the need for position close-outs and resulting transaction costs (e.g., the cost of reestablishing hedged

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41 Although we sometimes refer in this Report to a "transfer" of positions, the porting of positions may also occur by way of novation (and a transfer of related margin).

positions, including bid-offer spreads) and mitigates systemic risk concerns that may arise in connection with the sudden insolvency of a financial institution. As any transfer or novation of positions and related margin requires a willing transferee, it is important to consider the various factors that may diminish or enhance the likelihood that a willing transferee can be found.

As discussed in Part II.A. above, the Segregation Analysis is critical to whether customer positions and related margin are likely to be successfully transferred. To reiterate, the presence of the following factors could significantly enhance the Portability Analysis: (i) margin being held away from the CMs; (ii) margin not being commingled with the property of the CMs, and if possible, not commingled with the property of other custodial claimants of the CMs; (iii) the existence of a direct contractual relationship between customers and the margin holder; (iv) margin being free from liens and setoff rights (except liens and setoff rights in favor of the CCP and the CMs in respect of customer trades); and (v) margin not being subject to rehypothecation or on-transfer by the CMs (except to the CCP as margin for customer trades).

We discuss in Part III below several other considerations that may be relevant to the Portability Analysis, on a CCP-by-CCP basis.

C. Applicable Sharing Rules in the Event of a Shortfall

As noted above, the Segregation Analysis is critical because it affects (i) the likelihood that customer positions and related margin of an insolvent CM will be successfully transferred to another CM and (ii) whether customer rights to margin are proprietary rather than contractual in the event customer positions and related margin cannot be transferred. If customers were to have proprietary rights in the margin, such margin would not form part of the CM's insolvency estate, and customers would not be subject to the claims of unsecured creditors of the insolvent CM. However, in the event of a shortfall in custodial property, customers may be required to share with other proprietary claimants of the insolvent CM. These sharing rules are dependent upon the law that is applicable to the insolvent CM. We provide a brief overview of several potentially applicable sharing rules below.

1. U.S. Banks, U.S. Federal and New York Branches of Non-U.S. Banks and U.S. Unregulated Entities

With respect to U.S. banks, U.S. federal and New York branches of non-U.S. banks and U.S. unregulated entities, if the U.S. bank, branch or unregulated entity is acting as a "securities intermediary" under UCC Article 8 and has "credited" the margin to a "securities account" in the name of the customers (as "entitlement holders"),[42] and the securities

[42] An "entitlement holder" is defined in UCC § 8-102(a)(7) as a "person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary." A "security entitlement" is defined in UCC § 8-102(a)(17) to mean the "rights and property interest of an entitlement holder with respect to a financial asset." A "securities intermediary" is defined in UCC § 8-102(a)(14) as "a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for

intermediary's jurisdiction is the State of New York, the provisions of UCC Article 8 should apply.[43] Under UCC Article 8, such margin is not property of the securities intermediary, and customers would have proprietary interests in the securities intermediary's holdings of financial assets of the same issue (e.g., on a CUSIP-by-CUSIP basis for securities, and likely on a currency-by-currency basis for margin in the form of cash credited to a securities account). Customers would have priority with respect to such financial assets over the claims of unsecured creditors and secured creditors (except secured creditors with control). Any shortfall in financial assets of a particular CUSIP or currency would be shared pro rata between all claimants on whose behalf the securities intermediary credited financial assets of the same CUSIP or currency. The U.S. bank, branch or unregulated entity's proprietary securities or cash would likely be applied to satisfy any shortfalls in margin of the same issue.

If the U.S. bank, branch or unregulated entity is not acting as a "securities intermediary" with respect to the margin or has not credited the margin to a "securities account", it may be possible to create non-Article 8 custodial arrangements with respect to the margin under New York law, so long as there is an express agreement or clear evidence of intent that the parties intended the margin to be held for safekeeping or otherwise segregated. Under such an arrangement, so long as the margin remains traceable at the time of the U.S. bank, branch or unregulated entity's insolvency, customers should be entitled to recover the securities, prior to the claims of depositors and unsecured creditors of the U.S. bank, branch or

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others and is acting in that capacity." It is a factual matter as to whether a U.S. bank, branch or unregulated entity will qualify as a securities intermediary for purposes of UCC Article 8. First, the U.S. bank, branch or unregulated entity would need to be an entity that in the ordinary course of its business maintains "securities accounts" for others. (A "securities account" is defined in UCC § 8-501(a) of the UCC as "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset.") Second, even if the U.S. bank, branch or unregulated entity ordinarily maintains securities accounts for others, the U.S. bank, branch or unregulated entity would also need to be acting in its capacity as a securities intermediary with respect to the account to which customer's securities are credited.

As a result of the ambiguity underlying certain aspects of these definitions, it is unclear to what extent purely custodial claimants may be required to share with certain other counterparties to the U.S. bank, branch or unregulated entity, who may also be entitlement holders vis-à-vis the U.S. bank, branch or unregulated entity under UCC Article 8. Specifically, it is unclear to what extent entitlement holders whose securities have not been rehypothecated will be required to share with entitlement holders whose securities have been rehypothecated but which remain credited to their securities accounts. The answer largely depends on whether the rehypothecated securities in fact remain credited to the relevant entitlement holder's accounts at the securities intermediary. To the extent they remain so credited, entitlement holders who did not permit rehypothecation may be required to share any shortfalls in financial assets of the same issue with entitlement holders who allowed rehypothecation.

[43] The FDIA (in the case of insured U.S. banks and branches), the U.S. International Banking Act and applicable state banking law (in the case of uninsured U.S. branches) and the Bankruptcy Code (in the case of unregulated entities) would almost certainly look to state law in determining the rights of custodial claimants and the sharing of shortfalls in custodial property. See, e.g., In re: Koreag, Controle et Revision S.A., 961 F.2d 341, 349 (2nd Cir.), cert. denied, 506 U.S. 865 (1992) ("Although federal bankruptcy law determines the outer boundary of what may constitute property of the estate, state law determines the 'nature of a debtor's interest' in a given item."); O'Melveny & Myers v. FDIC, 512 U.S. 79 (1994); Butner v. U.S., 440 U.S. 48 (1979).

unregulated entity.[44] The sharing rules in the event of a shortfall in margin held outside of an Article 8 custodial arrangement would be determined under applicable state law. Under New York common law, it is unclear how shortfalls in custodial property would be shared.[45]

It is possible that non-U.S. law may also be relevant to the analysis of customer rights to recover margin, particularly in the case of U.S. branches of non-U.S. banks.

As noted above, the foregoing analysis in the case of U.S. banks, branches and unregulated entities is clearer for margin in the form of securities than it is for margin in the form of cash.

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[44] To our knowledge, with one exception involving a small national bank trust department that, according to news reports, made unauthorized investments of trust funds in affiliated companies, the FDIC has never liquidated a trust department of a failed bank. Instead, it has transferred trust assets to another depository institution promptly after the closing of the institution, either to the acquiror in a bridge bank or other purchase and assumption or similar transaction, or to a third party institution where there was a liquidating receivership of the original institution. Indeed, federal law makes explicit the right of the FDIC as conservator or receiver to transfer trust assets in such transactions. Under federal law, that right can be exercised without the consent of custodial clients. See 12 U.S.C. § 1821(d)(2)(G)(ii); NCNB Texas National Bank v. Cowden, 712 F.Supp.1249 (W.D. Tex. 1989), aff'd, 895 F.2d 1488 (5th Cir. 1990); Cf. 12 C.F.R. § 9.16 (whenever a receiver is appointed for a national bank, the receiver must proceed to close such trust accounts as can be closed promptly and to transfer all other accounts to substitute fiduciaries). Moreover, we are not aware of there ever having been a shortfall in securities held in a trust department of an institution taken into FDIC proceedings. And, as noted above, to our knowledge, in every case in which a large U.S. bank has become the subject of an FDIC receivership proceeding, all qualified financial contracts (e.g., CDS positions) and associated margin of the failed bank were transferred in their entirety to a single bridge bank or third-party acquiror. It follows that there are virtually no recent cases involving the rights of custodial customers in bank insolvencies. Although the margin held by an insolvent CM might not strictly qualify as a "trust" asset, the treatment of trust assets in bank insolvency is nonetheless relevant to this Report – primarily because of the paucity of modern case law addressing the treatment of assets held by a bank in a custodial capacity and the applicable sharing rules.

In addition, New York law generally supports the conclusion that a bank's unsecured creditors have no claim against custodial property. As long ago as 1886, the New York Court of Appeals (New York State's highest court) seemed to view the principle that custodial assets are not subject to creditors' claims as axiomatic. In Corn Exchange Bank of Chicago v. Blye, 37 Hun. 473, aff'd, 101 N.Y. 303 (1886), the Court of Appeals held that a provision of the National Bank Act prohibiting attachments against the property of a national bank prior to final judgment had no application to an action to recover custodial assets from a receiver. The Court of Appeals held, without citation, that "[t]he receiver, by his appointment, acquires no right to property in the custody of the bank which the latter does not own …". Id at 303. In Carnegie Trust Co., 162 App. Div. 76, 147 N.Y.S. 180 (1914), the Court required the New York Superintendent of Banks ("Superintendent"), who had assumed possession of an insolvent trust company, to return to the company's client certain warrants that had been left with the company "for safekeeping" for the client's account. It is significant that, although the assets of the company were vastly insufficient to meet the claims of the company's unsecured creditors, the Superintendent did not claim any right to retain the warrants. See also In the Matter of International Milling, 259 N.Y. 77, 85 (1932); In re De Wind, 144 Misc. 665, 259 N.Y.S. 554 (1932); Van Wagoner v. Buckley, 148 App. Div. 808, 133 N.Y.S. 599 (1912) (Superintendent, as receiver for New York trust company, had no right to trust funds).

[45] The results may depend upon the extent to which common law precedent (including case law pertaining to trust and custodial assets, and pre-1938 case law on stockbroker liquidations) remains good law and would be applied by a modern court.

2. U.S. FCMs

FCMs are required to segregate commodity customer assets from their proprietary assets, and separately account for and deal with such customer assets as belonging to the customers of such FCM. Irrespective of whether commodity customer assets are in fact segregated in the required manner, in the event the liquidation of the FCM is governed by Subchapter IV of Chapter 7 of the Bankruptcy Code ("Subchapter IV") and the rules promulgated thereunder by the CFTC at 17 CFR § 190 ("Part 190"), "customer property" would be distributed ratably to the FCM's "customers" on the basis of, and to the extent of, their allowed "net equity" claims with respect to each relevant "account class" (in the case of each of the foregoing, as defined in Subchapter IV and Part 190). Customer property would be distributed to customers prior to being distributed to unsecured creditors. This mutualized sharing regime among customers cannot be varied by contract—e.g., customers cannot enhance their recovery (relative to other customers of the FCM) by holding margin away from the FCM.

The application of the Subchapter IV and Part 190 framework is not free from uncertainty. Of particular importance in the present context, "customer" is defined in Subchapter IV and Part 190 to encompass only certain entities with a claim on account of, in relevant part, (i) commodity futures traded on, or subject to the rules of, a contract market or board of trade, (ii) commodity options or (iii) any other agreement or transaction that is similar to the foregoing. However, the CFTC has, by issuance of an interpretive statement,[46] construed the definition of "customer" in the Bankruptcy Code to encompass customers of an FCM whose OTC contracts have been cleared through a DCO. If the bankruptcy court administering the insolvent FCM's estate agrees that CDS are "commodity contracts" within the meaning of the Bankruptcy Code, customers clearing CDS through FCMs on a DCO would share in any shortfalls on a pro rata basis with other customers within the relevant account class.[47] There are reasonable arguments that CDS may be viewed as "commodity contracts" for purposes of Subchapter IV and Part 190. However, in light of residual uncertainty as to this issue,[48] we believe there is a significant possibility (in a worst-case scenario) that the

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[46] See 73 Fed. Reg. 65514.

[47] If the CDS margin has been commingled in a "Section 4d" account with property securing commodity futures and commodity options positions entered into through the FCM on a U.S. board of trade, the CDS customers would share in any shortfall ratably with such other customers. If the CDS margin has been commingled in a "Part 30.7" account with property securing commodity futures and commodity options positions entered into through the FCM on a non-U.S. board of trade, the CDS customers would share in any shortfall ratably with such other customers.

[48] As noted by the CFTC in its interpretive statement, "The determination of whether claims relating to cleared-only contracts in Section 4d accounts are properly includable within the meaning of 'net equity' is dependent upon whether an entity holding such claims is properly considered a 'customer.' This, in turn, as discussed below, requires an analysis of whether such claims are derived from 'commodity contracts.'"

The CME has argued in support of the proposition that CDS contracts, once cleared through a DCO such as the CME, constitute "commodity contracts" under the Bankruptcy Code. We received detailed responses (attached in Annex C) to certain questions we raised with the CME on this issue, and believe there are reasonable proposition that cleared CDS contracts constitute "commodity contracts" within the meaning of the Bankruptcy Code may be challenged. Such a challenge, if brought, would most likely originate from other customers of the insolvent FCM (e.g., commodity futures and options customers) forced to share in shortfalls arising from margin deficits on cleared CDS positions, or from unsecured creditors of the estate (particularly if, pursuant to CFTC Regulation § 190.08(a)(1)(ii)(J), the proprietary assets of the FCM are applied to satisfy shortfalls arising from margin deficits on cleared CDS positions).

Ultimately, we believe a court is likely to conclude that CDS are "commodity contracts" (on account of which CDS clearing customers are "customers" within the meaning of the Bankruptcy Code), given the complexity of the legal analysis, the likely reliance of market participants upon the CFTC's interpretation and policy considerations in favor of treating customers clearing CDS through the FCM similarly to other "cleared-only" customers and commodity futures and options customers of the FCM (to the extent CDS margin is commingled with margin for such transactions). However, this outcome is not at all certain. In addition, we also believe that any challenge to the proposition that CDS constitute commodity contracts would likely result in significant delay for customers seeking the return of margin through the insolvent FCM.

In addition, in the context of the insolvency of an FCM that is also a broker-dealer eligible for liquidation under SIPA, the interplay between the stockbroker liquidation provisions of SIPA and the commodity broker liquidation provisions of Subchapter IV and Part 190 is uncertain. SIPA provides that an insolvency representative appointed for a debtor that is a joint BD/FCM has the duties of an insolvency representative in a case under Subchapter IV, in addition to the duties of an insolvency representative under SIPA, but only to the extent consistent with SIPA.

In 1991, the Market Transactions Advisory Committee ("MTAC") was established in accordance with Section 17A(f)(4) of the U.S. Securities Exchange Act of 1934, to investigate (among other matters) issues surrounding the insolvency of a joint BD/FCM. MTAC reviewed applicable law governing the liquidation of joint BD/FCMs "to determine whether significant inconsistencies exist that could lead to confusion or uncertainty for investors or other market participants in the event such a firms [sic] becomes insolvent and needs to be liquidated."[49] It concluded as follows:

> The key problem identified was the possibility that a BD/FCM will become insolvent and its customers' positions will have to be transferred or liquidated. Because a broker-dealer is subject to one regulatory scheme and a futures commission merchant is subject to another, there is the potential in the case of

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arguments that CDS should be treated as commodity contracts, although the risk of a contrary conclusion is not insignificant.

49 Market Transactions Advisory Committee Report, Letter to SEC Chairman Arthur Levitt Jr. (January 13, 1997), p. 12.

> an insolvency of a BD/FCM that the distribution of customer property would be subject to conflicting rules ….
>
> The Advisory Committee understands that representatives from SIPC, the CFTC, and the Commission have met on several occasions since the formation of the Advisory Committee to discuss the priorities and distribution scheme upon an insolvency of a joint BD/FCM where there is a shortfall among assets available to be distributed. The group agreed that after examining the large dollar amounts of customer securities and commodities accounts held by joint BD/FCMs, the distribution upon an insolvency of a joint BD/FCM is an issue which must be addressed.

Notwithstanding MTAC's recommendation, the SEC and the CFTC have yet to develop a common framework for the resolution of a joint BD/FCM in insolvency. These complexities are exacerbated by the ongoing assertions of jurisdiction over CDS by both the SEC and the CFTC. Therefore, in the event the joint BD/FCM becomes insolvent while it still has securities and commodities customers and there is a shortfall in customer property, it is not clear how any such shortfalls would be apportioned among the CDS customers and other custodial claimants and unsecured creditors of the joint BD/FCM.[50]

In the event (i) a court concludes that CDS are not "commodity contracts", and therefore CDS customers are not "customers" within the meaning of the Bankruptcy Code, or (ii) the Subchapter IV and Part 190 framework is otherwise inapplicable (e.g., because the liquidation of the FCM is conducted under a federal equity receivership),[51] the rights of CDS

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50 See A. Corcoran, Bankruptcy Pitfalls for Dually-Licensed Brokerage Firms, Futures International Law Letter, Volume XII, Number 11 (1993). Some of these uncertainties may, however, serve to benefit "customers" of the FCM's estate. As MTAC noted:

> CFTC regulations extend the definition of customer property to include proprietary cash, securities, or other firm property of the BD/FCM to the extent that amounts actually segregated are not enough to satisfy public customer claims. As a result of this extension, proprietary positions, which would otherwise become part of the general estate, could become part of the customer property fund used to satisfy commodities claims. This conflict can treat securities customers and SIPC unfairly by taking funds out of the general estate and giving them to commodities customers. Furthermore, SIPC could lose its right to recover a share of funds from the general estate to pay administrative costs.

Market Transactions Advisory Committee Report, Letter to SEC Chairman Arthur Levitt Jr. (January 13, 1997), pp. 28-29. To the extent CDS customers are deemed to be "customers" of the FCM's estate, it is possible that proprietary assets of the joint BD/FCM may be applied to satisfy any shortfalls in the FCM's estate. It is not at all clear, however, whether the CFTC's interpretation of "customer property" as extending to proprietary assets of the joint BD/FCM would be upheld by a court. See In re Griffin Trading Co., 245 B.R. 291 (Bankr. N.D. Ill. 2000) (court held, in a decision that was vacated pursuant to a subsequent settlement, that the CFTC's interpretation of "customer property" as extending to the proprietary assets of the FCM in the event of a shortfall in customer property exceeded the CFTC's rulemaking authority and was contrary to the Bankruptcy Code).

51 The CFTC does not have plenary authority to initiate Bankruptcy Code proceedings in respect of an FCM. It is therefore possible that, if either a voluntary proceeding has not been initiated by the CM itself or the requisite number of qualifying creditors have not initiated Bankruptcy Code proceedings against the insolvent

customers to recover margin would be unclear, relative to other customers of the FCM and to unsecured creditors of the FCM's estate. For the reasons described above, these uncertainties may be exacerbated if the insolvent CM is a joint BD/FCM.

The outcome in such a scenario may largely depend on whether the FCM commingled the margin for the cleared CDS together with the customer property of commodities customers (e.g., because the FCM believed the cleared CDS were commodity futures or options contracts) or segregated the margin separately.[52] If the margin for the cleared CDS is deposited into an account designated for the segregated customer property of commodities customers, the result is unclear. In a worst case scenario, the margin for the cleared CDS may be treated as customer property of the commodities customers (and not as customer property of the CDS customers) and distributed to the commodities customers (to the extent of their net equity claims) before being made available to the cleared CDS customers or any other creditors. On the other hand, if the FCM segregates assets solely for the cleared CDS customers, then the cleared CDS customers' interest in those assets may be superior to any interest of the

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FCM, the FCM may be liquidated by means of a federal equity receivership (although as a practical matter, we view this as an unlikely possibility for large CMs that are members of a large corporate group). Such a proceeding would be governed by principles of equity, and Subchapter IV and Part 190 would not be directly applicable (although the court could look to the principles set forth in Subchapter IV and Part 190 to serve as a framework for decision-making). The ultimate outcome (from a customer protection standpoint) of a federal equity receivership is not clear.

52 For instance, in a case decided prior to the enactment of Subchapter IV and Part 190, In the Matter of Weis Securities, Inc., 425 F.Supp. 212 (S.D.N.Y. 1977), the court held that claimants trading commodity contracts through an insolvent commodity broker were entitled to have their claims ratably paid from a segregated pool of customer property securing such commodity contracts, to the extent the customer property was actually maintained in segregation. As to any unsegregated balance, however, such claimants merely constituted unsecured creditors of the state.

Andrea Corcoran (former Director of the CFTC's Division of Trading and Markets) and Susan Ervin (former Chief Counsel of the CFTC's Division of Trading and Markets)—in their law review article Maintenance of Market Strategies in Futures Broker Insolvencies: Futures Position Transfers from Troubled Firms, 44 Washington & Lee L. Rev. 849, 863-64 (1987)—described the bankruptcy treatment of commodity customers prior to the enactment of Subchapter IV and Part 190 as follows:

> In the absence of a specific statutory bankruptcy priority for commodity customers, the CFTC and its predecessor agency, the Commodity Exchange Authority, had urged that the bankruptcy courts treat bankrupt FCMs as holding the funds deposited by their customers to margin commodity positions in constructive trust. Under this approach, the FCM would have no access to such funds to satisfy its own obligations, and hence its trustee in bankruptcy as a direct successor in interest, likewise would "have no ownership interest in customers' funds deposited as margin in their accounts." Further, under this view, to the extent that such funds could be traced and identified, they would be recoverable by the depositing customer. Although bankruptcy trustees (and bankruptcy courts) generally had recognized the claims of commodity customers to funds in segregation, such decisions had lacked a clear rationale and commonly employed a makeshift extension of traditional trust law or an application of the law governing the bankruptcies of securities broker/dealers prior to 1938. In the CFTC's view at the time bankruptcy reform was being contemplated in the 1970s, the most serious deficiency in these ad hoc approaches was that they lacked a definitive legal theory and had not been endorsed by any appellate court.

commodities customers or unsecured creditors of the FCM, although this conclusion is not certain.

3. English Firms (FSA-Regulated Firms)

(a) Scope of CASS Rules

Firms authorized and regulated by the Financial Services Authority of the United Kingdom (the "FSA") (which would include English banks and English broker dealers conducting regulated activities) are required to comply with the rules contained in the Client Assets Sourcebook ("CASS") issued by the Financial Services Authority (the "FSA") relating to client money and client assets ("FSA-regulated firms"). CASS does not apply to an entity incorporated in a European Economic Area ("EEA") member state other than the U.K. if such entity is regulated in its home state for the "passported" activity that is to be provided in the U.K.[53] However, as CASS is based on the Markets in Financial Instruments Directive (Directive 2004/39/EC), similar rules are likely to apply to firms that are regulated elsewhere in the EEA. Thus, English branches of entities authorized and regulated in other EEA member states (for example, London branches of French and German banks) are outside the scope of CASS. However, English branches of entities not authorized and regulated in an EEA member state (for example, London branches of Swiss banks) are required to comply with CASS as they will be regulated by the FSA if they conduct regulated activities in the U.K.

(b) Client Money

An FSA-regulated firm receives and holds "client money"[54] as a trustee pursuant to a statutory trust.[55] FSA-regulated firms are required to segregate client money from their own house funds promptly upon receipt by depositing them with a central bank, certain authorized credit institutions or qualifying money market funds.[56] On the insolvency of an FSA-regulated firm, CASS 7A.2.4R states that client money held in each "client money account" of the firm is treated as pooled and the firm must distribute that client money so that each client receives a sum which is ratable to its client money entitlement.

However, it is unclear how the pooling would work in practice, particularly in more complex insolvencies given that these provisions of the CASS rules only came into force in November 1, 2007. Specifically, there are concerns as to what actually constitutes the client money pool and who has a claim to the pool. As a result, the administrators of LBIE have

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[53] CASS 1.2.3R: "CASS does not apply to … an incoming EEA firm … with respect to its passported activities."

[54] "Client money" is defined in CASS 7, which states that the Client Money Rules apply to "a firm that receives money from or holds money for, or on behalf of, a client in the course of or in connection with its MiFID business and/or its designated investment business…". However, "client money" does not include money transferred by a client to a firm pursuant to a title transfer collateral arrangement. CASS 7.2.3R.

[55] CASS 7.7.

[56] CASS 7.4.1R.

made an application to the English High Court on May 1, 2009 for directions seeking clarification of certain of the CASS rules relating to client money held by LBIE. In particular, the LBIE administrators draw attention to the fact that "client money account" is not a defined term in the CASS rules and that the glossary definition of "client bank account" does not clearly explain whether, for example, a house account containing client money (which LBIE was required or intended to segregate, but did not) is a client bank account for the purposes of CASS 7. The administrators have also asked the court whether clients for whom LBIE should have segregated client money but for whom it did not should nonetheless receive a distribution from the client money pool. The administrators have indicated that they take the view that clients should not receive such a distribution. This is consistent with the recent Global Trader case,[57] in which the English High Court held that clients whose money had not been segregated had no proprietary claim against the general assets of the broker, nor a right to share in the pool of client assets, unless they could trace those monies through the shared pool (which in practice will be very unlikely). Accordingly, their claims ranked as unsecured creditors of the firm only.

In the Global Trader case, the judge also imposed a further limitation, because he regarded profits on trading as not capable of constituting client money unless and until they had been segregated in a client money account. If the decision stands on this point, it means that profits on trading will not be regarded as client money even if traceable, unless they have at some time been placed in a segregated client money account.

It is reasonable to expect that, absent changes in the U.K. to the CASS rules, litigation arising from recent failures of financial institutions (such as LBIE and the Icelandic banks) will eventually provide answers to some of the questions arising out of complex administrations of entities holding client money. However, the judicial interpretation of these questions will not necessarily be determined in favor of protecting the margin of customers to the detriment of unsecured creditors and further regulatory or legislative changes would be needed if there is a policy shift to make paramount the protection of customer margin and its timely return to customers, or successor CMs.

(c) Client Assets

FSA-regulated firms must, when holding safe custody assets (e.g., initial margin in the form of securities) belonging to clients, make adequate arrangements to safeguard clients' ownership rights[58] and have adequate organizational arrangements to minimize the risk of the loss or diminution of clients' safe custody assets.[59] These are principle-based requirements, so firms have a certain amount of discretion as to how they segregate client assets in practice.

Unlike the client money rules, there are no corresponding rules under CASS in relation to the pooling of client assets in the event of a shortfall, and the statutory trust is in different

[57] Re Global Trader Europe Ltd (in liquidation) [2009] EWHC 602 before Sir Andrew Park.

[58] CASS 6.2.1R.

[59] CASS 6.2.2R.

language (without any specific requirement for segregated client accounts). Following the Global Trader case, it is possible that clients whose assets had not been segregated and could not be specifically identified or otherwise traced would have no proprietary claim against any assets of the insolvent firm, nor a right to share in the pool of segregated client assets. Accordingly, there is a risk that they will rank as unsecured creditors of the firm in respect of their claims for the return of their assets.[60]

(d) Banking Act 2009

It is at present unclear how the broad powers granted to the U.K. government pursuant to the Banking Act 2009 will affect the existing regime dealing with "client money" and "client assets" as it applies to CMs which carry on the regulated activity of accepting deposits. On insolvency of such a CM, the U.K. government could, in certain circumstances, transfer to a private sector purchaser some or all of the CM's property, rights and liabilities. These powers are expressed to extend to "property held on trust" but it is not clear whether this means property held by the CM as trustee, or property held by a third party "on trust" for the CM. Secondary legislation[61] has been implemented with the objective of ensuring that partial transfers of a bank's assets by the government do not interfere with netting and collateral arrangements. This secondary legislation makes a partial transfer of an insolvent bank's assets invalid if it conflicts with the Settlement Finality Directive, Part VII of the Companies Act 1989, or the legal protections afforded to title transfer financial collateral arrangements. This means that arrangements between "recognized clearing houses" and their members, or which are title transfer financial collateral arrangements, should not be affected by any exercise of the government's powers under the Banking Act 2009. Security arrangements between a clearing house and its members can be affected, but any collateral can only be transferred if the underlying secured liabilities are also transferred.

The Banking Act 2009 is relatively new and, at the time of writing, completely untested. It remains to be seen whether the U.K. government would exercise (to the extent it can) the powers available to it under the Act to interfere with a clearing house's own segregation or portability arrangements.

(e) Trusts (other than the CASS client money trust)

Cash or securities that are segregated and held "on trust" by a CM under an express trust (as envisaged above under "Posting of Margin") would be held by the CM for a specified

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[60] The LBIE administration is proposing a novel application of a scheme of arrangement under Part 26 of the Companies Act 2006 in relation to trust property/client assets. A scheme of arrangement is generally conducted between a company and its members or creditors (or any class of them) and not between the company and their clients for whom its holds assets. Such a trust property/client asset scheme of arrangement, if approved, will govern the return of segregated client assets held by LBIE and how any shortfalls in client assets are shared among the parties with a claim for the return of client assets. Although unlikely to change the legal framework for sharing deficiencies in the client assets, the LBIE scheme, if completed, may as a practical matter affect the outcome for the holders of client asset claims.

[61] The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009.

group of customers as beneficiaries to the extent specified by the terms of the trust and should not be vulnerable to sharing with other claims of those same customers or any claims of other customers of the CM (in contrast to the sharing position in the case of "client money" under CASS).

4. French Financial Institutions and English Branches of French Banks

For the purpose of this Report, we have assumed that French CMs would be French regulated financial institutions (i.e., licensed credit institutions, including banks, and investment firms licensed to provide investment services, including broker dealers) incorporated in France.

French CMs are required to segregate customer funds and assets from their proprietary funds and assets, and separately account for and deal with such property as belonging to the customers of such French CM.

Under French law, margin validly posted to cover financial obligations resulting from any transaction on financial instruments[62] between a customer and a regulated financial firm, including any CDS transaction,[63] constitutes financial collateral (whether the margin is transferred via title transfer or via security interest). Under French conflict of law rules, the rights and obligations of the customer, the French CM and third parties (including the customer's and the CM's creditors) in financial collateral which consists of securities are determined by the law of the jurisdiction where the custodian that maintains the account in which the securities are booked is located. With respect to financial collateral which consists of cash, pursuant to French conflict of laws rules, we believe, although this is not entirely free from doubt, that (i) the law governing the rights and obligations of the customer and the CM would be the law governing the financial collateral arrangement and (ii) the law governing the rights and obligations of any third parties would be the law of the jurisdiction where the custodian that maintains the account in which the cash is booked is located.

French insolvency law would, in principle, respect and give effect to the rights validly acquired under the non-French law to which the above-mentioned conflict of law rules would point, provided that such rights are comparable to French law rights to the same effect. French insolvency law would then, in principle, give the same effect to such non-French rights as to the comparable French rights.

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[62] Under French law, financial obligations are generally construed to include the obligations to make any cash payment and/or to deliver financial instruments.

[63] Under French law, the derivative contracts enumerated in a list set forth in Article D.211-1A of the French Monetary and Financial Code qualify as financial instruments. Such list includes in particular the following derivative contracts: (i) options, futures, swaps, forward rate agreements and any other derivative contracts relating to financial instruments, currencies, interest rates or yields, financial indices or financial measures which may be settled physically or in cash; and (ii) derivative instruments for the transfer of credit risk. Accordingly, CDS generally qualify as financial instruments under French law.

(a) French Financial Institutions Acting from France

Assuming that the margin (cash or securities) is booked in an account maintained at the French CM in France and pursuant to a valid French law-governed arrangement, based on the above conflict of law rules, French law would apply to determine the rights and obligations of the customer, the French CM and third parties in such margin.

(i) Margin Transferred Via Title Transfer

In France, financial collateral is generally transferred via title transfer. In this case, French law (Article L.440-7 of the French Monetary and Financial Code) provides that the margin posted with a French CM (whether deposited with the CM directly or in an account opened in the CM's name with a custodian) to cover positions in a market in financial instruments (which would include, although this is not entirely free from doubt, any positions on financial instruments traded on the OTC market such as CDS) is dedicated to cover (i) any loss resulting from the liquidation of the customer's open positions and (ii) any amount due to the French CM. Under this regime, creditors of the French CM have no right in such margin. In the event that an insolvency proceeding is commenced against the French CM in France, the customer would have priority over the claims of unsecured and secured creditors of the insolvent CM to recover the margin (after deduction of any above-mentioned losses and amounts due). It is, however, doubtful that this special regime would apply to margin posted by way of title transfer with a French CM in connection with the clearing of CDS positions with any non-French CCP.

French law (Article L.330-2 of the French Monetary and Financial Code) also provides that creditors of any participant, whether direct or indirect, in a "securities settlement system" (a "System") within the meaning of Article L.330-1 of the French Monetary and Financial Code, which implements Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems ("SFD"), shall not have any right in the margin posted in accordance with the System's rules to secure any payment obligations arising from the participation in such System, whether or not insolvency proceedings have been commenced against the participant.[64] This rule is primarily intended to protect the Systems' rights with respect to margin posted with them by any participant from such participant's insolvency. Absent any case law or other guidance on point, it is uncertain whether this rule would apply to protect the customers' rights in the margin. If, however, this were the case, in order to benefit from this rule, customers would need to qualify as an indirect participant in the concerned System, which may be subject to certain restrictions.

If none of the above-mentioned special regimes is applicable to French CMs of a non-French CCP, then the segregation and loss sharing rules applicable to margin transferred via

[64] Article L.330-2 of the French Monetary and Financial Code applies to French Systems but, in the event of an insolvency proceeding commenced in France against a French CM, although this is not free from doubt, the French insolvency court is likely to apply this rule to margin posted with another EEA System.

title transfer to the CM (whether deposited with the CM directly or in an account opened in the CM's name with a custodian) would be as follows:

(x) with respect to margin which consists of cash: the cash transferred to the CM by the customer would be commingled with other cash held by the CM and therefore the customer would not be entitled to segregate any such cash and, in case of the CM's insolvency, would be an unsecured creditor of the CM in this respect; the customer would thus share in any shortfall on a pro rata basis with other unsecured creditors of the CM; and

(y) with respect to margin which consists of securities: to the extent that the securities so transferred are booked in an account opened in the name of the CM (which should be the case if margin is posted by way of title transfer), French insolvency courts would consider that the customer would be an unsecured creditor of the CM in respect of such margin and therefore would share in any shortfall on a pro rata basis with other unsecured creditors of the CM.

(ii) Margin Transferred Via Security Interest

In the event that margin is transferred to the French CM via pledge and assuming that the special regime provided in Article L.330-2 of the French Monetary and Financial Code is not applicable, the following rules would apply in the event that an insolvency proceeding is commenced against the French CM in France:

(x) Customer Money

French courts would consider that the cash deposited with and pledged to the CM by the customer would be commingled with other cash held by the CM, even (i) if such cash is booked in an account opened in the name of the customer or (ii) if such cash is booked in an account opened with the CCP in the name of the CM, which holds it as agent on behalf of its customers, where the customer has no direct relationship or right against the CCP (e.g., as may be the case at ICE Trust—see Part III.A.2(e)). Accordingly, the customer would not be entitled to segregate any such cash and, in case of CM's insolvency, would be an unsecured creditor of the CM in this respect and therefore share in any shortfall on a pro rata basis with other unsecured creditors of the CM.

(y) Customer Securities

Customers are entitled to segregate the securities held in custody by the French CM, provided that such securities are booked in an account opened in the name of the customer.[65] Upon the commencement of the French insolvency proceeding, the French insolvency representative would count each type of securities held by the French CM in the books of

[65] Under French law, customers have proprietary rights in the securities recorded in the security accounts opened in their name at any custodian.

central depositaries or other financial institutions. In the event of a shortfall between the aggregate positions of customers in any particular securities as shown on the French CM's own books and the position of the French CM in such securities with the central depositaries and other institutions, the shortfall is pooled among all customers on a pro rata basis (i.e., among all claimants, regardless of whether they have or have not allowed rehypothecation). Once the counting and allocation have been made, clients may require that the financial instruments allocated to them be transferred to another financial institution. For the remainder of the shortfall, they become unsecured creditors of the French CM.

(b) English Branches of French Banks

In respect of an English branch of a French bank, French courts will have exclusive jurisdiction to open insolvency proceedings. Such proceedings will be governed by French insolvency law and, in principle, will relate to all assets and liabilities of the insolvent bank, irrespective of where such assets and liabilities are located or what law governs them. There are, however, certain deviations to this principle including as set forth below with respect to margin consisting of securities.

(i) Client Money

With respect to margin which consists of cash, whether transferred to the English branch of the French bank via title transfer or pledge, the French insolvency court would consider that it would be commingled with other cash held by the CM and therefore, in the case of the CM's insolvency, the customer would be an unsecured creditor of the CM and therefore share in any shortfall on a pro rata basis with other unsecured creditors of the CM.

(ii) Customer Securities

In the event that the French CM becomes subject to insolvency proceedings in France, with respect to the securities transferred as margin, French courts would point to the law of the jurisdiction where the account, register or centralized deposit system in which the securities are recorded is held or located, in order to determine the rights in such securities as well as the effect of the insolvency on such rights, provided that (i) the existence or transfer of such securities requires their recording in an account, a register or a centralized deposit system and (ii) such account, register or centralized deposit system is held or located in an EU Member State.

Accordingly, assuming that (x) the securities transferred as margin are booked in an account maintained at the English branch of the French bank and (y) the existence or transfer of such securities requires their recording in such account, French insolvency courts would point to English law (being the law of the place where the English branch of the French CM maintains the account in which the securities are booked is located) to determine the rights and obligations of the customer, the English branch of the French bank and third parties on such margin. French law would also point to English law if the securities posted as margin are recorded in a register or a centralized deposit system held or located in England under the same conditions as mentioned above.

5. German Financial Institutions and English Branches of German Banks

(a) Client Money

Under Section 34a of the German Securities Trading Act (*Wertpapierhandelsgesetz*), investment services enterprises (*Wertpapierdienstleistungsunternehmen*) are required to promptly segregate from their own funds any client monies and securities which they receive in connection with the performance of investment services for their customer. Generally, a German CM (including CMs that are English branches of German credit institutions) entering into CDS transactions on a regular basis would constitute an investment services enterprise within the meaning of Section 2(4) of the German Securities Trading Act.

The segregation of client monies and securities is effected by depositing them in segregated trust or custodian accounts with a third-party credit institution authorized to conduct deposit-taking business (or safe custody business, as applicable) in Germany, or an eligible credit institution domiciled abroad. Client monies and securities of different customers have to be segregated from each other. An investment services enterprise may deviate from these requirements only with the consent of the customer, which consent must not be contained in the enterprise's standard business terms. Any client monies and securities so deposited by the CM in trust accounts or custodian accounts would not form part of the insolvency estate of the CM.

If the CM, however, qualifies as a deposit taking credit institution (*Einlagenkreditinstitut*), client monies need not be (but can be) segregated from the CM's own funds or other clients' monies pursuant to such rules. The same applies if the CM accepts securities and is itself licensed to engage in safe custody business (*Depotgeschäft*). Accordingly, if a German CM licensed to engage in deposit-taking business (in the case of client monies) or a German CM licensed to engage in safe custody business (in the case of client securities) does not segregate the client monies or securities deposited with it in trust or custodian accounts with third parties, such assets generally would form part of the CM's insolvency estate, unless they can be excluded from the insolvency estate for other reasons (see below).

(b) Client Assets

(i) Securities Accounts Maintained in Germany

As a general matter, the location of the CM's branch that maintains the relevant securities account determines the applicable legal regime for the purposes of allocating shortfalls in custodial property consisting of securities deposited as collateral with a CM by its customers. Similarly, if the securities are deposited with a custodian of the customer, it is decisive where such custodian is located. Thus, in principle, if German insolvency proceedings are opened with respect to a CM (including an English branch of a CM that is a

German credit institution), German conflict of law rules result in the application of German law in respect of the allocation of shortfalls in securities if the securities account in which the respective securities are booked with constitutive effect[66] are maintained by the main office or a branch of the CM or the custodian, as applicable, which is located in Germany.[67]

(x) German Securities

Generally, if a customer deposits with a custodian bank (including a CM licensed to engage in safe custody business) securities ("German securities") that are held in collective safe custody (*Sammelverwahrung*) with the German central securities depository (*Wertpapiersammelbank*, currently Clearstream Banking AG), such securities will be held by the custodian bank in its securities account with the central securities depository in collective safe custody and credited to the customer's securities account on the books of the custodian bank. In collective safe custody, securities of the same category are held in a collective deposit for all custodian banks and their customers depositing such securities (Section 5 German Safe Custody Act). Under German law, each customer becomes a co-owner (*Bruchteilseigentümer*) of the total number of the respective securities so held in collective safe custody. This co-ownership right entitles the customers, in case of the insolvency of the custodian bank, to segregate (*aussondern*) their respective securities from the insolvency estate of the custodian bank (Section 47 of the German Insolvency Code (*Insolvenzordnung*)).

There is no explicit rule in the German Safe Custody Act addressing how potential shortfalls in securities that are held in collective safe custody would be shared among the customers of the custodian bank, in the event of the insolvency of the custodian bank. The concept of sharing shortfalls on a pro rata basis, however, is applied by other provisions of the

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66 Section 17a of the German Safe Custody Act (*Depotgesetz*) applies to disposals of securities which are entered into a register or booked in an account "with constitutive effect" (*mit rechtsbegründender Wirkung*). The meaning and implication of the words "with constitutive effect" in this context are highly disputed among German legal commentators, and, with one exception, we are not aware of any clarifying court ruling on point. Although there are good arguments that "with constitutive effect" means simply the recording of the transfer or the grant of security in a register or an account, some authors suggest that the wording has to be taken literally. If taken literally, only transactions for which the entry in a register or the booking in an account, respectively, *effects* the transfer or encumbrance of the affected securities are subject to Section 17a of the German Safe Custody Act. However, construing the meaning of the words "with constitutive effect" in such a manner is circular because whether a register entry or account booking is indeed "constitutive" within such meaning is a matter of applicable law, which law Section 17a of the German Safe Custody Act seeks to determine. Accordingly, Section 17a of the German Safe Custody Act would effectively become inoperative and expose the determination of the law applicable to the transfer and encumbrance of securities to considerable legal uncertainty. For a range of possibly applicable laws in this context, see the next footnote.

67 Section 17a of the German Safe Custody Act. Note that German law would also be applicable if (i) the law governing the security provides that the transfer of ownership or grant of security interest required the delivery of a certificate and such certificate is physically located in Germany upon the completion of the transfer or grant, (ii) the law governing the security provides that the transfer of ownership or grant of security interest requires an endorsement of a certificate, the delivery and endorsement of a certificate, or where the certificate bears a blank endorsement, and the certificate is physically located in Germany upon the completion of the transfer or grant, or (iii) the respective securities are governed by German law and their transfer does not require the delivery or endorsement of a certificate.

German Safe Custody Act. Pursuant to Section 7(2), the central securities depository generally will be liable for any loss occurring to the collectively held securities. However, if the loss was caused by circumstances beyond the central securities depository's control, the co-owners of the collectively held securities will bear such loss on a pro rata basis. In addition, according to Section 32 of the German Safe Custody Act, certain creditors which hold contractual claims for the delivery of securities against an insolvent custodian bank and who have fulfilled their contractual obligations *vis-à-vis* the insolvent custodian bank, have the right to preferential satisfaction of their delivery claims. If the insolvent custodian bank holds the respective securities in its proprietary accounts with the central securities depository, but has not yet credited the newly-acquired securities to a customer's account, such customers may claim delivery of such securities irrespective of the custodian bank's insolvency. If the custodian bank's account with the central securities depository does not contain a sufficient number of securities to discharge all such claims, the available securities are distributed among such preferential creditors on a pro rata basis, proportionate to the amount of their outstanding claims (Section 32(3) of the German Safe Custody Act).

Neither Section 7(2) nor 32(3) of the German Safe Custody Act explicitly addresses the question of how customers would share in shortfalls of a particular security if the custodian bank does not hold a sufficient number of securities in its account with the central securities depository. We believe, however, that such provisions set forth a principle which should be applied generally. In addition, German law co-owners (*Bruchteilseigentümer*) benefit from, and bear the risks and losses associated with, the co-owned asset proportionate to their respective holdings (Sections 741, 743, and 748 of the German Civil Code, *Bürgerliches Gesetzbuch*), unless they agree otherwise. Accordingly, we would expect a German court to apply the pro rata principle of Sections 7(2) and 32(3) of the German Safe Custody Act and Sections 741, 743, and 748 of the German Civil Code generally to shortfalls on the books of a custodian bank with respect to securities held in collective safe custody for the custodian bank. Accordingly, customers would likely share any shortfall in securities of the same category which are held in collective safe custody through the central securities depository on a pro rata basis if the custodian bank becomes subject to German insolvency proceedings and does not hold a sufficient number of securities in its customer account with the central securities depository. To the extent that it can be established that certain creditors have lost their segregation right, e.g., because the debtor rehypothecated the asset, such creditors would likely not share the remaining (customer) assets of the same class with other creditors who (still) have proprietary interests in such assets, but rather be deemed to have an unsecured claim for the return of assets of the same type.

(y) Non-German Securities

Under German credit institutions' standard business terms, German custodian banks do not convey to their customers legal title to securities ("non-German securities") that the custodian acquires abroad on their customers' behalf. Instead, the German custodian banks acquire title to (or equivalent rights under non-German law) to the non-German securities and hold such rights "on trust" for their customers, and the customers have a claim against their custodian bank for the delivery of the securities (*Wertpapierrechnung*). Although such delivery claim does not constitute a proprietary right within the meaning of German law, the prevailing view among German commentators is that it nevertheless entitles the customer to the segregation of the non-German securities if the custodian bank becomes subject to German insolvency proceedings. Based upon this similarity with German securities held in collective safe custody, we believe that a shortfall in the insolvent custodian bank's non-German securities' also would likely be shared among the custodian bank's customers on a pro rata basis. This is further supported by German credit institutions' standard business terms, under which customers for whom the custodian bank holds non-German securities "on trust" bear (proportionate to their holdings) all risks of losses occurring with respect to such securities if the loss is caused by *force majeure* or any other event beyond the custodian bank's control.

(ii) Securities Accounts Maintained by Non-German Branches of German Banks

If the securities account in which the securities are booked with constitutive effect is maintained by a non-German branch of the German credit institution, e.g., an English or U.S. branch of a German credit institution, or if the register in which the securities are registered with constitutive effect, as applicable, is subject to a law other than German law, the law of the jurisdiction where such branch is located or which governs the register, as applicable, should generally govern the rights of the customers as to these securities. German insolvency law is, from a German law perspective, applicable to the assets and liabilities of the debtor irrespective of where such assets or liabilities (including the assets and liabilities of a German credit institution's English branch) are located. German insolvency law would, in principle, respect and give effect to rights under non-German law that the customer has validly acquired in such securities in accordance with German conflict of law rules, provided that these rights are comparable to German law rights, and submit them to the same rules as comparable German law rights. Accordingly, German courts might apply the law applicable to such rights in order to determine how any shortfalls are to be shared. Or, alternatively, if the German courts did not apply such law, they could apply a pro rata sharing approach based upon the German law principles described above. In such a case, the relevant assets not forming part of the estate of the debtor would be shared among all creditors who are entitled to the segregation of the assets. To the extent that it can be established that certain creditors have lost their segregation right, e.g., because the debtor rehypothecated the asset, such creditors would likely not share the remaining (customer) assets of the same class with other creditors who (still) have proprietary interests in such assets, but rather be deemed to have an unsecured claim for the return of assets of the same type.

6. Swiss Financial Institutions and English Branches of Swiss Banks

(a) Scope of Discussion

The following discusses the Swiss law rules applicable to Swiss CMs that are banks incorporated and licensed in Switzerland and Swiss branches of non-Swiss banks licensed in Switzerland, and English branches of Swiss Banks.

(b) No Duty to Hold Client Money and Assets Segregated

There is no Swiss law statutory duty of Swiss Banks to hold client money or client assets segregated from their own or other clients' money and assets, it being understood, though, that in its books (but not the books of a third party custodian), the Swiss Bank would need at all times to identify monies and assets belonging to a particular client. That being said, it should be noted that, although the MiFID is not applicable in Switzerland, Swiss Banks may have implemented MiFID standards and agreed to adhere to these as a matter of contract and thereby agreed to a segregation of client money and assets as provided for by MiFID.[68] Furthermore, Swiss Banks may have otherwise contractually agreed to hold such client assets segregated.

(c) Sharing of Shortfalls

In the event of a shortfall, we are of the understanding that the CCP rules will provide for how such shortfall is to be allocated to the relevant omnibus accounts and with that to the relevant CMs and their customers.

While not being expressly provided for by statutory law, it is held that, in the event of the insolvency of a Swiss Bank, in a first step, its own assets held by the CCP (absent segregation at the CCP level) will be taken to cover any shortfall in its clients' assets. In a second step, if after such allocation a shortfall persists, the clients will share in such shortfall pro rata. Absent a Swiss Bank's insolvency, the Swiss Bank's assets held with the CCP, as far as they are not segregated from its client's assets, will also be taken to cover the shortfall in its clients' assets.

(d) Segregation Upon the Insolvency of a Swiss Bank

In an insolvency (*Bankenkonkurs*) of a Swiss Bank, certain assets do not form part of the Swiss Bank's insolvency estate, irrespective of the fact that the Swiss Bank may be the *legal* owner thereof, but may be segregated in favor of the customers pursuant to articles 16 and 37d of the Swiss Federal Banking Act ("BA"). In particular, such segregation right applies to the following assets which are deposited in a custody account of the client (*Depotwerte*): (i) tangible assets and certificated or uncertificated securities which are owned or held by the Swiss Bank's clients, (ii) tangible assets, certificated and uncertificated securities and claims owned or held by the Swiss Bank on a fiduciary basis for its clients and (iii) certain claims of the Swiss Bank against third parties which the Swiss Bank has acquired for the account of its clients. In addition, if the Swiss Bank has placed the aforementioned assets with certain Swiss or non-Swiss sub-custodians, the relevant assets or claims against the sub-custodians may also be segregated (article 37d par. 2 BA). In this case, there is a statutory presumption that any assets being placed in such sub-custodian custody account are assets belonging to the insolvent's clients. Furthermore, in the case of sub-custody, the liquidator of the Swiss Bank

[68] In the case of a Swiss branch of a non-Swiss bank, the laws applicable to the non-Swiss bank in its home country (to which we cannot speak), including the applicable implementation of MiFID, may provide for such duties and declare them applicable to its branch.

will have to ensure that the bank complies with its contractual obligations under the relevant fiduciary deposits in order to protect the customer's claims thereunder (article 37d par. 3 BA).

Client money deposited with a Swiss Bank, on the other hand, is not segregated upon the insolvency of the Swiss Bank. Pursuant to article 37b BA, clients have a priority claim against the Swiss Bank for certain deposits. This priority is, however, limited to deposits up to CHF 100,000 per client.

(e) Portability Upon the Insolvency of a Swiss Bank

If there is reasonable concern that a Swiss Bank is overindebted or has serious solvency issues, the Swiss Financial Market Supervisory Authority ("FINMA") may impose protective measures as provided for by articles 25 et seq. BA that may limit the Swiss Bank's ability to dispose, possibly including the ability to transfer, or agree to a transfer of, the relevant transactions. It is however conceivable that FINMA would agree to such a transfer as such a protective measure.

Should a Swiss Bank become insolvent on the other hand and as a result of this be adjudicated bankrupt (*Bankenkonkurs*) by FINMA, it loses all capacity to dispose of its assets, and any power of attorney granted to or by the bankrupt Swiss Bank extinguishes as a matter of law. A Swiss Bank would therefore lack the legal capacity to agree to a transfer of transactions; the authority to decide on and agree to such transfer would rest with the receiver in insolvency. An advance consent of a Swiss Bank to such a transfer would probably not be sufficient to implement such transfer after the adjudication of bankruptcy, in particular not to implement a transfer of any margin with the contracts.

(f) Rehypothecation Issues

With respect to securities being used as margin, the following issue is of importance: Pursuant to article 17 par. 1 BA (which will be replaced by a similar provision set forth in the Swiss Federal Act on Book Entry Securities on January 1, 2010), a Swiss Bank may not use as collateral or enter into a repo in respect of assets which have been pledged to it by a client without such client's written consent, which needs to be granted on a separate form. Article 17 par. 2 BA and article 33 of the implementing ordinance to the BA further restrict the Swiss Bank's right to use the pledged assets.

According to the predominant view in legal doctrine, article 17 BA not only applies to assets which have been pledged under a regular pledge (*reguläres Pfandrecht*) to a Swiss Bank pursuant to articles 884 et seq. of the Swiss Civil Code, but also to movable assets and claims which have been transferred or assigned, respectively, for security purposes (*Sicherungsübereignung und Sicherungszession*). Still pursuant to this view, if on the other hand, the movable assets and claims have been made subject to an irregular pledge (*irreguläres Pfandrecht*) article 17 BA is held not to apply for the following reasons: In case of an irregular pledge title to the relevant assets is transferred to the pledgee. Upon the security interest being released, the pledgee (contrary to a transfer of title for security purposes or an assignment) merely has the obligation to return assets which are of the same sort and quality but not necessarily identical to the assets which have been transferred to the pledgee originally. Hence, it is held that the pledgee is under no particular custody obligation with respect to the individual assets which have been made subject to an irregular pledge and, consequently, the underlying rationale for the restrictions of the right of use as set forth in article 17 BA is not applicable.

In addition, article 17 par. 2 BA limits the amount for which such securities may be rehypothecated to the amount for which the securities have been pledged, transferred or assigned to the Swiss Bank. As a consequence of this latter limitation (which will have no equivalent under the revised law which will enter into force on January 1, 2010), where collateral is granted by means of a security arrangement that does fall under article 17 BA, it is does not appear that a Swiss Bank could use such collateral to post margin with a CCP as the use of such margin would not be limited to such amount.

That being said, the Federal Banking Commission (the predecessor organization to FINMA) has clarified that the above restrictions imposed by article 17 BA do not apply to security arrangements which are entered into in order to secure payment and performance obligations within the context of clearing systems.

Furthermore, in practice, it is not uncommon to see arrangements between a Swiss Bank and its clients providing for margin arrangements mirroring the ones agreed upon by the Swiss Bank and the CCP. Under such arrangements, clients post margin in form of securities to the Swiss Bank which in turn posts margin to the CCP using its own securities. Additionally, it is not uncommon to see that Swiss Banks explicitly include irregular pledges in their contractual arrangements to solve the aforementioned problem.

III. Analysis of CCP Responses to Questionnaires

The following is a summary of our analysis of the CCP's responses to the questionnaires. For each CCP, we highlight certain responses relevant to the issues discussed above. We then summarize the CCP's requests for legal change or clarification, and discuss what we perceive to be the primary remaining issues for each.

A. U.S. CCP Solutions

1. CME

(a) Segregation Analysis

CMs clearing customer trades through the CME must be registered FCMs, subject to regulation by the CFTC. Consequently, customers clearing CDS through the CME will be required to maintain a clearing relationship with an FCM, which will serve as their agent and guarantor in respect of cleared CDS.[69] From the CME's perspective, its counterparty for cleared CDS will consist of each CM, with the CM acting as agent for unidentified principals[70]—e.g., the customers.

Under the CEA, an FCM must segregate in an account separate from its proprietary account (and deal with as belonging to the relevant customer) any property received from its customers to margin, guarantee or secure commodity futures or commodity options (i) traded on a U.S. exchange, pursuant to Section 4d(a)(2) of the CEA (such an account, a "4d Account"), or (ii) entered into by U.S. customers and traded on a non-U.S. exchange, pursuant to Part 30.7 of the CFTC Regulations (such an account, a "30.7 Account"). In addition, a clearing organization must separately segregate in an account separate from its proprietary account (and deal with as belonging to customers of the relevant FCM) any property received from an FCM's customers to margin, guarantee or secure commodity futures or commodity options traded on a U.S. exchange, pursuant to Section 4d(b) of the CEA (such an account also referred to herein as a "4d Account").

The FCM or clearing organization (as applicable) must generally maintain its 4d Account or 30.7 Account at a qualifying bank, trust company, clearing organization or other FCM (referred to as a "depository"). In addition, the FCM or clearing organization is required to obtain from each such depository a written acknowledgment that the depository was informed that such property belongs to commodity futures or commodity option customers, and is being held in accordance with the CEA and the regulations thereunder. So long as the FCM or clearing organization obtains the required written acknowledgment, the depository may be affiliated with the depositing FCM or clearing organization.[71]

Neither Section 4d of the CEA nor Part 30.7 of the CFTC Regulations is directly applicable to margin securing cleared CDS. However, the CME is in the process of seeking CFTC approval to permit both it and its CMs to segregate CDS margin in a 4d Account, commingled with margin securing U.S. commodity futures and options. As of the date of this Report, the CFTC has yet to issue such an order (although the CME expects to obtain the order soon), and has obtained such orders in the past (for other cleared-only OTC products). Until the order is approved, the CME will hold such CDS margin in a segregated account that it labels a "30.7 Account", together with margin securing certain other OTC products cleared by the CME. In addition, the CME requires its CMs to segregate CM Excess Margin in the 30.7

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69 In addition, customers of the FCM must be "eligible contract participants," as defined in Section 1a(12) of the CEA, generally defined to include certain financial institutions, insurance companies, commodity pools and certain other entities with assets exceeding certain thresholds.

70 Because the CME is aware that the CMs are acting on behalf of customers, but does not recognize the specific identity of each such customer, we refer to customers under the CME's clearing structure as "unidentified" principals (e.g., the third party has notice that the agent is acting for a principal but does not have notice of the principal's identity), rather than "undisclosed" principals (e.g., the third party has no notice that the agent is acting for a principal). See Restatement (Third) of Agency § 1.04 (2006).

71 Holding margin at an affiliated custodian may, especially for cash margin, increase the risk to customers, in the event of the custodian's insolvency.

Accounts of CMs, together with margin securing (a) non-U.S. commodity futures and options and (b) certain other OTC products cleared by the CME.[72]

The CME requires the Gross Amount posted by CDS customers to their CMs to be passed on to the CME—e.g., even if a CM's customer positions are exactly offsetting in the aggregate, the CME will collect from such CM the aggregate sum of margin amounts required by the CME for each customer's CDS positions (but giving effect to any risk offsets from portfolio-based margining for each such customer). The Gross Amount will be held in the CME's 4d Account or "30.7 Account" (as applicable), in the name of the CME, for the benefit of customers of the relevant CM. With respect to CM Excess Margin, such margin will be held in the CM's 4d Account or 30.7 Account (as applicable), in the name of the CM, for the benefit of the CM's customers. Rehypothecation of customer margin held in a 4d Account or 30.7 Account at the CME or a CM is prohibited. In addition, such margin will not be subject to any liens or rights of setoff in respect of non-cleared trades.[73]

Whether margin is posted in the form of securities or cash, it should remain property of the pledging customers. Further, as discussed in Part II.C. above, the sharing rules applicable to commodity customers of insolvent FCMs in the event of a shortfall in a Bankruptcy Code proceeding do not differ on the basis of whether margin was posted in the form of securities or cash.

In summary, certain aspects of the CME's arrangement are helpful to the Segregation Analysis, including the following: (i) margin is held away from the CMs in segregated accounts; (ii) margin is not commingled with proprietary assets of the CMs; (iii) margin is free from liens and setoff rights (except for liens and setoff rights granted to the CCP or CM to secure customer positions); (iv) the Gross Amount (rather than just the Net Amount) is held in segregated accounts; and (v) margin is not subject to rehypothecation by the CM (except to the CCP as margin for customer trades).

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[72] Rule 8F03 of the CME Rulebook provides (in relevant part):

> OTC Derivatives submitted for clearing for the account of a Clearing Member's customer shall be assigned and held in a Regulation §30.7 account of such Clearing Member. All collateral deposited as performance bond to support positions in such Regulation §30.7 account and all positions, collateral or cash in such account shall be segregated from the Clearing Member's proprietary account. Notwithstanding the foregoing, if the CFTC issues an order permitting OTC Clearing Members to commingle customer funds used to margin particular OTC Derivatives that are cleared by CME with other funds held in CEA Section 4d(a)(2) customer segregated accounts, such positions may be held in the customer accounts of an OTC Clearing Member and, if so held, all collateral deposited as performance bond to support such positions and all variation margin payments made from such accounts shall be commingled with similar property of regulated customers.

[73] We asked the CME whether liens or rights of setoff in respect of non-cleared trades would be permitted. Although the CME left open the possibility that it would allow such liens or rights of setoff under certain limited circumstances, the existence of such liens and rights of setoff would generally weaken the Segregation Analysis and Portability Analysis. For purposes of this Report, we have assumed that the CME will not permit any liens or rights of setoff in respect of non-cleared trades.

However, there are risks inherent in the CME's proposed structure that may have negative ramifications for the Segregation Analysis. Under the proposed structure for holding customer margin, a particular customer's CDS margin may be commingled with (i) other CDS margin, (ii) margin securing commodity futures or commodity options entered into on a U.S. board of trade (and, in certain cases, on a non-U.S. board of trade) and (iii) margin securing other OTC products cleared through the FCM. Upon the occurrence of a large market movement for which customers (of any of the foregoing types) are unable to satisfy their margin obligations, and the CM is unable to remedy the shortfall from its own resources, the CME would have the ability to access CDS customer margin to satisfy any shortfall.[74] Therefore, CDS customers should be mindful of the risks of a shortfall arising from positions carried by other customers (including other CDS customers) of the CM in 4d Accounts or 30.7 Accounts.[75]

(b) Portability Analysis

So long as the margin has been adequately segregated in an account that the CME has the ability to access (notwithstanding the CM's insolvency), the CME should be able to facilitate the transfer of customer margin to the segregated account of a transferee CM. However, the existence of a significant margin deficit in respect of the CDS positions—e.g., a margin deficit that the CM is unable to remedy out of its own resources—would adversely affect the Portability Analysis. Whether such a margin deficit is likely to arise is critically linked to the Segregation Analysis above. In addition to the foregoing, several other considerations are relevant to the Portability Analysis.

Issues may arise from the fact that the customer positions will be subject to account documentation negotiated between CMs and customers, the details of which may significantly differ in any particular instance. If a transferee CM and a customer have not already agreed to account documentation, the transferred positions will, at the option of the transferee CM, be governed either by (i) the account documentation previously in effect between the transferor CM and the customer, or (ii) the transferee CM's standard form of account documentation, for a period of 60 days while the transferee CM and the customer attempt to negotiate a new set of

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[74] In the event the FCM becomes insolvent and is liquidated under Subchapter IV and Part 190, if the CFTC's interpretation that CDS cleared through a derivatives clearing organization like the CME is applicable, customers of the FCM would not appear to be able to avoid this mutualized sharing regime by holding their margin "away" from the 4d Account or 30.7 Account (e.g., in a tri-party custodial arrangement).

[75] Conversely, in the event of a margin deficit resulting from cleared CDS positions, the commingling of CDS margin with non-CDS margin may reduce the losses that CDS customers would otherwise experience if CDS margin were held in a separate account commingled only with the margin provided by other CDS customers. Whether this is beneficial from the perspective of CDS customers depends upon whether commingling with commodity futures and commodity options customers, and possibly customers clearing other types of OTC products through the CM as well, increases or decreases the ultimate recovery for CDS customers. The answer to this question is likely to depend on the facts and circumstances of each particular case. See Part II.A.1.(c) below for a discussion of how any shortfalls in custodial property of a CM would be allocated.

account documentation.[76] This default rule mitigates the risk of the CM inadvertently assuming unfavorable account documentation, but may present issues for customers forced to accept the transferee CM's standard form of account documentation. However, these issues should only be temporary; the customer can transfer its positions to a willing transferee CM with more favorable documentation or, if it is unable to find such a willing transferee, the customer can liquidate its positions.

In the period leading up to the insolvency of an FCM, customers could attempt to move their positions and related margin away from the deteriorating FCM.[77] (An FCM is generally required to cooperate with customers' requests to transfer their accounts to another FCM.) Once an FCM's capital levels have breached certain thresholds of impairment (as set forth in Part 1.17 of the CFTC Regulations), the FCM is required to transfer all customer accounts[78] and cease doing business as an FCM, until it is able to demonstrate compliance with the minimum financial requirements mandated by the CFTC.[79]

Once the FCM has entered insolvency proceedings under the Bankruptcy Code, Subchapter IV and Part 190 apply to establish a framework for facilitating transfers of a failing FCM's "commodity contracts" (as defined in Bankruptcy Code § 761(4)) and associated margin. The insolvency representative is required to use its best efforts to transfer (in whole or in part) the FCM's commodity contracts (and associated margin) immediately upon the commencement of Bankruptcy Code proceedings. In addition, Subchapter IV and Part 190 insulate certain CFTC-approved transfers of commodity contracts from the insolvency representative's avoidance powers under the Bankruptcy Code. Whether Subchapter IV and Part 190 are applicable to customers clearing CDS through an FCM depends, however, upon (i) whether the Bankruptcy Code governs the insolvency of the CM, and if so, (ii) whether the claims of CDS customers to margin are on account of "commodity contracts" (as defined in Bankruptcy Code § 761(4)). These issues are discussed in Part II.C. above.

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76 If no documentation is agreed to within 60 days (and the customer has not transferred its positions to another CM), the CM can close the customer's account. The CME indicated that it was open to exploring the possibility of having a standardized set of documentation governing the relationship between a transferee CM and customers (in the event the parties have no existing relationship) until the parties have agreed otherwise. However, the CME has yet to develop any such agreement (and may decide not to do so).

77 To the extent certain customers warned of the impending default are permitted to transfer equity from the firm, to the exclusion of other customers seeking to do the same, it is possible that the insolvency representative may be able to bring avoidance actions in respect of such withdrawals, in the event the FCM later becomes the subject of Bankruptcy Code proceedings. However, Section 764(b) of the Bankruptcy Code provides a safe harbor from the trustee's avoidance powers for any transaction entered into before (or within a certain period after) the FCM's bankruptcy, if the transaction is approved by the CFTC and involves an open contractual commitment.

78 In seeking to arrange a bulk transfer of customer positions and related margin, an FCM would be required to obtain negative consents from its customers.

79 These provisions were enacted to encourage transfers prior to any serious undersegregation, thereby permitting "ameliorative measures to be taken before customer losses occur." 46 Fed. Reg. 57545 (1981).

(c) Applicable Sharing Rules in the Event of a Shortfall

In the event of a shortfall in customer property held at an FCM, the analysis set forth in Part II.C. above would apply.

(d) CCP Requests for Legal Change or Clarification

In response to our request for whether legislative or regulatory reforms would be helpful to the CCP's customer protection framework, the CME indicated that it does not believe that the Bankruptcy Code is in need of reform, and maintains that it is "highly confident that the CFTC's Interpretative Statement and the legal analysis contained therein fully and adequately address the range of legal issues in respect of customer property that might arise in the event of a CM insolvency." However, as discussed above, we believe there is a not insignificant degree of uncertainty associated with this issue. In light of our views on this matter, the CME has offered a proposed amendment that would revise Section 761(4)(F) of the Bankruptcy Code to read as follows:

> (4) "commodity contract" means— …
>
> (F) any other contract, option, agreement or transaction that is similar to a contract, option, agreement or transaction referred to in this paragraph; for this purpose, a similar contract, option, agreement or transaction shall include, without limitation, any contract, option, agreement or transaction cleared by a derivatives clearing organization that is registered with the Commission; …

We support this amendment, and believe its enactment would be very helpful in enhancing the rights of customers under the CME's clearing framework.

The CME did not suggest any proposals to resolve the issues surrounding the interplay between SIPA and the commodity broker liquidation provisions of the Bankruptcy Code upon the insolvency of a joint BD/FCM (or the CFTC's inability to initiate Bankruptcy Code proceedings in respect of a failing FCM). As stated above, we believe these are second-order issues. However, we believe (and the CME agrees in principle) that such changes should be considered, especially in light of other legislative changes being considered in regard to the resolution of systemically important financial institutions.

(e) Outstanding Issues

The CME's clearing framework requires that customer CDS positions be cleared through FCMs. We note that dealers do not currently conduct their CDS business through FCMs. An analysis of the advantages or disadvantages of this requirement is beyond the scope of this Report (other than to the extent relevant to the legal analysis contained herein).

We believe that the CME's proposals for the segregation of CDS customer positions and related margin are generally quite strong, from the perspective of customers' legal rights to ultimately recover their margin, although questions may arise as to the range of custodial claimants with whom customers would be required to share in any shortfalls in a worst-case scenario. The portability analysis is also generally quite strong (although portability will ultimately depend upon the existence of a willing transferee).

At the same time, we believe that material uncertainties remain in regard to the insolvency treatment of a defaulted FCM's CDS clearing customers—in particular, whether a customer clearing CDS through the CME is, upon an insolvency of its CM, a "customer" with a claim on account of "commodity contract" under Subchapter IV and Part 190. We believe that the uncertainties underlying the CFTC's interpretation (regarding CDS contracts cleared through a derivatives clearing organization) could be resolved through relatively straightforward legislative amendments, which CME has proposed (at our request) and which we support. Other uncertainties—e.g., the complexities raised by a joint BD/FCM insolvency (as well as the possibility that an FCM may be liquidated in a federal equity receivership)—should also be considered, although resolution of these issues is, in our view, less important as a practical matter.

2. ICE Trust

(a) Segregation Analysis—Generally and U.S. CMs

ICE Trust generally does not limit the organizational type or jurisdictions of organization of potential CMs (other than through the requirement that CMs be subject to supervision as to capital adequacy by a competent authority). Thus, the Segregation Analysis must be conducted with respect to each applicable entity type in each applicable jurisdiction—for purposes of this Report, U.S. banks, U.S. federal and New York branches of non-U.S. banks, U.S. unregulated entities, English FSA-regulated entities, French, German and Swiss financial institutions, and English branches of French, German and Swiss banks.[80]

CMs under ICE Trust's clearing framework act as principals vis-à-vis both the CCP and customers. Where a customer has executed a principal CDS trade with its CM that both parties have agreed to clear through ICE Trust, the clearing process consists of two steps—(i) the CM submits to ICE Trust for clearing a two-sided trade between the CM and ICE Trust, with one side of the trade as a customer position (the "Cleared Customer Position") and the other side of the trade as a house position (the "Cleared House Position"), and simultaneously with ICE Trust's acceptance of the submitted trade, (ii) the CM records a back-to-back trade with the customer that offsets the Cleared Customer Position but which is not cleared through ICE Trust (the "Mirror Customer Position").[81]

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[80] Although this Report focuses on these entities, if entities with different organizational types or from different jurisdictions will serve as CMs under ICE Trust's clearing framework, additional analysis will be needed for such entities.

[81] ICE Trust's clearing framework also accommodates the clearing of CDS trades that customers originally agreed to with an executing dealer different from the CM with which it has a clearing relationship—e.g., pursuant to a give-up arrangement between a customer, its clearing CM (or "prime broker") and the original CM (as executing dealer). In such an arrangement, Cleared House Positions will be between the executing dealer and ICE

As the CM's gains or losses on its Mirror Customer Position are completely offset by corresponding losses or gains on its Cleared Customer Position, the CM's market exposure arises solely from its Cleared House Position. Further, the CM is able to on-pledge or on-transfer to ICE Trust margin posted by the customer for its Mirror Customer Position, in order to satisfy the CM's margin obligations arising from its Cleared Customer Position.

ICE Trust will have no direct relationship with customers, and therefore no direct liability to customers. However, ICE Trust may require a CM to collect from a customer, in respect of Mirror Customer Positions, an amount of margin that it calculates in its sole discretion (on the basis on each particular customer's portfolio risk)[82]—i.e., the Gross Amount. CMs are required to on-pledge the aggregate Gross Amount (for all its customers) to one of two types of client omnibus accounts held at ICE Trust.[83] Each account is a segregated omnibus account at ICE Trust, solely for the use of a particular CM and its customers, with any property deposited therein held by ICE Trust for the benefit of customers of a particular CM (or for the benefit of the particular CM as agent and custodian for its customers), subject only to any liens from ICE Trust or the CM. The first account (the "Net Margin Account") will contain the Net Amount, and will be subject to a lien in favor of ICE Trust and the CM. The second account (the "Excess Omnibus Account") will contain the difference between the Gross Amount and the Net Amount, and will be subject to a lien in favor of the CM (and, in limited circumstances,[84] in favor of ICE Trust). Margin held in the Net Margin Account or Excess Omnibus Account will not be subject to any liens in favor of affiliates of the CM, or rights of

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Trust, while the Cleared Customer Positions and the related Mirror Customer Positions will be with the prime broker. Because the Cleared House Positions are not relevant to the customer protection analysis of customer positions and related margin, it is unnecessary to separately discuss such arrangements.

82 As is the case with the other CCPs, ICE Trust's rules do not expressly limit the ability of ICE Trust to request potentially unlimited amounts of additional margin from CMs (and effectively, therefore, from customers, since CMs are required to collect margin for Mirror Customer Positions in an amount at least equal to ICE Trust's requirement for the related Cleared Customer Positions).

83 Until CMs have transferred margin received from customers to the Net Margin Account or Excess Omnibus Account, CMs are required by ICE Trust rules to segregate such margin from their proprietary assets, and otherwise reflect such margin on their books and records as being held in a custodial capacity (without any right of reuse or rehypothecation).

84 ICE Trust will have access to amounts in the Excess Omnibus Account in only two circumstances. First, when a CM is in default and a customer whose positions have not been transferred (and are being liquidated) has a payable to the CM on the close-out of its Mirror Customer Positions, ICE Trust is permitted to collect on that payable under the security interest in the Mirror Customer Positions granted by the CM to ICE Trust. If the customer fails to pay, ICE Trust will have the right to access that customer's assets that are in the Excess Omnibus Account. (This does not mutualize losses across other clients since ICE Trust will have no right to use the assets in the Excess Omnibus Account that belong to any other customer. In fact, this may reduce the mutualization of loss by allowing ICE Trust to prevent losses by collecting on the amounts owed in respect of Mirror Customer Positions.) Second, ICE Trust may move margin from the Excess Omnibus Account to the Net Margin Account, to the extent necessary to maintain the Net Amount. Such adjustments can occur when Cleared Customer Positions are ported from one CM to another, as well as a result of the purchase, sale or termination of a Cleared Customer Position.

setoff in respect of non-cleared trades.[85] CMs will be required to maintain records of each customer's Mirror Customer Positions, and the amount and form of margin delivered with respect thereto (and held in the Net Margin Account and the Excess Omnibus Account), and provide ICE Trust with daily updates of such records.

A CM may reallocate margin amounts between the Net Margin Account and the Excess Omnibus Account as necessary to comply with its obligation to maintain the Net Amount in the Net Margin Account (which will be done pro rata based on each customer's gross margin requirement). The CM may also withdraw a defaulting customer's margin from the Excess Omnibus Account to the extent necessary to satisfy obligations owing to the CM or to return it to the customer. CMs will not otherwise be permitted to use or rehypothecate margin in the Excess Omnibus Account.

ICE Trust does not place any limitations on the amount of CM Excess Margin that may be collected by CMs, or the manner in which CM Excess Margin is held.[86] CMs and customers may agree to (i) hold CM Excess Margin in the Excess Omnibus Account, (ii) hold CM Excess Margin separately at the CM or a custodian, without any rights of rehypothecation or other reuse or (iii) deliver CM Excess Margin to the CM together with rights of rehypothecation and reuse.[87] To the extent CM Excess Margin is held outside of the Excess Omnibus Account, ICE Trust will not itself be able to transfer such margin.

In the event of a CM default, if a net amount were owed to a CM in respect of Cleared Customer Positions, ICE Trust would not offset that amount against any amount owed by the CM to ICE Trust in respect of Cleared House Positions. Further, ICE Trust would not be permitted to satisfy margin deficits arising from Cleared House Positions by accessing funds in the Net Margin Account or the Excess Omnibus Account. ICE Trust would, however, be able to satisfy any margin deficits arising from Cleared Customer Positions by accessing funds in the Net Margin Account and, under certain limited circumstances, the Excess Omnibus Account.

In contrast to the Net Margin Account, ICE Trust would be prohibited from using customer property in the Excess Omnibus Account to satisfy customer margin deficits, except under certain limited circumstances. Therefore, margin held in the Excess Omnibus Account

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[85] We asked ICE Trust whether liens or rights of setoff in respect of non-cleared trades would be permitted. Although ICE Trust left open the possibility that it would allow such liens or rights of setoff under certain limited circumstances, the existence of such liens and rights of setoff would generally weaken the Segregation Analysis and Portability Analysis. For purposes of this Report, we have assumed that ICE Trust will not permit any liens or rights of setoff in respect of non-cleared trades.

[86] The analysis of customer rights to CM Excess Margin held directly at the CM in the event of the CM's insolvency is beyond the scope of this Report. In such an event, it would be highly preferable from a customer protection standpoint if the margin were held away from the insolvent CM.

[87] CMs and customers may also agree to hold such CM Excess Margin in the customer's name, subject only to the CM's lien, thereby achieving an even greater degree of segregation.

may be more likely to be recoverable in the event of a CM default than margin held in the Net Margin Account.

Margin posted to the Net Margin Account or the Excess Omnibus Account may be in the form of either cash or G7 government securities.[88] For the reasons discussed in Part II.A.1. above, and the considerations discussed in the paragraph below, it may be disadvantageous from a customer protection perspective for customers to post margin in the form of cash rather than securities.

Both the Net Margin Account and the Excess Omnibus Account include a cash subaccount for cash collateral and a custody subaccount for securities collateral. With respect to cash in the cash subaccount, CMs and customers are required to acknowledge, pursuant to ICE Trust's rules, that such cash will become property of ICE Trust (subject to ICE Trust's contractual obligation to return the cash upon satisfaction of the secured obligations). Vis-à-vis the CM, the customers would likely have proprietary rights in the contractual obligation of ICE Trust to return the cash (after satisfaction of the secured obligations) to the CM as agent or custodian for the customer.

With respect to securities in the custody subaccount, ICE Trust has acknowledged (under its rules) that such collateral will remain property of the relevant customers, subject to any security interest it or the CMs may have. Customers would likely maintain proprietary rights in their securities collateral held in custody, and upon the satisfaction of any liens owing to ICE Trust or the CM, would likely be entitled to recover such securities collateral, free from the claims of the CM's unsecured creditors.

In summary, certain aspects of ICE Trust's arrangement are helpful to the Segregation Analysis, including the following: (i) margin is held away from the CMs in segregated accounts; (ii) margin is not commingled with the proprietary assets of the CMs; (iii) margin is free from liens and setoff rights (except for liens and setoff rights granted to the CCP or CMs to secure customer positions); (iv) the Gross Amount (rather than just the Net Amount) is held in segregated accounts; and (v) margin is not subject to rehypothecation by the CM (except to the CCP as margin for Cleared Customer Positions). Further, it is a helpful fact that ICE Trust's structure permits CMs and customers to effectively hold CM Excess Margin "away" from the CM—i.e., entirely outside the CM's estate upon the CM's insolvency.

However, there are risks inherent in ICE Trust's structure that may have negative ramifications for the Segregation Analysis. Under the proposed structure, a particular customer's CDS margin may be commingled with other CDS margin. Upon the occurrence of a large market movement for which other CDS clearing customers are unable to satisfy their margin obligations, and the CM is unable to remedy the shortfall from its own resources, ICE

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[88] ICE Trust permits customers to post a wider range of collateral types to their CMs, so long as the CMs post margin of the permitted types to the CCP. In such a case, the collateral posted by the CMs in lieu of customer margin will be placed in the Net Margin Account, and the collateral posted by customers will be placed in the Excess Omnibus Account. A customer's claim in this event would be to the assets in the Excess Omnibus Account, not to the assets in the Net Margin Account.

Trust would have the ability to access CDS customer margin in the Net Margin Account to satisfy any shortfall. Therefore, CDS customers should be mindful of the risks of a margin deficit arising from positions carried by other CDS customers. However, in the ICE Trust structure, this sharing of risk is limited to the Net Margin Account. The Excess Amount is held in the Excess Omnibus Account and would not be available to ICE Trust to satisfy shortfalls.[89]

(b) Portability Analysis—Generally and U.S. CMs

So long as the margin has been adequately segregated in an account that ICE Trust has the ability to access (even after the CM's insolvency), ICE Trust should be able to facilitate the transfer of customer margin to a transferee CM. However, the existence of a significant margin deficit in respect of the CDS positions—e.g., a margin deficit that the CM is unable to remedy out of its own resources—would adversely affect the Portability Analysis. Whether such a margin deficit is likely to arise is critically linked to the Segregation Analysis above. In addition to the foregoing, several other considerations are relevant to the Portability Analysis.

Mirror Customer Positions will be documented under a negotiated ISDA Master Agreement between the CM and the customer, supplemented with a standardized annex in the form approved by ICE Trust (the "Standard Annex") that contains several provisions relevant to the Portability Analysis. Specifically, the Standard Annex will provide: (i) standardized events of default and termination events applicable to CMs;[90] (ii) that the termination amount owing on Mirror Customer Positions will be set to equal the termination amount owing on Cleared Customer Positions; (iii) customer consent to the pledge by CMs of their rights in Mirror Customer Positions (and associated margin) to the CCP; (iv) customer consent to standstill on Mirror Customer Positions for a specified period of days following a CM default; (v) the option for customers to either (a) provide advance consent for ICE Trust to attempt to

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[89] See Part II.A.2.(c) below for a discussion of how any shortfalls in custodial property of a CM would be allocated. We note that, in addition to ICE Trust's exclusion of customer property in the Excess Omnibus Account from loss mutualization, the range of other customers across which losses are mutualized, and accordingly both the potential losses from non-CDS trading activities to which CDS customers may be exposed and also the assets of non-CDS customers which would be available to share in losses from CDS and non-CDS activities, is narrower under ICE Trust's clearing structure than it is under the CME's clearing structure. Whether this is beneficial from the perspective of CDS customers depends upon whether commingling with commodity futures and commodity options customers, and possibly customers clearing other types of OTC products through the CM as well, increases or decreases the ultimate recovery for CDS customers. The answer to this question is likely to depend on the facts and circumstances of each particular case.

[90] Any failure by the CM to perform a payment or delivery obligation under a Mirror Customer Position would constitute a CM event of default under the Standard Annex. Upon the occurrence of such a default, customers would be permitted to terminate their Mirror Customer Positions with the CM. However, ICE Trust's portability procedures would not apply in such a scenario, unless it were to officially declare the CM to be in default.

Separately, we note that the Standard Annex does not provide a standardized set of events of default and termination events applicable to customers; such matters are left to bilateral agreement between a CM and its customers.

transfer its Mirror Customer Positions to (or otherwise establish replacement transactions with) a new CM, or (b) instruct ICE Trust in advance to liquidate its Mirror Customer Positions, in each case following the default of the customer's CM; and (vi) limitations on customer rights to set off amounts payable to the CM upon the termination of Mirror Customer Positions against other uncleared transactions with the CM.

In the period leading up to the insolvency of an CM, customers could attempt to voluntarily move their positions and related margin away from the deteriorating CM. Prior to the default of a CM, the CM is required to agree to the transfer of a customer's Mirror Customer Positions and the related Cleared Customer Positions to a transferee CM that has agreed to assume such positions (and associated margin). In order to effect such a transfer, the customer, the transferor CM and the transferee CM must agree to a novation confirmation setting forth certain details relating to the positions. Upon ICE Trust's acceptance of the novation confirmation, ICE Trust will (i) terminate the related Cleared Customer Positions with the transferor CM and reestablish new Cleared Customer Positions with the transferee CM and (ii) simultaneously transfer the Mirror Customer Positions to the transferee CM. If agreed to between a transferor CM and a customer, supporting margin in the Net Margin Account and Excess Omnibus Account would be transferred directly to the transferee CM for the benefit of the customer.

Subsequent to a CM default, the failed CM's insolvency representative may attempt to transfer its CDS positions and related margin. In the case of a CM that is an insured U.S. bank, the FDIC, if it were acting as receiver of the failed CM, would have the ability to transfer all (but not fewer than all) of the CM's "qualified financial contracts" (which includes CDS positions) and related margin with any particular counterparty (and such counterparty's affiliates) to a single entity (including to certain existing financial institutions or to a newly-created "bridge bank").[91] From the time the FDIC is appointed as receiver until the earlier of (a) the time customers receive notice from the FDIC of the transfer of the CM's qualified financial contracts, and (b) 5:00 p.m. on the business day following the appointment of the FDIC as receiver, customer payment or delivery obligations under its qualified financial contracts with the CM could be suspended in accordance with any contractual rights the customer may have. Subsequent to the one-day standstill period imposed under the FDIA (and any additional standstill agreed to by the customers pursuant to the Standard Annex), customers could exercise their contractual liquidation rights under the ISDA Master Agreement if there were no transfer.[92]

[91] This statutory requirement—that if any of a customer's (or its affiliates') CDS or other qualified financial contracts with the defaulting CM are transferred, all such qualified financial contracts with the defaulting CM (whether cleared or uncleared) must also be transferred—would (absent legislative change) hinder the FDIC's ability to transfer only Cleared Customer Positions and Mirror Customer Positions. As a practical matter, however, the FDIC has always transferred all qualified financial contracts to a single successor entity.

[92] These rules would also apply to a non-FDIC receivership of an uninsured U.S. national bank or federal branch of a non-U.S. bank. See 12 U.S.C. § 4406.

In the case of a U.S. CM that is not an insured U.S. bank (or an uninsured U.S. national bank or uninsured U.S. federal branch of a non-U.S. bank), there are no provisions for the transfer of qualified financial contracts (such as CDS positions) and related margin by the insolvency representative itself. For this reason, it is unclear how the failed CM's insolvency representative would, in this instance, have the ability to arrange for the transfer of customer positions and related margin.

In the event the defaulting CM's insolvency representative has not arranged the transfer of customer positions and related margin, ICE Trust would attempt to facilitate such a transfer (and may, but is not required to, give effect to customer preferences regarding transferee CMs). However, ICE Trust faces practical difficulties in doing so, given that it is not a party to Mirror Customer Positions. In order to facilitate portability, ICE Trust will obtain from CMs a security interest in the rights of CMs in their Mirror Customer Positions (and associated margin). To the extent the Mirror Customer Positions are "in-the-money" to a CM at the time of its default, ICE Trust can foreclose upon and assign such rights to a transferee CM, thereby increasing the likelihood that it is able to find a willing transferee for the Mirror Customer Positions.

Even if the Mirror Customer Positions are "out-of-the-money" to a CM at the time of its default, or if ICE Trust does not otherwise foreclose on any pledged rights it may have against the customer in respect of Mirror Customer Positions, ICE Trust would nevertheless have the ability (pursuant to advance consents in the Standard Annex) to simultaneously: (i) terminate a customer's Mirror Customer Positions with the defaulting CM and the related Cleared Customer Positions, (ii) procure a transferee CM to enter into (a) replacement Mirror Customer Positions with the customer on the same terms as the terminated positions, offset by (b) the related Cleared Customer Positions and (iii) transfer appropriate amounts of margin from the Net Margin Account and Excess Omnibus Account of the defaulting CM to the transferee (collectively, the "Termination/Replacement Procedures"). Upon the completion of (i) to (iii) above, the parties will be deemed to have agreed that no net termination amounts will be owing by ICE Trust, the defaulted CM, the transferee CM or the customer.

The success of ICE Trust's portability framework largely depends upon the enforceability of the grant by CMs of a security interest in their rights under Mirror Customer Positions to ICE Trust) and the Termination/Replacement Procedures. ICE Trust has stated that it does not perceive that any enforceability issues should arise in connection with either arrangement. We believe, however, that in the case of the Termination/Replacement Procedures, there may be a risk that the termination of an "in-the-money" position (either the Cleared Customer Position or Mirror Customer Position, depending upon the direction of the trade), and the agreement of the parties that no net termination amounts will be payable in respect thereof, may be viewed as an unenforceable forfeiture of property belonging to the insolvent CM's estate. ICE Trust has stated that it believes there are no enforceability issues with this arrangement, since simultaneously with any extinguishment of payment rights (from either the customer or ICE Trust), the corresponding payment obligations (to either ICE Trust or the customer) are also discharged.[93] However, we believe this structure may also be viewed as a multilateral netting arrangement, which raises concerns over mutuality—e.g., the requirement that one person's claim must not be used to pay another person's debt—thereby raising potential enforceability issues.[94] This concern is less pressing when the Mirror Customer Positions are "in-the-money" to the insolvent CM, as ICE Trust may rely on its ability to foreclose upon the CM's pledge of its rights against the customer in such a case. But where ICE Trust must rely on the Termination/Replacement Procedures to facilitate portability (i.e., situations in which the Mirror Customer Positions are "out-of-the-money" to the insolvent CM), enforceability concerns may be more significant.[95]

The likelihood that a successful transferee can be found under ICE Trust's portability framework may be affected by several other factors. First, although ICE Trust may have a lien over CM Excess Margin (pursuant to the CM's pledge to ICE Trust of its rights under its Mirror Customer Positions), it is not clear whether ICE Trust will have the ability to move (or cause the CM's insolvency representative to move) CM Excess Margin that is not held in the Excess Omnibus Account. As a result, even if Mirror Customer Positions are transferred pursuant to the Termination/Replacement Procedures, it is unclear whether CM Excess Margin will also be transferred.

Second, issues may arise from the fact that the Mirror Customer Positions will be subject to an ISDA Master Agreement, the details of which may significantly differ in any particular instance (other than with respect to the terms of the Standard Annex, which cannot be varied, except where elections are expressly provided to CMs and customers). In the event a transferee CM and a customer have not entered into an ISDA Master Agreement, the replacement Mirror Customer Positions will be subject to the terms of the ISDA Master Agreement in effect between the defaulted CM and the customer. In a distress scenario, a review of the existing ISDA Master Agreement will not be feasible, and thus the possibility of

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93 This arrangement effectively results in a netting of (1) (x) the customers' right to receive payment from (or obligation to pay) the defaulting CM and (y) the defaulting CM's right to receive payment from (or obligation to pay) the CCP, against (2) (x) the customers' obligation to pay (or receive payment from) the transferee CM and (y) the transferee CM's obligation to pay (or receive payment from) the CCP.

94 The Bankruptcy Court for the District of Delaware recently held that Section 553 of the Bankruptcy Code prohibits "triangular setoff" as a matter of law because the debts and claims being setoff are between different parties and therefore not "mutual". In re SemCrude, 2009 WL 68873 (Bankr. D. Del. Jan. 9, 2009). Because the advocates of the setoff did not raise the issue, the court expressly did not consider arguments that triangular setoff would be protected by Section 362(b)(17), 560 or 561 of the Bankruptcy Code when the debts and claims involved arise from swap agreements. In addition, because no clearing corporation was involved, the court did not consider the effect of the clearing organization netting provisions of 12 U.S.C. § 4401 et seq, which may be helpful (at least for certain CMs) to the enforceability of the Termination/Replacement Procedures.

95 To address these concerns, ICE Trust is considering contractual arrangements (e.g., an assignment of rights or grant of a security interest) that may convert this multilateral netting arrangement to a bilateral netting arrangement or a security arrangement, but the details of such arrangements have not been finalized.

assuming an unfavorable ISDA Master Agreement may present an unacceptably high level of documentation risk for potential transferee CMs.[96]

(c) Applicable Sharing Rules in the Event of a Shortfall

In the event of a shortfall in margin held at a CM, the analysis set forth in Part II.C. above would generally apply.

(d) Requests for Legal Change or Clarification

ICE Trust has expressed a high degree of confidence that its segregation and portability framework for customers is, under existing U.S. law, generally sufficient to protect customer positions and related margin, to the extent U.S. law is applicable. Nevertheless, in response to our request for whether legislative or regulatory reforms would be helpful to the CCP's customer protection framework, ICE Trust responded as follows:

> There are several U.S. regulatory or legislative reforms that might enhance the legal certainty of the framework described above. In particular,
>
> 1. Regulatory Changes:
>
> - For CMs that are regulated entities, the appropriate regulator (such as the FDIC for insured U.S. bank CMs) could provide confirmation that it would respect the segregation of, and cooperate with the return of, IM and would not seek to interfere with, and would cooperate with, attempts by the clearinghouse to implement portability rules. More generally, such regulators could provide guidance as to the manner in which they would expect to treat cleared transactions in the event of the insolvency of a regulated entity.
>
> - Regulators could also provide clarity as to the capital treatment of cleared transactions.
>
> - As noted above, ICE Trust is seeking ROCH status in the U.K.
>
> 2. Legislative Changes:

[96] Although ICE Trust has indicated that it is open to exploring the possibility of having a standardized ISDA Master Agreement govern the relationship between a transferee CM and customers (in the event the parties have no existing relationship) until the parties have agreed otherwise, such an agreement has yet to be developed.

This concern may be mitigated to the extent customers have, prior to a CM default, entered into a back-up arrangement (including a negotiated ISDA Master Agreement) with a second CM which could be activated should its primary CM default.

- Relevant statutes (including FDICIA) could be amended to cover explicitly the enforceability of clearinghouse rights to transfer positions (including customer positions) and related margin, in addition to being able to terminate and net such transactions and apply security.

- Relevant statutes could be amended to provide the FRB or other appropriate regulator authority to create a regulatory framework for the segregation of customer property in connection with cleared CDS, analogous to the Section 4d/[P]art 190 framework under the CEA.

- The FDIA could be amended to allow the FDIC to transfer cleared positions separately from non-cleared positions.

Specific legislative amendments suggested by ICE Trust in respect of U.S. entities are included in Annex B. We support these amendments, and believe their enactment would be very helpful in enhancing the rights of customers under ICE Trust's clearing framework.[97]

ICE Trust has not, at this stage, provided legislative proposals for English, French, German and Swiss CM entity types. Therefore, customers of non-U.S. CMs would continue to face the uncertainties highlighted in this Report to the extent non-U.S. law were applicable, even if ICE Trust's suggested legislative amendments were enacted in the U.S. We would encourage ICE Trust to consider proposing specific legislation for non-U.S. CMs, as it has done for U.S. CMs. In this endeavor, we believe ICE Trust should also consider the legislative and regulatory reforms described above for the European CCPs.

(e) Analysis for CMs that Are Not U.S. Entities

CMs That Are English FSA-Regulated Entities

Segregation

It is likely that FSA-regulated CMs that have received margin from customers to be transferred to ICE Trust would fall under the ambit of the CASS Rules. This is because CMs of ICE Trust are required pursuant to ICE Trust's rules and the Standard Annex to receive margin as agent or custodian for their customers and must transfer such margin on to ICE Trust. Pending transfer of such margin, the CM is required under the rules and the Standard Annex to hold the margin in segregation from its other assets and is prohibited from using the margin received for any other purpose. Furthermore, the CM would be required to reflect such margin in its books and records as being received in a custodial capacity. As a result, the margin

[97] As noted above, one of the provisions suggested by ICE Trust leaves open the applicable federal regulator empowered to make certain determinations. Further consideration needs to be given to the identity of such a regulator for U.S. CMs that are branches of non-U.S. banks or that are unregulated U.S. entities. More generally, in the case of branches of non-U.S. banks, consideration needs to be given to the effect, if any, of non-U.S. law.

posted by the customer to the CM is likely to be classified as "client money" or "client asset", as the case may be.

If margin is received as "client money", an FSA-regulated CM will receive and hold such money as a trustee pursuant to a statutory trust.[98] FSA-regulated CMs are required to segregate client money from their own house funds promptly upon receipt by depositing them with a central bank, certain authorized credit institutions or qualifying money market funds.[99] If margin is received as "client assets", FSA-regulated CMs must make adequate arrangements to safeguard clients' ownership rights[100] and have adequate organizational arrangements to minimize the risk of the loss or diminution of clients' safe custody assets.[101] These are principle-based requirements, so firms have a certain amount of discretion as to how they segregate client assets in practice.

On the insolvency of an FSA-regulated CM, "client money" or "client asset" will not be considered property of the insolvent CM and therefore will not be available for distribution to its unsecured creditors.

ICE Trust is considering bolstering these arrangements with a requirement that FSA-regulated CMs declare their rights to receive from ICE Trust customer margin and related proceeds in trust for their customers pursuant to an express declaration of trust.

We note that it is at present unclear how the broad powers granted to the U.K. government pursuant to the Banking Act 2009 will affect the existing regime dealing with "client money" and "client assets" as it applies to CMs which carry on the regulated activity of accepting deposits. On insolvency of such a CM, the U.K. government could, in certain circumstances, transfer to a private sector purchaser some or all of the CM's property, rights and liabilities. These powers are expressed to extend to "property held on trust" but it is not clear whether this means property held by the CM as trustee, or property held by a third party "on trust" for the CM. The Banking Act 2009 is relatively new and therefore it remains to be seen whether the U.K. government would exercise the wide-ranging powers available to it under the Act to effect transfers of customer margin from an insolvent CM to a new solvent CM.

Portability

At present, ICE Trust is not a "recognised overseas clearing house" for the purposes of the Companies Act 1989, although we understand that it is currently in the process of applying for this status. This means that the protections of Part VII of the Companies Act 1989 are not at present available to protect the default portability procedures applicable on the insolvency of

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98 CASS 7.7.

99 CASS 7.4.1R.

100 CASS 6.2.1R.

101 CASS 6.2.2R.

an English CM. ICE Trust's ability to transfer open positions and margin from the insolvent English CM to a new CM would be significantly curtailed if ICE Trust is not a "recognised overseas clearing house" because:

(a) mandatory insolvency set-off would, subject to certain exceptions, automatically apply in relation to mutual debts between ICE Trust and the insolvent CM;

(b) the transfer of CDS contracts following the insolvency of the English CM would either be prohibited (if the defaulting CM is in liquidation) or require the consent of the defaulter's administrator or the court (if the defaulting CM is in administration or an administration application has been made);

(c) contracts between the ICE Trust and the defaulting CM could be subject to insolvency clawback on the grounds of transactions at undervalue, preferences or transactions defrauding creditors or disclaimer by the liquidator; and

(d) common law rules against forfeiture and changes to the *pari passu* distribution principle would apply and could conflict with ICE Trust's rules relating to the portability of positions and related margin.

ICE Trust is currently in the process of applying for "recognised overseas clearing house" status, which, once obtained will protect ICE Trust's contracts with its CMs from many of the English insolvency rules that would hamper the operation of its rules as currently envisaged. The porting of margin is not an established practice for clearing houses regulated in the U.K. and legal certainty with respect to that aspect of the operation of the ICE Trust default rules (even after obtaining approval of "recognised overseas clearing house" status) might be enhanced by specific legislative amendments (particularly if it is intended that CM excess margin will be included in the customer margin that would be ported by the CCP to the new CM). Even prior to ICE Trust obtaining this status, close-out and netting rights (but less so mandatory portability rules) would generally be protected under the U.K. Financial Collateral Arrangements (No. 2) Regulations 2003.

In respect of English CMs that are deposit-taking institutions, the Banking Act 2009 has introduced a Special Resolution Regime which would allow the U.K. government to stabilize certain institutions in distress. The U.K. government may in certain circumstances transfer some or all of the property, rights and liabilities of a bank (including any CDS positions (and potentially customer margin[102])) to a private sector purchaser or to a bridge bank. However, secondary legislation[103] has been implemented with the objective of ensuring that partial transfers of a bank's assets by the government do not interfere with netting and collateral arrangements. This secondary legislation makes a partial transfer of an insolvent

102 Although there are provisions in the Banking Act 2009 that deal with "property held on trust", it is unclear what the term means as it could mean property held by the bank as trustee or property as to which the bank is the beneficiary.

103 The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009.

bank's assets invalid if it conflicts with the Settlement Finality Directive, Part VII of the Companies Act 1989, or the legal protections afforded to title transfer financial collateral arrangements. Security arrangements are dealt with separately, by providing that no partial transfer of secured assets may be made without also transferring the secured liability. Given the relative novelty of the Banking Act 2009 and related legislation (and the fact that they have not been used to date) it is not possible to say how interventionist the U.K. government would seek to be in respect of a relevant CM's CDS arrangements with its customers and a CCP.

CMs That Are French Financial Institutions (including English Branches of French Banks)

Segregation

If French insolvency proceedings are opened with respect to a French financial institution (i.e., licensed credit institutions, including banks, and investment firms licensed to provide investment services, including broker dealers), such proceedings will, in principle, relate to all assets and liabilities of the French financial institution, irrespective of where such assets and liabilities are located and what law governs them.

Under French law, a customer is, under certain conditions, entitled to segregation on securities deposited with a French financial institution (see Part II.C.4 above). French insolvency law would, in principle, respect and give effect to non-French law rights that customers of an insolvent French financial institution have validly acquired in accordance with French conflict of laws rules, provided that such rights are comparable to French law rights entitling clients to segregation.

Cash

If a customer transfers or deposits and pledges cash as margin with a French CM (including an English branch of a French bank) which becomes subject to insolvency proceedings in France, the French insolvency court would consider that the cash so transferred or deposited and pledged would be commingled with other cash held by the French CM. Accordingly, the customer would not be entitled to segregate any such cash, and would be an unsecured creditor of the French CM.

In the event that the customer's cash margin is fully on-pledged to ICE Trust, although the Net Margin Account and the Excess Omnibus Account would be held by ICE Trust for the benefit of the CM's customers or the CM as agent for the customers, the same analysis is likely to apply since we understand that (i) there is no direct relationship between ICE Trust and the customer and (ii) ICE Trust would return any cash margin in all circumstances, including the insolvency of the CM, to the CM, the same analysis is likely to apply.

Securities

French law would point to the law of the jurisdiction where the custodian that maintains the account in which the securities deposited by customers as margin are booked is located to determine the rights and obligations of the parties and third parties.

If the account is maintained in France, a French insolvency court would apply French law to determine the customer's rights in the deposited securities (see Part II.C.4 above).

If the account is maintained in England and the CM is a French bank acting through its English branch, French insolvency law would defer to English law to determine the rights of the customer, the French bank and third parties (including creditors of such French bank) as well as the effect of the French bank's insolvency on such rights, provided that the existence or transfer of the securities so deposited as margin with the English branch of the French bank requires their recording in that account.[104]

In the event that the account is maintained in New York, French insolvency law would point to and respect and give the same effect to the margin validly granted under New York law as a comparable arrangement under French law. Under NY law, any securities margin pledged by customers to their CMs and on-pledged to ICE Trust remains the property of the customers. French insolvency law should recognize the New York law effect of the pledge not to transfer to the CM or ICE Trust legal or beneficial ownership in the securities margin, but rather, only a security interest therein.[105] To the extent that they are considered as having proprietary rights in the securities deposited with the CM under French law, the customers should be entitled to segregate securities margin from the CM's insolvency estate in accordance with French law, provided that the obligations secured by the securities margin have been completely discharged. Under French law, the securities held by the insolvent French CM on behalf of customers are shared among them on a pro rata (and security per security) basis (i.e., among all claimants, regardless of whether they have or have not allowed rehypothecation). Once the allocation among customers has been made, customers may require that the securities allocated to them be transferred to another financial institution. For the remainder of the shortfall, they become unsecured creditors of the French CM.

In the event that the customer's securities margin is fully on-pledged to ICE Trust, the same analysis as the one above is likely to apply, for the same reasons as discussed for cash margin above.

Portability

French law does not provide for any rule applicable to transfer of customer positions and related margin to another solvent CM when the CCP is not regulated in the EEA, as is the

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[104] French law would also point to English law if the securities posted as margin are recorded in another securities account, a register or a centralized deposit system held or located in England, provided that such recording is required for the existence or transfer of such securities.

[105] French law does not provide for a concept equivalent to the U.S. concept of "security entitlements". It is thus unclear under French law whether a "security entitlement" constitutes the equivalent of a proprietary right in securities within the meaning of French law, or a contractual right. However, based on the analysis of the main characteristics of "security entitlement", there are good arguments to conclude that the customer's rights in a "security entitlement" should constitute proprietary rights (within the meaning of French law) in the concerned securities, but there is no case law on point and no guidance in legal writings and accordingly, there remains some uncertainty in this regard.

case with ICE Trust. As a result, in the event insolvency proceedings are commenced against a CM that is a French financial institution (or an English branch of a French bank) in France, any such transfer would need to be agreed upon among the customer, the French insolvency court, the new CM and ICE Trust in order to be binding on the relevant French insolvency court.

If a CM that is a French financial institution (or an English branch of a French bank) becomes subject to French insolvency proceedings and the CM's business activities are continued, the insolvency representative has discretionary power to terminate any contract entered into by the insolvent CM if it determines that such contract is not necessary for the continuation of the CM's business. If the insolvency representative makes such a decision, the CM's open positions with ICE Trust and the corresponding customer's open positions with the CM would be liquidated thereby preventing any transfer of such positions to a new CM.

CMs That Are German Financial Institutions (including English Branches of German Banks)

Segregation

If German insolvency proceedings are opened with respect to a CM that is a German financial institution, such proceedings will, in principle, relate to all assets and liabilities of the German financial institution, irrespective of where such assets and liabilities are located and what law governs them (Section 335 of the German Insolvency Code).[106] Deviating from such principle, Section 340(3) of the German Insolvency Code provides that the rights and duties of insolvent participants in a "system" within the meaning of Section 1(16) of the German Banking Act (a "System") are governed by the laws of the jurisdiction applicable to the System—in the case of ICE Trust, the laws of New York. Section 1(16) of the German Banking Act was enacted in connection with implementing Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems ("SFD"). According to Section 1(16) of the German Banking Act, a system located in a non-EEA member state qualifies as a "System" if it materially complies with the requirements of a System under the SFD.

According to the information provided by ICE Trust, there are good arguments that ICE Trust will likely qualify as a System within the meaning of Article 2 of the SFD irrespective of it not being notified as a "system" to the European Commission by the competent regulator. Thus, in principle, Section 340(3) of the Insolvency Code will apply if a German CM becomes subject to German insolvency proceedings. Accordingly, in principle, the laws of New York (including insolvency laws) would govern the relationship of the insolvent German CM with ICE Trust and the effect of the CM's insolvency on such relationship. However, whether the customers' rights with respect to margin would also be governed by the laws of New York would in particular depend on whether the scope of Section 340(3) of the German Insolvency

[106] An English branch of a German CM that is a credit institution cannot become subject to English insolvency proceedings, and therefore no liquidation or administration proceedings may be taken in England in respect of these entities, so English law will not be relevant.

Code comprises matters of segregation of margin by customers within the meaning of Section 47 of the German Insolvency Code.

There is no German case law on point as to whether the segregation of margin by customers falls under Section 340(3) of the German Insolvency Code. Some legal commentators state that the purpose of Section 340(3) of the German Insolvency Code is to ensure that the transactions within a System are not impaired by any restrictions in the national laws of the participants. Accordingly, Section 340(3) should be interpreted broadly. Even such a comprehensive approach, however, does not necessarily encompass a claim for segregation of customer margin from the CM's insolvency estate, because an argument could be made that the segregation of assets does not form part of the System itself. The purpose of the SFD, which is aimed at minimizing the disruption to a System caused by the applicable insolvency provisions of the member states concerned, does itself not contain any explicit rules on the protection of a customer's rights as to the collateral security provided in case of the insolvency of the CM. Article 9 of the SFD only deals with the protection of the rights of the holder of collateral security and not the provider of such collateral security. Accordingly, although the applicability of Section 340(3) of the German Insolvency Code might provide a legal basis for the segregation of customer margin, we have set out below an analysis of the principles that would be applicable if the question of segregation of customer margin was not governed by Section 340(3) of the German Insolvency Code.

Under Section 47 of the Insolvency Code, a customer is entitled to the segregation (*Aussonderung*) of an asset from the insolvency estate of the debtor if it holds a right *in rem* or, in very limited circumstances, a right *in personam* pursuant to which the creditor can claim that the asset does not belong to the insolvency estate. In this regard, German insolvency law, in general, would respect and give effect to rights under non-German law that the creditor has validly acquired in accordance with German conflict of law rules, provided that such rights are comparable to German law rights entitling creditors to segregation.

Thus, in order to be entitled to claim the segregation of margin posted by the customers to the CM and by the CM to ICE Trust and held in the Net Margin Account or the Excess Omnibus Account, as applicable in an insolvency of the CM, the customers must have validly acquired in accordance with German conflict of law rules an *in rem* or *in personam* right which is comparable to German law rights entitling creditors to segregation.

Cash

We understand that the customers would not retain any proprietary interest in any cash margin deposited in the Net Margin Account or the Excess Omnibus Account by the CMs, and that ICE Trust would be obligated only contractually to return cash margin, after giving effect to any lien it or the CM may have. Furthermore, we understand that ICE Trust would return any cash margin in all circumstances, including the insolvency of the CM, to the CM. Accordingly, although the Net Margin Account and the Excess Omnibus Account would be held by ICE Trust for the benefit of the CM's customers or the CM as agent for the customers, it is uncertain whether the customers would be entitled to the segregation of cash margin from the insolvency estate of the CM because their respective claim against the CM for the return of such cash margin, from a German law perspective, probably does not constitute an in rem right or contractual right entitling a creditor to segregation within the meaning of German law. However, it might be possible to construe the arrangements regarding the Net Margin Account and the Excess Omnibus Account, and any claim for the return of cash margin deposited therein, as a trust arrangement within the meaning of German law, in which case the customers might be allowed to segregate from the insolvency estate cash margin deposited in such accounts.

Securities

Under New York law, any securities margin pledged by customers to their CMs and on-pledged to ICE Trust remains the property of the customers. It will be held in the Net Margin Account and the Excess Omnibus Account and will be pledged to the CM and (in the case of securities margin deposited in the Excess Omnibus Account) ICE Trust. The pledge does not transfer any legal or beneficial ownership in the securities to the CM or ICE Trust, but instead takes effect as a bare security interest. Thus, any securities margin remains the property of the customers, and the CM's and ICE Trust's rights to the securities margin are limited to their respective security interests. Once the obligations secured by the securities margin have been discharged, the CM and ICE Trust maintain no further interest in the securities.

German insolvency law should recognize the New York law effect of the pledge not to transfer to the CM or ICE Trust legal or beneficial ownership in the securities margin, but rather only a security interest therein.[107] Under New York law, the customer's legal entitlement to the securities margin *vis-à-vis* the CM and ICE Trust does not consist of a mere contractual right, but rather of an ownership interest in the securities, and we understand that such "ownership" position in the securities margin is comparable to a right *in rem* within the meaning of German law. Thus, the customers should be entitled to segregate securities margin from the CM's insolvency estate, and therefore should be able to ultimately recover their securities margin from the CM, notwithstanding any German insolvency proceedings opened with respect to the CM, provided that the obligations secured by the securities margin have been completely discharged. We note, however, that this analysis is subject to some uncertainty because the customers would hold a security entitlement in the securities margin

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[107] German law does not provide for a concept equivalent to the U.S. concept of "security entitlements". It is thus unclear under German law whether a "security entitlement" constitutes a "security" within the meaning of German law and, in particular, whether Section 17a of the German Safe Custody Act would therefore apply in respect of security entitlements credited to an account maintained in New York, or a contractual right. In light of this uncertainty, the possibly applicable laws include: (i) the law governing the account and the securities entitlement, or the law of the jurisdiction where the relevant account is maintained (Section 17a of the Safe Custody Act) – in this case presumably New York since The Bank of New York Mellon is ICE Trust's custodian, (ii) the law governing the securities or register thereof—e.g., U.S. federal law in the case of U.S. Treasury Securities, or the law of Canada, France, Germany, Italy, Japan, United Kingdom or the U.S. in case of G7 Government Securities, or (iii) the law of the location of any certificate – inapplicable in any the case of U.S. Treasury Securities and German Government Securities. We believe, however, that there is at least a substantial likelihood that New York law would be applied to securities (or, rather, security entitlements) credited to a securities account maintained in New York.

rather than title to the securities themselves and German law does not provide for a similar concept of indirectly holding securities.

Portability

If a CM became subject to German insolvency proceedings, the portability of customer-CM positions and CM-ICE Trust positions would be subject to some uncertainty.

First, generally, upon the opening of insolvency proceedings, the right to administer the insolvency estate passes to an insolvency representative (unless self-administration is ordered by the insolvency court), and any advance consent by the debtor to disposals which would occur after the opening of insolvency proceedings would become invalid. Thus, any transfer of a CM position will likely require the insolvency representative's consent.

Second, as discussed above, there are good arguments that ICE Trust will likely qualify as a System, in which case the law governing the System would govern the relationships of the "participants" of the System (Section 340(3) of the German Insolvency Code), and German insolvency law would not be applicable. In such case, there are also good arguments that the portability of positions is not affected by the opening of the insolvency proceedings because the System is governed by New York law, provided that such portability would not be affected if U.S. insolvency proceedings were opened with respect to the CM. In particular, any provisions providing for the termination of transactions, the determination of close-out amounts, the application of collateral and the transfer of CM-CCP positions are likely to remain unaffected by German insolvency law. However, there is no German case law or commentary available discussing to what extent a "portability framework" of a System would be upheld in a participant's insolvency, in particular as regards the possibility to port customer-CM positions. This matter therefore remains subject to some uncertainty and is a topic for further legal analysis. We note, however, that, in order to facilitate portability of Mirror Customer Positions (and associated margin) in the event of a CM default, the CMs will grant to ICE Trust a security interest in the CMs' rights in their Mirror Customer Positions (and associated margin) and will put into place Termination/Replacement Procedures which will be applicable if ICE Trust does not foreclose on such pledged rights, which arrangements should increase the likelihood that the Mirror Customer Positions may be ported in the event of CM's insolvency.

CMs That Are Swiss Financial Institutions (including English Branches of Swiss Banks)

As ICE Trust mandates the segregation of clients' assets and money on the CM level in certain situations, the CM would have the contractual obligation to segregate in such way, even though there is no Swiss statutory duty as set forth in Part II.C.6.(b) above.

In respect of segregation requirements in relation to an English branch of a CM which is incorporated in Switzerland (or indeed, any non-EU country), it is expected that any such branch conducting regulated activities in the U.K. would be regulated by the FSA. As a result, the segregation requirements would be similar to that of CMs that are English FSA-regulated entities as set out above.

In respect of the portability analysis for an English branch of a CM which is incorporated in Switzerland (or any non-EU country), in certain circumstances it can be possible for insolvency proceedings to be commenced in England, where the protection offered by Part VII of the Companies Act 1989 would be available.[108] Section 221 of the Insolvency Act 1986 allows the English courts to wind up an insolvent non-English company. The presence of a branch and assets in England will be relevant criteria for the court in deciding to exercise jurisdiction under Section 221. In practice, the most likely scenario is that the defaulting CM's "home" state would commence main insolvency proceedings, and an English court would commence ancillary proceedings (applying English law) in respect of the English branch, in which the protections of Part VII of the Companies Act 1989 (if available) would apply.

(f) Discussion of Outstanding Issues

ICE Trust's clearing framework allows participants to leverage the existing market infrastructure for OTC derivatives transactions—in particular, by retaining the ISDA Master Agreement as the governing framework for cleared CDS positions and providing dealers with the flexibility to clear CDS through the same entities in which they currently conduct their CDS business. At the same time, the flexibility that ICE Trust has afforded to its CMs has presented it with the challenge of accommodating CMs of differing organizational types across multiple jurisdictions. Particularly in the context of our inquiry into segregation and portability of customer CDS positions and related margin upon a CM default, this flexibility has rendered the analysis particularly lengthy.

For U.S. entities, the Segregation Analysis is generally quite strong, from the perspective of customers' legal rights to ultimately recover their margin, but questions may arise as to certain factual issues that may affect the range of custodial claimants with whom customers would be required to share in any shortfalls with. The Portability Analysis is not as strong, in light of certain issues arising from the back-to-back principal trade structure, and questions surrounding the enforceability of ICE Trust's Termination/Replacement Procedures. However, ICE Trust is currently in the process of developing contractual mechanisms that may largely mitigate these enforceability concerns.

For English CMs, the segregation analysis is generally clear as a legal matter and should not, of itself, be a cause for concern for customers as to their right to recover their margin eventually. However, until ICE Trust has received approval as a "recognised overseas clearing house", its ability to port open positions and related margin of an insolvent English CM may be significantly curtailed due to the application of certain mandatory rules under English insolvency law.

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108 For a discussion on the protections offered by Part VII of the Companies Act 1989, see the Portability Analysis in relation to CMs that are English FSA-regulated entities above.

ICE Trust does not currently have any CMs that are French financial institutions (or English branches of French banks). However, to the extent any French financial institutions (or English branches of French banks) clear customer positions through ICE Trust in the future, our analysis of the rights of such customers would be as follows. The analysis regarding segregation is relatively weak if the margin is deposited with the French CM (i.e., deposited in an account opened in the name of the customer with the French CM or in an account opened in the name of the CM with itself, its custodian or the CCP) since, in case of insolvency, French law requires customers who have deposited cash margin (whether via security interest or title transfer) or security margin (via title transfer) with the French CM to share in any shortfall on a pro rata basis with all other unsecured claimants of the French CM and those who have deposited security margin via security interest to share any shortfall pro rata on a CUSIP per CUSIP basis with all other claimants of the French CM (whether or not they have allowed rehypothecation of the deposited securities). However, in the case of CMs that are French banks acting through their English branch and securities margin is held in an account opened in England, the rights and effect of the French CM's insolvency on such securities should, under certain conditions, be determined under English law. The analysis regarding portability of positions and related margin is subject to considerable uncertainty due to mandatory rules of French insolvency law (i.e., the porting of positions and margin would require the consent of the French insolvency court).

For CMs that are German financial institutions (including English branches of German banks), a customer should ultimately be allowed to segregate margin from the insolvency estate of an insolvent CM if the margin was posted in accordance with ICE Trust's clearing rules. Although there are good arguments that ICE Trust's portability procedures would be given effect in German insolvency proceedings opened with respect to a CM that is a German financial institution, this is a topic for further legal analysis.

For CMs that are Swiss financial institutions (including English branches of Swiss banks), although there is no Swiss statutory duty to segregate client money and assets, such CMs would, as ICE Trust mandates such segregation, have a contractual obligation to do so. Client assets (i.e., securities margin) held by the CM or a sub-custodian will by law be segregated upon the bankruptcy of the CM, while there is no such segregation upon bankruptcy in respect of client money (i.e., cash margin). The analysis regarding portability of positions and related margin is subject to considerable uncertainty due to mandatory rules of Swiss regulatory and insolvency law, although in the case of English branches of Swiss banks, certain protections described above for FSA-regulated entities may apply to the extent they are available.

ICE Trust has suggested legislative amendments that would enhance the portability analysis for certain U.S. entities acting as CMs. We believe that ICE Trust's proposals would be very helpful for U.S. entities acting as CMs. However, ICE Trust has not, at this stage, provided legislative proposals for English, French, German and Swiss Financial Institutions. Therefore, customers of non-U.S. CMs would, even if ICE Trust's suggested legislative amendments were enacted, continue to face the uncertainties highlighted in this Report, to the extent non-U.S. law is applicable.

B. European CCP Solutions

1. Eurex

(a) Segregation Analysis

Under Eurex's clearing conditions, only proprietary funds of CMs are transferred to Eurex as margin. Accordingly, no customer margin is passed on to Eurex, unless a CM is entitled to rehypothecate customer margin. However, from Eurex's perspective, all the margin posted to it is CM proprietary margin. Since only proprietary funds of CMs are posted to Eurex, the clearing conditions of Eurex do not distinguish between a CM's house margin and customer margin, and aside from the rehypothecation of customer margin, there will be no commingling of proprietary assets and customer property at the CCP level.

At the CM level, generally, any margin segregation requirements will be determined by the laws applicable to the relevant CM and its arrangements with its customers. Except as described below, Eurex's clearing conditions do not provide for segregation requirements applicable at the CM level. However, CMs need to be regulated as credit institutions or financial services institutions within the European Union, Switzerland or the U.S. Since the principal domiciles of Eurex's CMs are anticipated to be Germany, the U.K., and the U.S., the relevant regulators of CMs would likely be the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) for German CMs, the FSA for English CMs, and SEC, CFTC, FED, OCC, OTS, NY Department of Banking Supervision and/or FDIC for U.S. CMs. CMs located in the European Union or Switzerland must hold a license to engage in safe custody business (*Depotgeschäft*), lending business (*Kreditgeschäft*) and deposit taking business (*Einlagengeschäft*), and CMs located in the U.S. must be similarly licensed.

In regard to German CMs, segregation of customer margin posted with the CMs will depend on the arrangements between the CM and its customers as well as applicable law. Given that CMs located in the European Union must hold a license to engage in safe custody business and deposit taking business, German CMs would constitute credit institutions and, thus, under German law, would not be subject to statutory segregation requirements. English CMs will have to comply with the FSA CASS Rules, although the CM-customer security arrangement may fall outside the ambit of the rules as set out below. For U.S. CMs, the requirements to segregate margin are set out below. The exact details of these requirements applicable to U.S. CMs (and, in certain cases, U.S. customers of non-U.S. CMs) are subject to ongoing discussions with the SEC and, once implemented, will apply through an order of the SEC as well as Eurex's clearing conditions

CMs That Are U.S. Entities

Margin transferred by customers to CMs under Eurex's clearing structure will typically be transferred under a title transfer arrangement. Eurex's clearing conditions, however, impose segregation requirements with respect to CMs located in the U.S. and all other CMs to the extent their customer is a U.S. person, unless they are already subject to segregation requirements with respect to cleared CDS collateral under U.S. law or regulation. Specifically, each CM not subject to such a legal segregation requirement must segregate the margin (including any increase resulting from the positions carried for the benefit of the customer) posted to it by any customer (in the case of CMs located in the U.S.) or by only U.S. customers (in the case of CMs not located in the U.S.) in respect of cleared CDS contracts. As a result of this segregation requirement, U.S. CMs must independently fund the Eurex margin requirement for all CDS transactions they clear for customers through Eurex and non-U.S. CMs must independently fund the Eurex margin requirement for all CDS transactions they clear for U.S. customers through Eurex.

Any U.S. CM (or non-U.S. CM with respect to U.S. customers) segregating assets pursuant to Eurex's clearing conditions must maintain the segregated assets (i) with a U.S. bank in a separate custodial deposit account explicitly for the benefit of each customer of the CM, or (ii) with a U.S. bank as a separate special custodial securities account explicitly for the benefit of each customer of the CM, or (iii) in a custodial account at and in the name of a U.S. bank acting as a third-party custodian explicitly for the benefit of the customers of the CM. The custodian must provide an acknowledgement that it is not entitled (i) to combine the segregated customer funds account with any other account or (ii) to exercise any right of set-off or counterclaim against assets in that account in respect of any sum owed to it on any other account of the CM. Finally, the customers covered by Eurex's segregation requirement would be granted a security interest in the segregated assets, which security interest would be perfected by control over the segregated assets in accordance with UCC § 9-104 or § 9-106.[109] Accordingly, although customers generally transfer margin to Eurex CMs under a title transfer arrangement, customers covered by Eurex's segregation requirements are protected by a security interest in segregated assets that are at least equivalent to their posted margin. In the event of a U.S. CM default (including a CM insolvency), customers would have the right to terminate their transactions with the CM (to the extent such transactions have not been transferred) and to exercise remedies against any segregated assets pledged for their benefit, although these rights may be limited by applicable insolvency law. In the following, we consider only the insolvency laws applicable to U.S. banks and FCMs.[110]

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[109] "Control" under these sections generally exists when the bank or securities intermediary carrying the account agrees that it will comply with instructions from the secured party without the further consent of the pledgor.

[110] Eurex notes that, although its Clearing Conditions would permit FCMs to become CMs, no FCM has thus far expressed an interest in clearing through an FCM. Eurex would also permit U.S. broker-dealers to become clearing members. We do not analyze customer transactions cleared by U.S. registered broker-dealers because we understand it to be unlikely that any U.S.-registered broker-dealer would clear CDS transactions in a customer's securities accounts through Eurex. Any U.S. entity dually registered as a broker-dealer and FCM that clears CDS transactions in a customer's commodities accounts through Eurex will be subject to the analysis below of U.S. FCMs and have the additional issue for dually licensed broker-dealer/FCMs described in Part II.C.2 above.

(i) U.S. Banks

CMs that are U.S. banks generally are not subject to segregation requirements under U.S. law or regulation and accordingly would be subject to Eurex's segregation requirement. In the case of a CM that is a U.S. bank that has entered receivership or conservatorship under the FDIA,[111] the termination of swap agreements based on the insolvency, financial condition, conservatorship or receivership of the bank is stayed (i) if the bank has entered conservatorship, for the duration of such conservatorship and (ii) if the bank has entered receivership, until 5:00 p.m. on the business day after the appointment of the receiver. While the termination of swap agreements is stayed, the conservator or receiver for the U.S. bank will have the right to transfer such swap agreements to another financial institution (together with all other qualified financial contracts between such bank and the customer or any of the customer's affiliates, and all related margin and credit support). After 5:00 p.m. on the business day after the appointment of a receiver for a U.S. bank, however, counterparties to swap agreements with such bank is permitted to terminate such swap agreement (if they have not been transferred to a different financial institution) and exercise their rights under any security agreement related to such swap agreements. Accordingly, customers whose CDS are cleared with Eurex through a U.S. bank should be able to terminate those cleared CDS shortly after the bank enters receivership (if the CDS are not transferred by the bank's receiver) and exercise remedies against the segregated assets pledged by the U.S. bank to the customers.

(ii) U.S. FCMs

U.S. FCMs are generally required by U.S. law and regulation to segregate assets received from customers to margin, purchase, guarantee, or secure commodity futures or commodity option transactions.[112] It is not clear, however, whether CDS cleared by Eurex are commodity futures or commodity options transactions for this purpose.[113] The U.S. FCMs will therefore be faced with uncertainty about whether they are subject to a segregation requirement

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[111] This report does not address the treatment of U.S. banks that are not insured by FDIC and subject to insolvency proceedings under the FDIA as it does not appear that any such banks currently contemplate clearing customer CDS transactions through Eurex.

[112] An exception to this general rule relates to assets received from persons located outside the U.S. to margin, purchase, guarantee, or secure non-U.S. futures or options. As a consequence, even if the cleared CDS were to be a commodity future or commodity option transaction, the U.S. FCM may not have a segregation requirement under U.S. law or regulation with respect to customers located outside the U.S. if the cleared CDS is determined to be non-U.S. futures or options transactions.

[113] As described in Part II.C.2 above, the CFTC has issued an interpretation that certain "cleared-only contracts" are "commodity contracts" within the meaning of the Bankruptcy Code and, in that interpretation, also stated that such contracts are "contracts for the purchase or sale of a commodity for future delivery" within the meaning of the Bankruptcy Code. This interpretation addressed the status of "cleared-only contracts" that are (i) executed over-the-counter and cleared by a registered derivatives clearing organization and (ii) the subject of a CFTC order pursuant to Section 4d(a)(2) of the CEA. Eurex, however, is not a registered derivatives clearing organization and has not indicated that it intends to so register, nor has it indicated that it intends to seek an order under Section 4d(a)(2). Moreover, this interpretation addressed the status of these contracts for purposes of the Bankruptcy Code and will not necessarily apply to the meaning of the related terms under the CEA.

under U.S. law or regulation or, instead, the segregation requirements of the Eurex clearing conditions. Moreover, it is unclear whether the Eurex-cleared CDS constitute "commodity contracts" under the Bankruptcy Code and the related CFTC rules.[114]

In a liquidation of the U.S. FCM under the Bankruptcy Code,[115] if the court determines that the Eurex-cleared CDS transactions are "commodity contracts", then (i) these contracts and the related margin provided by the customers should be included in the calculation of the customers' "net equity", (ii) the margin related to these contracts provided by the customers will be considered "customer property" available for distribution to all members of the relevant "account class",[116] and (iii) the cleared CDS customers will share, together with all other customers of the same account class, on a pro rata basis in any shortfalls in customer property of the account class. Although not completely clear, this treatment is likely to occur regardless of whether the U.S. FCM had held the margin collected in relation to the Eurex-cleared CDS separately from the assets segregated for the other members of the relevant account class, and regardless of whether the margin was pledged back to the Eurex-cleared CDS customers.

However, if the court in a Bankruptcy Code liquidation determines that the Eurex-cleared CDS transactions are not "commodity contracts" under the Bankruptcy Code, then the outcome may depend on whether the FCM commingled the margin for the Eurex-cleared CDS together with the customer property of commodities customers (e.g., because the FCM believed the Eurex-cleared CDS were commodity futures or options contracts) or segregated the margin separately. If the margin for the Eurex-cleared CDS is deposited into an account designated for the segregated customer property of commodities customers, the result is unclear. In the worst case, the margin for the Eurex-cleared CDS may be treated as customer property of the commodities customers and distributed to the commodities customers (to the extent of their net equity claims) before being made available to the cleared CDS customers or any other creditors.[117] This treatment would only matter if there were a shortfall in customer property, but could have the consequence that the Eurex-cleared CDS customers absorb the entire shortfall even if it was caused by the commodities customers. On the other hand, if the FCM segregates assets solely for the Eurex-cleared CDS customers, and the cleared CDS customers have a perfected security interest in those segregated assets, then the cleared CDS customers' interest in those assets should be superior to any interest of the commodities customers or unsecured creditors of the FCM.

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[114] See Part II.C.2 above.

[115] A U.S. FCM can also be subject to a federal equity receivership, rather than liquidation under the Bankruptcy Code. Such proceedings are governed by principles of equity and the ultimate outcome of such a proceeding is not clear.

[116] 17 C.F.R. § 190.01(a) identifies the following five account classes: U.S. futures accounts, non-U.S. futures accounts, leverage accounts, commodity option accounts and delivery accounts. It is unclear into what account class Eurex-cleared CDS would be classified.

[117] There is also a chance that, in such a case, the court would treat the cleared CDS customers as commodities customers of the same class based on an argument that the CDS transactions themselves and the related margin do or could constitute margin for other commodities contracts between the cleared CDS customers and the FCM. See 73 Fed. Reg. 65514, 65515-16 (Nov. 4, 2008).

CMs That Are English FSA-Regulated Entities

Whether a CM that is an English firm regulated by the FSA is required to segregate margin received from the client would depend on the nature of the collateral arrangement between the CM and the client. Eurex does not restrict the form of collateral arrangement between the CM and its client and they are therefore free to agree to any form of collateral arrangement between them as permitted under applicable laws.

Generally, CMs which are English firms regulated by the FSA are required to segregate margin received only if the margin falls under the category of "client money" or "client assets" in accordance with CASS Rules as set out in Part II.C.3. above. If the margin is transferred outright from the customer to the CM pursuant to a "title transfer collateral arrangement", such margin will not be considered "client asset" or "client money" under the CASS Rules and is therefore not required to be segregated by the CM. In the event of the CM's insolvency, the customer whose margin was transferred pursuant to a "title transfer collateral arrangement" will only have a non-proprietary contractual unsecured claim against the CM for equivalent margin to be returned.

Where a CM has received full title or full ownership to money under a collateral arrangement, the fact that it has also taken a security interest over its obligation to repay that money to the client would not result in the money being client money. This can be compared to a situation in which a firm takes a charge or other security interest over money held in a client bank account, where that money would still be client money as there would be no absolute transfer of title to the firm. However, if that security interest includes a "right to use arrangement", under which the client agrees to transfer all of its rights to money in that account to the CM upon the exercise of the right to use, the money may cease to be client money, but only once the right to use is exercised and the money is transferred out of the account to the CM.

If the margin is transferred by the customer to the CM as "client money" or "client assets", then the CM must hold such client money as a trustee pursuant to a statutory trust.[118] FSA-regulated firms are required to segregate "client money" from its own house funds promptly upon receipt by placing them in a central bank, certain authorized credit institutions or qualifying money market funds.[119] In relation to "client assets", FSA-regulated firms must, when holding safe custody assets (e.g., initial margin in the form of securities) belonging to clients, make adequate arrangements to safeguard clients' ownership rights[120] and have adequate organizational arrangements to minimize the risk of the loss or diminution of clients'

[118] CASS 7.7.

[119] CASS 7.4.1R.

[120] CASS 6.2.1R.

safe custody assets.[121] These are principle-based requirements, so the firms have a certain amount of discretion as to how they segregate client assets in practice.

In respect of margin posted by U.S. customers to English CMs, Eurex requires each English CM to segregate in a third-party bank funds, qualified securities or permitted investments equivalent to margin posted to such English CM by U.S. customers and to grant the U.S. customers a security interest in such segregated assets. We understand from Eurex that the U.S. SEC has not yet issued an order with respect to this requirement and Eurex's clearing conditions are still being refined with regard to this point. Eurex is exploring ways to mandate that the transfer of assets by a U.S. customer to an English CM will be effected in such a way that it would qualify as "client money" or "client assets" so that the transferred margin will be protected by a statutory trust pursuant to the CASS Rules and/or that the English CM will grant a security interest in respect of such transferred assets in favor of the U.S. customer.

We note that it is at present unclear how the broad powers granted to the U.K. government pursuant to the Banking Act 2009 will affect the existing regime dealing with "client money" and "client assets" as it applies to CMs which carry on the regulated activity of accepting deposits. On insolvency of such a CM, the U.K. government could, in certain circumstances, transfer to a private sector purchaser some or all of the CM's property, rights and liabilities. These powers are expressed to extend to "property held on trust" but it is not clear whether this means property held by the CM as trustee, or property held by a third party "on trust" for the CM. The Banking Act 2009 is relatively new and therefore it remains to be seen whether the U.K. government would exercise the wide-ranging powers available to it under the Act to effect transfers of customer margin from an insolvent CM to a new solvent CM.

CMs That Are French Financial Institutions (Including English Branches of French Banks)

If French insolvency proceedings are opened with respect to a French financial institution (i.e., licensed credit institutions, including banks, and investment firms licensed to provide investment services, including broker dealers), such proceedings will, in principle, relate to all assets and liabilities of the French financial institution, irrespective of where such assets and liabilities are located and what law governs them.

Deviating from such principle, French law provides that the rights and obligations of insolvent participants in a "securities settlement system" (a "System") within the meaning of Article L.330-1 of the French Monetary and Financial Code are determined by the law governing the System, provided that this is the law of an EEA jurisdiction. Article L.330-1 of the French Monetary and Financial Code was enacted in connection with implementing Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems ("SFD") under French law.

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121 CASS 6.2.2R.

We understand from Eurex that it is a System within the meaning of Article 2 of the SFD. Thus, in principle, Article L.330-1 of the French Monetary and Financial Code will apply if a French CM becomes subject to French insolvency proceedings. Accordingly, German law would govern the rights and obligations of the insolvent French CM "arising from, or in connection with, its participation" in Eurex, as well as the effect of the French CM's insolvency on such rights and obligations. However, whether the customers' rights with respect to margin would also be governed by German law would in particular depend on whether such customers' rights are determined to be part of the French CM's "rights and obligations arising from, or in connection with, its participation" in Eurex. There is no case law or other guidance on point. However, the fact that Eurex's rules generally leave it to CMs and their customer to implement measures for the protection of customer margin could constitute an argument against such a determination.

Since it is legally uncertain whether French insolvency courts would consider that German law should govern the customers' rights with respect to margin, we have set out below an analysis of the principles that would be applicable if the question of segregation of customer margin was governed by French insolvency law.

Article L.330-2 of the French Monetary and Financial Code provides that creditors of any participant, whether direct or indirect, in a System shall not have any right in the margin posted in accordance with the System's rules to secure any payment obligations arising from the participation in such System, whether or not insolvency proceedings have been commenced against the participant.[122] This rule is primarily intended to protect the Systems' rights with respect to margin posted with them by any participant from such participant's insolvency. Absent any case law or other guidance on point, it is uncertain whether this rule would apply to protect the customers' rights on the margin return. If, however, this were the case, in order to benefit from this rule, customers would need to qualify as an indirect participant in the concerned System. Under Section 1(16) of the German Banking Act, only customers that are licensed credit institutions generally qualify as indirect participants of a System. Therefore, customers which are not licensed credit institutions in Germany or in another EU Member State cannot qualify as indirect participants of Eurex.

Accordingly, although the applicability of Article L.330-2 of the French Monetary and Financial Code might provide a legal basis for the segregation of the customer margin, we have set out below an analysis of the principles that would be applicable if Article L.330-1 was not applicable. Since Eurex does not allow the direct posting of margin by customers with it and does not mandate any specific form of collateral arrangement, the customer's rights in the margin posted with the French CM would depend on the nature of the collateral arrangement between such customer and the CM.

Title transfer arrangements

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[122] Article L.330-2 of the French Monetary and Financial Code applies to French Systems but, in the event of an insolvency proceeding commenced in France against a French CM, although this is not free from doubt, the French insolvency court is likely to apply this rule to margin posted with another EEA System.

French law provides for a specific segregation and loss-sharing regime applicable to margin (cash or securities) posted by way of title transfer with a French CM in France. Under this regime, (i) the margin posted with a French CM to cover positions in a market in financial instruments (which would include, although this is not entirely free from doubt, any positions on financial instruments traded on the OTC market such as CDS) is dedicated to cover (i) any loss resulting from the liquidation of the customer's open positions and (ii) any amount due to the French CM; and (ii) creditors of the French CM have no right in such margin so that in the event that an insolvency proceeding is commenced against the French CM in France, the customer would recover the margin (after deduction of any above-mentioned losses and amounts due) ahead of the French CM's creditors. It is, however, doubtful that this special regime would apply to margin posted by way of title transfer with a French CM in connection with the clearing of CDS positions with any non-French CCP.

If this special regime is not applicable to French CMs of Eurex, then the segregation and loss sharing rules applicable to margin transferred via title transfer to such CMs (whether deposited with the CM directly or in an account opened in the CM's name with a custodian) would be as follows:

(x) with respect to margin which consists of cash: the cash transferred to the CM by the customer would be commingled with other cash held by the CM and therefore the customer would not be entitled to segregate any such cash and, in case of the CM's insolvency, would be an unsecured creditor of the CM in this respect; the customer would thus share in any shortfall on a pro rata basis with other unsecured creditors of the CM; and

(y) with respect to margin which consists of securities: to the extent that the securities so transferred are booked in an account opened in the name of the CM, French insolvency courts would consider that the customer would be an unsecured creditor of the CM in respect of such margin and therefore would share in any shortfall on a pro rata basis with other unsecured creditors of the CM. By exception to the foregoing, in the event that the account in which the securities posted as margin is maintained at the English branch of the French bank CM, French insolvency courts would to the extent that the existence or transfer of the securities so deposited as margin with the English branch of the French bank requires their recording in that account, defer to English law to determine the rights of the customer, the French bank and third parties (including creditors of such French bank) as well as the effect of the French bank's insolvency on such rights.[123]

Security interest arrangements

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[123] French law would also point to English law if the securities posted as margin are recorded in another securities account, a register or a centralized deposit system held or located in England, provided that such recording is required for the existence or transfer of such securities.

Cash

If the customer deposits and pledges any cash margin with the CM that is a French financial institution (or an English branch of a French bank) and such French CM becomes subject to insolvency proceedings in France,[124] French insolvency courts would certainly consider that the cash deposited with the French CM by the customer would be commingled with other cash held by the French CM. The same would apply to cash deposited by the customer with Eurex if such cash is booked in an account opened in the name of the French CM acting as agent on behalf of its customers where the customer has no direct relationship or right against Eurex. Accordingly, the customer would not be entitled to segregate any such cash and would rather be an unsecured creditor of the French CM in this respect.

Securities

If the securities margin is deposited and pledged with the French CM and such securities would be booked in an account opened with the French CM in the name of the customer in France, French segregation rules should apply. Under such rules, the securities held by the insolvent French CM on behalf of customers are shared among them on a pro rata (and security per security) basis (i.e., among all claimants, regardless of whether they have or have not allowed rehypothecation). Once the allocation among customers has been made, customers may require that the securities allocated to them be transferred to another financial institution. For the remainder of the shortfall, they become unsecured creditors of the French CM.

As mentioned above, by exception to the foregoing, in the event that the account in which the securities posted as margin is maintained at the English branch of the French bank, French insolvency court could point to English law to determine the rights under such securities as well as the effect of the French bank's insolvency on such rights.

U.S. Security Interest Structure

In respect of margin posted by U.S. customers to French CMs, Eurex requires each French CM to segregate in a U.S. bank funds, qualified securities or permitted investments equivalent to margin posted to such French CM by U.S. customers and to grant the U.S. customers a security interest in such segregated assets. French law should respect and give effect to such security interest in any French insolvency proceedings opened with respect to the French CM if (i) the obligations secured by such security interest qualify as financial obligations within the meaning of Article L.211-36 of the French Monetary and Financial

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124 Assuming that all French CMs would be credit institutions, an English branch of such a credit institution cannot become subject to English insolvency proceedings, and therefore the protections of Part VII of the UK Companies Act 1989 will not be available.

Code,[125] (ii) the security agreement is governed by the law of a U.S. jurisdiction, (iii) the segregated assets consist of book-entry securities qualifying as financial instruments under French law or cash held in an account located in such jurisdiction, (iv) the security interest is properly created and perfected by control under the law of such jurisdiction.

CMs That Are German Financial Institutions (Including English Branches of Banks)

First, since CMs post only proprietary funds as margin to Eurex, customers will not be entitled to request the segregation of any such dealer margin if a German CM becomes subject to German insolvency proceedings.[126]

Second, in regard to customer margin posted to German CMs, the following principles should apply, always subject to applicable documentation and that the secured obligations of the customer have been discharged in full:

If margin was posted to the CM by way of an outright transfer, with an unsecured claim of the customer to the return of the margin, irrespective of what law governs such outright transfer, the customer would not be entitled to segregate any margin posted to the CM. The same would apply if the CM has rehypothecated the margin. We understand that this will be the typical arrangement between German customers and their CMs.

If cash margin was posted to the CM in accounts with the CM, the customer would most likely have an unsecured claim for the repayment of such cash margin even if, under applicable substantive law, tracing and segregation is possible under certain circumstances. Any arrangement, however structured, where the cash is held by the CM itself would almost certainly not be recognized by German courts as entitling the customer to segregation because, from a German law perspective, any cash transferred by the customer to the CM would be commingled with other cash held by the CM. On the other hand, if cash margin in accordance with client money rules was deposited by the CM with a third party custodian in a trust account for the benefit of the customer, such cash margin would not form part of the CM's insolvency estate and could be segregated.

If securities margin was posted to the CM and such securities margin was deposited with a third party custodian who held the securities margin "on trust" for the customer, such securities margin would not form part of the CM's insolvency estate and could be segregated.

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125 The security interest would be granted to secure the French CM's obligation to return margin to the U.S. customers. Since these obligations would result from transactions on financial instruments (under French law, financial instruments include derivative instruments for the transfer of credit risk) and the French CM would be a regulated financial institution, the obligations secured by the security interest should qualify as financial obligations under French law.

126 An English branch of a German CM that is a credit institution cannot become subject to English insolvency proceedings, and therefore the protections of Part VII of the Companies Act 1989 will not be available.

If securities margin was posted to the CM and such securities margin was not deposited with a third party custodian, the customer should nevertheless be entitled to segregate the securities margin from the insolvency estate of the German CM if certain requirements are met, as described below.

Under Section 47 of the German Insolvency Code (*Insolvenzordnung*), a creditor is entitled to the segregation (*Aussonderung*) of an asset from the insolvency estate of the insolvent entity if it holds a right *in rem* or, in very limited circumstances, a right *in personam* pursuant to which the creditor can claim that the asset does not belong to the insolvency estate. In this regard, German insolvency law, in principle, would respect and give effect to rights under non-German law that the creditor has validly acquired in accordance with German conflict of law rules, provided that such rights are comparable to German law rights entitling creditors to segregation.

Thus, in order to be entitled to claim the segregation of the securities margin posted by the customer with the CM, the position of the customer in respect of the securities under its arrangements with the CM (i) must have been validly acquired in accordance with German conflict of law rules and (ii) must be comparable to German law rights entitling creditors to segregation. In order to establish the foregoing, a detailed analysis of the relationships between the customer and the CM, the posted securities margin, and the collateral arrangements would be required. No information in this regard is provided in the response to the questionnaire. In general, however, the following should apply: If German law applied to the acquisition of the securities and the grant of the pledge therein in accordance with the principles described under Part II.C.5.(b) above and the customer is the legal and beneficial owner of the securities pledged to the CM, the customer would be able to segregate the securities in any German insolvency proceedings opened with respect to the CM.[127] The same would apply if the customer is the owner of the securities under applicable non-German law, e.g., if the securities are booked in an account maintained by a non-German branch of the CM or a non-German custodian, or if the securities are transferred by entries in registers pursuant to non-German law, all in accordance with the principles described under Part II.C.5.(b) above, and the rights acquired under the relevant non-German law are equivalent to a German law right entitling the owner of such right to the segregation of the relevant asset.

Third, Eurex requires each German CM to segregate in a U.S. bank funds, qualified securities or permitted investments equivalent to margin posted to such German CM by U.S. customers and to grant the U.S. customers a security interest in such segregated assets. If (i) the security agreement is governed by the law of a U.S. jurisdiction, (ii) the segregated assets consist of book-entry securities or cash carried in an account located in such jurisdiction[128] and (iii) the security interest is properly created and perfected through control

[127] In principle, the same result could be achieved with a German law transfer for security purposes (*Sicherungsübereignung*). As a practical matter, however, transfers for security purposes are rarely used as a means to secure obligations resulting from CDS transactions.

[128] The determination of the law applicable to the transfer or encumbrance of securities is subject to some uncertainty. See Part II.C.5.(b) above.

under the law of such jurisdiction, then German law should respect and give effect to such security interest in any German insolvency proceedings opened with respect to the CM. Similar results should be yielded if the German CM is required to segregate margin in accordance with U.S. statutory requirements, provided that the implementation and effects of such segregation are similar to the structures described above entitling customers to segregation under contractual arrangements. In this regard, German insolvency law would probably not give effect to any laws providing for "deemed segregation" if the relevant assets were not actually segregated.

CMs That Are Swiss Financial Institutions (Including English Branches of Banks)

As Eurex does not mandate segregation on the CM level, Swiss Banks are not required to segregate client money and assets as there is, as set out in Part II.C.6.(b) above, no corresponding Swiss statutory duty.

In respect of segregation requirements in relation to an English branch of a CM which is incorporated in Switzerland (or indeed, any non-EU country), it is expected that any such branch conducting regulated activities in the U.K. would be regulated by the FSA. As a result, the segregation requirements would be similar to that of CMs that are English FSA-regulated entities as set out above.

(b) Portability Analysis

Under Eurex's clearing conditions, Eurex generally enters into transactions with CMs on a principal-to-principal basis, and Eurex has a contractual relationship only with the CM. The CMs, on the other hand, enter into transactions with their customers also on a principal-to-principal basis. In addition to CMs, certain "Registered Customers" may submit trades for clearing through Eurex if they have entered into a tripartite clearing agreement in the form specified by Eurex with a CM and Eurex. Such tripartite agreement gives Eurex the power to enforce any provision of that agreement also vis-à-vis the customer. Following the clearing of a trade submitted by a Registered Customer, the submitted trade is replaced by relationships similar to the ones described above. Although Eurex always has (after clearing) a contractual relationship only with the CMs, Eurex's maintains, for each CM, different accounts for "principal" and "agent" positions. "Principal" positions are those entered into by CMs without an offsetting customer position, and "agent" positions are positions entered into by CMs with an offsetting customer position. This account structure allows Eurex to identify customer positions and enhances portability.

In terms of portability of customer positions, Eurex does not have the authority to mandate the transfer of any CM or customer positions, although at our initial meeting with Eurex, Eurex indicated that it is open to changing its clearing conditions to allow mandatory transfers, if and to the extent the same would be permitted under German insolvency law (as the law governing the Eurex clearing conditions). At present, Eurex can only do so with the cooperation of the customer, the (defaulting) CM (or its insolvency representative), and a receiving CM. Accordingly, both the Eurex-CM position and the underlying CM-customer position can be ported together on a CM's default to a new CM only if all parties agree. If a customer of a defaulting CM intends to port its position, it must arrange to have a new CM accept the customer's positions.

In terms of portability of customer margin, Eurex does not hold customer margin at the CCP level on behalf of CMs. Thus, Eurex cannot move customer margin maintained at the defaulting CM or its custodian. The transfer of customer margin must originate from the defaulting CM (or its insolvency representative) or its custodian. In the event that customer margin is not transferred from the defaulting CM to the new CM, the customer would need to fund margin required by the new CM upon such transfer.

In addition to the impediment to portability that the customer and the defaulting CM need to agree to the transfer, it should be noted that Eurex's clearing conditions currently provide for automatic early termination of all CM-Eurex positions upon the opening of formal insolvency proceedings in respect of a CM. Upon automatic early termination, the respective parties' outstanding obligations would be closed-out and netted. The respective close-out amount would be determined by Eurex. Accordingly, a position could after the CM's insolvency be ported only if all parties concerned (including the CM's insolvency representative) agree to reinstate the position. As a practical matter, we would expect that most of the German CMs' master agreements with customers also provide for automatic early termination upon the CM's insolvency.

CMs That Are U.S. Entities

If positions and margin are transferred by agreement among the customer, the U.S. CM and Eurex while the CM is not subject to insolvency proceedings, U.S. law generally will not interfere with the transfer. Moreover, if the U.S. CM enters insolvency proceedings under the Bankruptcy Code (applicable to U.S. FCMs, broker-dealers and unregulated business entities) or the FDIA (applicable to FDIC-insured banks) after a transfer, U.S. law should prevent the CM's insolvency representative from avoiding the transfer of the position or related margin.[129]

Although Eurex's rules provide for the automatic termination of a CM's cleared CDS positions upon the insolvency of the CM, such a termination will be subject to a stay if a conservator or receiver has been appointed under the FDIA for a CM that is a U.S. bank. The stay lasts for the duration of the conservatorship and until 5:00 p.m. on the business day after the appointment of the receiver. While the termination is stayed, the conservator or receiver for the U.S. bank will have the right to transfer all swap agreements (and other qualified financial contracts) between the bank and Eurex (and all of its affiliates), together with all related margin and credit support, to another financial institution. Termination by the customers would be likewise stayed and the conservator or receiver would likewise have the power to transfer to another financial institution all swap agreements (and other qualified financial contracts) between the bank and any customer (and all of such customer's affiliates),

[129] 11 U.S.C. § 560; 12 U.S.C. § 1821(e)(8)(C). These protections do not apply, however, where the transfer was made with actual intent to hinder, delay or defraud the CM or its creditors.

together with all related margin and credit support. Termination under Eurex's rules could take effect after the expiration of the stay, if the cleared CDS have not been transferred.

The provision of Eurex's rules for the automatic termination of a CM's cleared CDS positions upon the insolvency of the CM should be given effect notwithstanding the CM's status as a debtor in proceedings under the Bankruptcy Code.[130]

CMs That Are English FSA-Regulated Entities

Eurex is a "recognised overseas clearing house" for the purposes of the Companies Act 1989. It will therefore be able to take advantage of the protections offered by that law, which should allow it to give effect to its portability procedures without restriction by the liquidator or administrator of an English CM's estate. Part VII of the Companies Act 1989 has the effect of disapplying the parts of English insolvency law that could be used to challenge or restrict actions taken by a "recognised overseas clearing house" under its default rules to the extent they fall within the protections provided to market contracts of regulated clearing houses. The details of Eurex's portability procedures are still be developed so it is not possible to identify specific concerns but one potential area that will need to be carefully considered is the ability of Eurex to include within its default rules which benefit from the Part VII protection rules that deal with margin which is held by Eurex in excess of the margin requirements for the related positions.

To the extent Eurex is also a "designated system" within the meaning of The Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "Settlement Finality Regulations"), its portability procedures will be further protected because Regulation 14 of the Settlement Finality Regulations provides that Eurex's default arrangements are to take precedence over general insolvency proceedings of the English CM.

In respect of English CMs that are deposit-taking institutions, the Banking Act 2009 has introduced a Special Resolution Regime which would allow the U.K. government to stabilize certain institutions in distress. The U.K. government may in certain circumstances transfer some or all of the property, rights and liabilities of a bank (including any CDS positions (and potentially customer margin[131])) to a private sector purchaser or to a bridge bank. However, secondary legislation[132] has been implemented with the objective of ensuring

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130 In our meeting with Eurex, they reported to us that the termination of a CM's cleared CDS positions would not necessarily occur when the CM enters insolvency proceedings, unless the CM is actually insolvent at the time. When LBIE entered administration, for example, Eurex's board determined that LBIE was not insolvent and therefore facilitated consensual transfers of LBIE's positions. In the event cleared CDS are not terminated by Eurex when a U.S. CM enters insolvency proceedings, transfers consented to by the CM's insolvency representative generally will be given effect.

131 Although there are provisions in the Banking Act 2009 that deal with "property held on trust", it is unclear what the term means as it could mean property held by the bank as trustee or property in which the bank is the beneficiary.

132 The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009.

that partial transfers of a bank's assets by the government do not interfere with netting and collateral arrangements. This secondary legislation makes a partial transfer of an insolvent bank's assets invalid if it conflicts with the Settlement Finality Directive, Part VII of the Companies Act 1989, or the legal protections afforded to title transfer financial collateral arrangements. Security arrangements are dealt with separately, by providing that no partial transfer of secured assets may be made without also transferring the secured liability. Given the relative novelty of the Banking Act 2009 and related legislation (and the fact that they have not been used to date) it is not possible to say how interventionist the U.K. government would seek to be in respect of a relevant CM's CDS arrangements with its customers and a CCP.

CMs That Are French Financial Institutions (Including English Branches of French Banks)

As mentioned above, Eurex's CDS clearing system qualifies as a System and French law provides that when a French CM (including an English branch of a French bank) becomes subject to insolvency proceedings in France, the rights and obligations arising from, or in connection with, its participation in a System regulated in the EEA are governed by the law governing such System.

Therefore, in the event that a French CM becomes subject to insolvency proceedings in France, German law should govern the CM's rights and obligations arising from, or in connection with, its participation in Eurex. This should include any provisions applicable in the event of a CM's default such as the liquidation of positions, the determination of close-out amounts and the application of collateral, as well as any provisions relating to the transfer of the CM-CCP positions and related margin. French insolvency law should therefore not be applicable to these matters and French insolvency courts should respect without restriction the transfer arrangements made in accordance with German law.

With respect to the transfer of the customer-CM positions and related margin corresponding to the Eurex/French CM positions transferred to a new CM, in particular if the customers' rights with respect to margin are determined to be part of the French CM's "rights and obligations arising from, or in connection with, its participation" in Eurex, the above rule should apply and such transfers should also be governed by German law and French insolvency courts should respect them without restrictions.

There is, however, no French case law or other guidance available as to what extent a "portability framework" of a System would be upheld in a French participant's insolvency, in particular with respect to the possibility to port the customer-CM positions and related margin. This remains therefore subject to uncertainty and would require further analysis.

If a CM that is a French financial institution (or an English branch of a French bank) becomes subject to French insolvency proceedings and the CM's business activities are continued, the insolvency representative has discretionary power to terminate any contract entered into by the insolvent CM if he determines that such contract is not necessary for the continuation of the CM's business. If the insolvency representative makes such a decision, the

CM's open positions with Eurex and the corresponding customer's open positions with the CM would be liquidated thereby preventing any transfer of such positions to a new CM.

CMs That Are German Financial Institutions (Including English branches of German Banks)

If a German CM becomes subject to German insolvency proceedings, the CM's position with Eurex would terminate automatically in accordance with Eurex's clearing conditions, and a close-out amount would be determined by Eurex, and German insolvency law would probably not give effect to any provisions under non-German law delaying or preventing such early termination.[133] Assuming any master agreements entered into between the CM and its customers would also provide for automatic early termination, such master agreements would also be terminated and closed out. (However, if a master agreement were governed by a law other than German law, and such law included provisions delaying or preventing early termination, German insolvency law would likely uphold such provisions.) Unless the CM's insolvency representative, the customer, and a new CM agree to "port" the CM's position and the customer's position to the new CM, including margin, the positions would thus generally be liquidated, and it would not be possible to port any terminated positions without the cooperation of the insolvent CM's insolvency representative.

CMs That Are Swiss Financial Institutions (Including English Branches of Swiss Banks)

As set forth in Part II.C.6.(e) above, a transfer of a transaction after the CM has been made subject to protective measures by FINMA or adjudicated bankrupt would be subject to the cooperation of FINMA or the receiver in insolvency, respectively, as the CM will have lost some or all (as the case may be) capacity to dispose of its assets.

In respect of the portability analysis for an English branch of a CM which is incorporated in Switzerland (or any non-EU country), in certain circumstances it can be possible for insolvency proceedings to be commenced in England, where the protection offered by Part VII of the Companies Act 1989 would be available. Section 221 of the Insolvency Act 1986 allows the English courts to wind up an insolvent non-English company. The presence of a branch and assets in England will be relevant criteria for the court in deciding to exercise jurisdiction under Section 221. In practice, the most likely scenario is that the defaulting CM's "home" state would commence main insolvency proceedings, and an English court would commence ancillary proceedings (applying English law) in respect of the English branch, in which the protections of Part VII of the Companies Act 1989 (if available) would apply.

(c) Applicable Sharing Rules in the Event of a Shortfall

In the event of a shortfall in customer property held at a CM, the analysis set forth in Part II.C. above would apply.

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[133] An English branch of a German CM that is a credit institution cannot become subject to English insolvency proceedings, and therefore the protections of Part VII of the Companies Act 1989 will not be available.

(d) CCP Requests for Legal Change or Clarification

Although Eurex did not make any proposals in response to our request for legislative proposals, Eurex has indicated that it is in continuous contact with all relevant authorities regarding possible improvements in the insolvency regimes applicable to the relationships between Eurex and its CMs if a CM becomes subject to insolvency proceedings.

(e) Discussion of Outstanding Issues

Since Eurex has no contractual relationship with the CMs' customers, Eurex's clearing conditions currently leave it to the customers (other than in the case of U.S. customers or customers of U.S. CMs) to protect their interests with respect to margin themselves, but also do not restrict customers and CMs in respect of implementing any measures for the protection of customer margin. In addition, Eurex is in the process of implementing a structure which, for U.S. CMs and U.S. customers of non-U.S. CMs, requires that customer margin be segregated by the CM and in certain circumstances requires that the margin be pledged to the customer by the CM. The effectiveness of such pledges and the effect of such an arrangement in the event of the default or insolvency of a customer would have to be examined in each relevant jurisdiction on a customer-by-customer basis; the CMs will need to have clear rights in the margin in a customer default. For non-U.S. customers of non-U.S. CMs, segregation of customer margin is currently not required by the Eurex structure beyond what may be mandated by the laws applicable to the customer's relationship with the relevant CM. However, Eurex is in the process of considering segregation structures for non-U.S. CMs and customers generally. Accordingly, segregation requirements contained in Eurex's clearing conditions might be subject to significant change in the near future.

Although portability of positions may be possible under certain circumstances, Eurex does not mandate portability of CM-customer positions and Eurex-CM positions including margin because German insolvency law effectively prohibits the portability of positions upon the opening of formal insolvency proceedings in respect of a CM, and because customer margin is held with the defaulting CM and not Eurex. Also, Eurex's clearing conditions currently provide for automatic early termination of all CM-Eurex positions upon the opening of formal insolvency proceedings in respect of a CM, which effectively limits the time during which customer positions can be ported, unless all parties concerned (including the CM's insolvency representative) agree to reinstate the positions. Prior to that time, customer positions (i.e., both the customer-CM positions and the related CM-Eurex positions) may be transferred with the consent of all parties concerned (including the customer). In such a case, Eurex would release to the CM any margin no longer required to cover the transferred CM-Eurex positions. It would depend on the transfer arrangements between the customer and its CM whether the CM would release to the customer any customer margin no longer required to cover the transferred customer-CM position. In LBIE, Eurex was able to successfully port customer positions prior to formal insolvency proceedings being opened.[134]

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[134] With respect to customer margin, see footnote 11 above.

2. ICE Clear Europe

(a) Segregation Analysis

ICE Clear Europe is currently developing its framework in relation to its CDS clearing activities and therefore its structure as set out below may be subject to ongoing refinement. Currently, ICE Clear Europe intends to enter into transactions with CMs on a principal-to-principal basis in relation to CDS transactions. The CM's proprietary transactions will be recorded separately from its customer transactions. Where a CM enters into a customer transaction with ICE Clear Europe, the CM will also enter into a back-to-back principal-to-principal transaction between itself and the customer. The transactions between the CM and the customer will be documented by an ISDA Master Agreement with a standardized annex (the "Standard Annex") between the customer and the CM dealing only with ICE Clear Europe cleared contracts and not with any other derivative transactions. The customer will not have a direct relationship with ICE Clear Europe other than through certain rights, which ICE Clear Europe may enforce pursuant to the Standard Annex. The Standard Annex is currently being developed and is not available for general distribution as yet, although a description of certain provisions has been provided. Therefore we are not able to comment on the precise legal framework set out in the Standard Annex, and the discussion below is therefore subject to the finalization of the Standard Annex and any further changes that ICE Clear Europe might implement.

Segregation of Margin

CMs will be required to post margin to ICE Clear Europe on a net basis (e.g., all of the CM's customer positions are combined and margined based on the net position across all of that CM's customers) ("ICE Net Margin"). Customers will be required under the Standard Annex to post to the CM the minimum margin required by ICE Clear Europe based on that single customer's portfolio risk (the "ICE Gross Margin") together with any CM Excess Margin.

It is currently contemplated that a CM's customer accounts at ICE Clear Europe will comprise one customer omnibus account per CM (the "ICE Customer Omnibus Account") and one excess customer omnibus account per CM (the "ICE Excess Omnibus Account", and together with the "ICE Customer Omnibus Account", the "ICE Customer Accounts"). Margin posted by the CM to ICE Clear Europe in respect of the CM's customer positions in the ICE Customer Accounts will be segregated from margin posted by the CM to ICE Clear Europe in respect of the CM's proprietary positions. The ICE Customer Omnibus Account will contain the ICE Net Margin. The ICE Excess Omnibus Account will contain the difference between the aggregate ICE Gross Margin collected by the CM from its customers and the ICE Net Margin posted by the CM to the CCP in the Customer Omnibus Account (the "ICE Excess Margin" and together with the CM Excess Margin, the "Excess Margin"). Treatment of CM Excess Margin would be as agreed between the customer and CM. If the CM and the customer agree that the CM Excess Margin is to be held with ICE Clear Europe, whether such margin will be held in the ICE Excess Omnibus Account or a separate account is under deliberation by

ICE Clear Europe. The CM will be required to maintain records showing the amount and form of Excess Margin held in the ICE Excess Omnibus Account in respect of positions of each relevant customer separate from the ICE Customer Omnibus Account. Excess Margin would be held by ICE Clear Europe through its custodian (which is currently JPMorgan Chase, an FSA-regulated entity) effectively as banker (in relation to cash) and as custodian (in relation to non-cash assets) for the benefit of the CM who in turn holds such rights and the receivables thereunder "on trust" for the benefit of its customers. This arrangement may be helpful in the event of the CM's insolvency, as it would likely allow customers to recover any such trust margin that is returned to the insolvent CM ahead of unsecured creditors.

Customers are required to transfer the ICE Gross Margin and CM Excess Margin (if any) to the CM pursuant to a "title transfer collateral arrangement". The CM will agree in the Standard Annex to comply with certain segregation requirements in respect of margin collected from each customer, although the CM will have the right to rehypothecate any margin collected from the customer to ICE Clear Europe. The CM will be required to transfer the ICE Net Margin to ICE Clear Europe into the ICE Customer Omnibus Account pursuant to a "title transfer collateral arrangement". It will also be required to transfer the ICE Excess Margin to the ICE Excess Omnibus Account.[135] The margin received by ICE Clear Europe from the CM will be segregated in the ICE Customer Omnibus Account or the ICE Excess Omnibus Account, as the case may be. CMs are required to post ICE Gross Margin to ICE Clear Europe into the relevant ICE Customer Accounts within certain timelines, whether they are on-posting margin provided to them by customers or using their own assets. Failure to provide margin within such timelines will constitute a default by the CM under the rules of ICE Clear Europe. To the extent a CM has received customer margin and not transferred it to ICE Clear Europe, the margin, pursuant to the Standard Annex, must be held by the CM in segregation from the CM's assets.

There is a concern that customers may not have a proprietary right to margin posted to the CM but not yet transferred to ICE Clear Europe (the "Margin-in-Transit") because margin is transferred from the customer to the CM pursuant to a "title transfer collateral arrangement". If this were to be the case, then the Margin-in-Transit could be available for distribution to creditors of the insolvent CM generally and the customer who transferred such margin could only have an unsecured debt claim against the insolvent CM. Whether customers have any proprietary right to the Margin-in-Transit would depend on the jurisdictional insolvency analysis of the CMs (as set out in further detail below).[136]

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135 Note: The legal structure of this transfer is still to be determined.

136 To the extent that ICE Clear Europe has made a margin call on the CM, the transfer of margin from the CM to ICE Clear Europe may be protected from the insolvency of the CM as a result of the margin call being considered a "transfer order" for purposes of the Settlement Finality Directive. In such a case, the rules of the clearing house which is also a "system" under the Settlement Finality Directive are to be respected notwithstanding any rules of insolvency law that might otherwise invalidate them (e.g., an insolvency rule that invalidates dispositions made by the CM after the commencement of its insolvency proceedings without a court order).

CM Default

In the event of a CM default, ICE Clear Europe would not be permitted to net proprietary positions against customer positions. ICE Clear Europe would also not be permitted to satisfy margin deficits arising solely from proprietary positions by applying funds from the ICE Customer Accounts. However, ICE Clear Europe would be able to satisfy any margin deficits arising from customer positions by accessing funds in the ICE Customer Omnibus Account. Withdrawals from the ICE Customer Omnibus Account would be allocated pro rata among customers of the insolvent CM. In contrast to the ICE Customer Omnibus Account, ICE Clear Europe would be prohibited from using customer funds in the ICE Excess Omnibus Account to satisfy customer margin deficits resulting from default losses. However, ICE Gross Margin held in the ICE Excess Omnibus Account may be transferred into the ICE Customer Omnibus Account to satisfy any margin shortfall resulting from transfers of some, but not all, of the customer positions of the defaulting CM. Therefore, margin held in the ICE Excess Omnibus Account is more likely to be recoverable, in the event of a CM insolvency, than margin held in the ICE Customer Omnibus Account.

If ICE Clear Europe does not effect a transfer within the relevant transfer period (e.g., because no CM was willing to accept transfer of such customer positions), the Standard Annex would permit the customer to terminate the relevant customer-CM transactions in accordance with their terms. In that case, remaining customer margin in the ICE Customer Accounts would be returned by ICE Clear Europe to the insolvent CM, who will hold such rights against ICE Clear Europe for the return of the customer margin and all receivables thereunder subject to a trust declared by the CM in favor of its customers. Any assets received by the CM's insolvency representative must therefore be placed by its insolvency representative in a separate trust account for the benefit of the customers. It is expected that customers of the insolvent CM would have a proprietary claim to any customer margin so received by the CM from ICE Clear Europe as well as in the claim for such return. Such returned customer margin would therefore not be available to the CM's insolvency practitioner for distribution to creditors generally. However, as the customer margin would still be returned by ICE Clear Europe to the defaulting CM (or, more likely, the defaulting CM's insolvency representative), depending on the applicable insolvency rules and procedures, there may be timing issues in the return of customer margin held "on trust" for the defaulting CM's customers.

In summary, certain aspects of ICE Clear Europe's arrangement are helpful to the Segregation Analysis, including the following: (i) customer margin once received by the CM must be segregated pending transfer to ICE Clear Europe; (ii) customer margin once transferred to ICE Clear Europe is held in segregated accounts and is not commingled with the proprietary assets of the CM; (iii) the CM holds the right against ICE Clear Europe for the return of customer margin and all receivables thereunder "on trust" for the benefit of its customers; and (iv) the ICE Gross Margin and ICE Excess Margin (but not necessarily the CM Excess Margin) are held in segregated accounts at a custodian of ICE Clear Europe.

CMs That Are U.S. Entities

Under the rules of ICE Clear Europe, all margin held at or for the CCP ("CCP Margin") posted by customers to a CM must be posted pursuant to a title transfer arrangement, and must, in turn, be posted to ICE Clear Europe in a title transfer arrangement. The CM therefore retains only a contractual right to the return of the CCP Margin. ICE Clear Europe's rules provide that the CM holds the contractual right to the return of the CCP Margin in trust for the customers who posted such CCP Margin. In receivership proceedings under the FDIA, property held in trust by the failed financial institution is generally not regarded as property of the failed financial institution available for distribution to its customers. Similarly, property in which a debtor under the Bankruptcy Code[137] has a only a legal title and not an equitable interest is excluded from the debtor's bankruptcy estate. The contractual right to the return of the CCP margin, however, is not held purely in trust for the customers, nor is the CM's interest in the contractual right solely legal title—the customers posted the CCP Margin to the CM first and foremost as credit support for the customers' obligations to the CM under the CDS transactions between the customers and the CM that are cleared through ICE Clear Europe. Accordingly, there is some uncertainty regarding whether, in an insolvency proceeding involving a U.S. CM, the CM's rights to the return of the CCP Margin (or the CCP Margin itself after it is returned to the CM) will be considered the property of the cleared CDS customers or included among the resources of the insolvent U.S. CM that are available to satisfy the claims of the CM's unsecured creditors (although the degree of this uncertainty may merit further analysis).

CMs That Are English FSA-Regulated Entities

To the extent a CM has received customer margin and not transferred it to ICE Clear Europe, the margin must be held by the CM in segregation from the CM's assets pursuant to the Standard Annex. However, such margin is transferred from the customer to the CM pursuant to a "title transfer collateral arrangement". As a result, such margin will not be considered "client asset" or "client money" under the CASS Rules and is therefore not required to be held under a statutory trust by a CM that is an FSA-regulated English entity. There is a concern that, in the event of the CM's insolvency, the customer, whose margin was transferred pursuant to a "title transfer collateral arrangement" to the CM, but such margin has not been transferred on to ICE Clear Europe, will only have a non-proprietary contractual unsecured claim against the CM for equivalent margin to be returned. The margin would then be available for distribution to creditors of the insolvent CM generally and the customer who transferred the margin would only have an unsecured debt claim against the insolvent CM.

In respect of margin returned from ICE Clear Europe to the insolvent CM, even though such margin is to be held "on trust" by the insolvent CM for the benefit of its customers, there is a risk that any assets returned to an insolvent CM that is subject to the English insolvency rules would be required to share such assets with other clients who may have a trust claim

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[137] We do not consider any U.S. entities other than FDIC-insured banks and unregulated U.S. entities as ICE Clear Europe does not presently have any other types of U.S. CMs.

against the insolvent CM's customer assets, but could not recover their assets due to a shortfall. However, considering that the trust to be declared by a CM in relation to its receivables from ICE Clear Europe would be an express trust separate from any other trusts that may exist, the customers being beneficiaries of the express trust should not need to share proceeds from the express trust with other non-beneficiaries. This is supported by the Global Trader case[138] (which, although it is only a first instance decision, represents the current law at the time of writing this Report) which held that clients whose money had not been segregated had no proprietary claim against the general assets of the broker, nor a right to share in the pool of client assets, unless they could trace those monies through the shared pool. Given that the margin would be returned as a separate pool of trust money or assets from ICE Clear Europe to the insolvent CM, unrelated clients of the CM whose money had not been segregated should not be able to trace their monies or assets into that pool. However, this remains a fluid area of law and it is possible that an appellate court may decide that customers whose assets had not been segregated, but should have been segregated, should have a right to share in the pool of client assets, even if they could not trace their assets through the shared pool. The administrators of LBIE have recently made a court application in respect of this issue.

We note that it is at present unclear how the broad powers granted to the U.K. government pursuant to the Banking Act 2009 will affect the existing regime dealing with "client money" and "client assets" as it applies to CMs which carry on the regulated activity of accepting deposits. On insolvency of such a CM, the U.K. government could, in certain circumstances, transfer to a private sector purchaser some or all of the CM's property, rights and liabilities. These powers are expressed to extend to "property held on trust" but it is not clear whether this means property held by the CM as trustee, or property held by a third party "on trust" for the CM. The Banking Act 2009 is relatively new and therefore it remains to be seen whether the U.K. government would exercise the wide-ranging powers available to it under the Act to effect transfers of customer margin from an insolvent CM to a new solvent CM.

CMs That Are French Financial Institutions (Including English Branches of French Banks)

If French insolvency proceedings are opened with respect to a French financial institution (i.e., licensed credit institutions, including banks, and investment firms licensed to provide investment services, including broker dealers), such proceedings will, in principle, relate to all assets and liabilities of the French financial institution, irrespective of where such assets and liabilities are located and what law governs them.

Deviating from such principle, French law provides that the rights and obligations of insolvent participants in a "System" within the meaning of Article L.330-1 of the French Monetary and Financial Code are determined by the law governing the System, provided that this is the law of an EEA jurisdiction. Article L.330-1 of the French Monetary and Financial Code was enacted in connection with implementing the SFD under French law.

[138] Re Global Trader Europe Ltd (in liquidation) [2009] EWHC 602 before Sir Andrew Park.

We understand from ICE Clear Europe that it is a System within the meaning of Article 2 of the SFD. Thus, in principle, Article L.330-1 of the French Monetary and Financial Code will apply if a French CM becomes subject to French insolvency proceedings. Accordingly, English law would govern the rights and obligations of the insolvent French CM "arising from, or in connection with, its participation" in ICE Clear Europe, as well as the effect of the French CM's insolvency on such rights and obligations. However, whether the customers' rights with respect to margin would also be governed by English law would in particular depend on whether such customers' rights are determined to be part of the French CM's "rights and obligations arising from, or in connection with, its participation" in ICE Clear Europe. There is no case law or other guidance on point. However, the facts that (i) ICE Clear Europe's rules require that the ICE Net Margin and the ICE Excess Margin to ICE Clear Europe be transferred by the CM and held in segregated accounts, (ii) ICE Clear Europe is aware of the identity of the customers and (iii) the customers qualify as (indirect) participants of ICE Clear Europe could constitute arguments in favor of such a determination.

Since it is legally uncertain whether French insolvency courts would consider that English law should govern the customers' rights with respect to margin, we have set out below an analysis of the principles that would be applicable if the question of segregation of customer margin was governed by French insolvency law.

Article L.330-2 of the French Monetary and Financial Code provides that creditors of any participant, whether direct or indirect, in a System shall not have any right in the margin posted in accordance with the System's rules to secure any payment obligations arising from the participation in such System, whether or not insolvency proceedings have been commenced against the participant.[139] This rule is primarily intended to protect the Systems' rights with respect to margin posted with them by any participant from such participant's insolvency. Absent any case law or other guidance on point, it is uncertain whether this rule would apply to protect the customers' rights on the margin return. If, however, this were the case, in order to benefit from this rule, customers would need to qualify as an indirect participant in ICE Clear Europe. Under Regulation 9 of the English Financial Markets and Insolvency (Settlement Finality) Regulation of 1999, the competent authority may treat an indirect participant (such as a customer) as a participant of a System if it considers this to be required on grounds of systemic risk. It is therefore not possible to determine in advance whether a customer would be so treated.

Accordingly, although the applicability of Article L.330-2 of the French Monetary and Financial Code might provide a legal basis for the segregation of the customer margin, we have set out below an analysis of the principles that would be applicable if Article L.330-1 was not applicable. Since ICE Clear Europe requires that margin posted by customers to French CMs be transferred via title transfer, the customer's rights in the margin would be as follows: Article L.440-7 of the French Monetary and Financial Code provides for a specific segregation

[139] Article L.330-2 of the French Monetary and Financial Code applies to French Systems but, in the event of an insolvency proceeding commenced in France against a French CM, although this is not free from doubt, the French insolvency court is likely to apply this rule to margin posted with another EEA System.

and loss-sharing regime applicable to margin (cash and securities) posted by way of title transfer with a French CM in France. Under this regime, (i) the margin posted with a French CM to cover positions in a market in financial instruments (which would include, although this is not entirely free from doubt, any positions on financial instruments traded on the OTC market such as CDS) is dedicated to cover (i) any loss resulting from the liquidation of the customer's open positions and (ii) any amount due to the French CM; and (ii) creditors of the French CM have no right in such margin so that in the event that an insolvency proceeding is commenced against the French CM in France, the customer would recover the margin (after deduction of any above-mentioned losses and amounts due) ahead of the French CM's creditors. It is, however, doubtful that this special regime would apply to margin posted by way of title transfer with a French CM in connection with the clearing of CDS positions with any non-French CCP.

If this special regime is not applicable to French CMs of ICE Clear Europe, then the segregation and loss sharing rules applicable to margin transferred via title transfer (whether deposited with the CM directly or in account opened in the CM's name with a custodian) to the French CMs would be as follows:

(x) with respect to margin which consists of cash: the cash transferred to the CM by the customer would be commingled with other cash held by the CM and therefore the customer would not be entitled to segregate any such cash and, in case of the CM's insolvency, would be an unsecured creditor of the CM in this respect; the customer would thus share in any shortfall on a pro rata basis with other unsecured creditors of the CM; and

(y) with respect to margin which consists of securities: to the extent that the securities so transferred are booked in an account opened in the name of the CM, French insolvency courts would consider that the customer would be an unsecured creditor of the CM in respect of such margin and therefore would share in any shortfall on a pro rata basis with other unsecured creditors of the CM. By exception to the foregoing, in the event that the account in which the securities posted as margin is maintained at the English branch of the French bank, French insolvency courts would, to the extent that the existence or transfer of the securities so deposited as margin with the English branch of the French bank requires their recording in that account, defer to English law to determine the rights of the customer, the French bank and third parties (including creditors of such French bank) as well as the effect of the French bank's insolvency on such rights.[140]

Trust over the CM's right to the return of the margin posted with ICE Clear Europe in favor of customer's margin return

[140] French law would also point to English law if the securities posted as margin are recorded in another securities account, a register or a centralized deposit system held or located in England, provided that such recording is required for the existence or transfer of such securities.

The qualification by French insolvency courts of this trust is uncertain. Among several possible qualifications, two are likely to be considered by the French insolvency court having jurisdiction over the insolvency proceeding of the French CM, as follows:

- Trust: French insolvency courts may recognize and give effects to the trust provided that (i) the trust has been validly created and perfected under the law governing the trust arrangement, i.e., English law, and (ii) its application would not lead to results contrary to fundamental principles of public policy (*ordre public international*);

- Security Interest: To the extent, however, that title to the rights to be held "on trust" would not have actually been transferred to a trustee, French insolvency courts may rather consider that it qualifies as a security interest granted to secure the obligations of the French CM to the customers (including its obligation to return the customers' margin). In the event that such a qualification would be made, French courts should respect and give effect to such security interest in any French insolvency proceedings opened with respect to the French CM if (i) the obligations secured by such security interest qualify as financial obligations within the meaning of Article L.211-36 of the French Monetary and Financial Code,[141] (ii) the security agreement is governed by English law, (iii) the rights that would be secured would be governed by English law, and (iv) the security interest is properly created and perfected under the law of English law.

CMs That Are German Financial Institutions (Including English Branches of German Banks)

If German insolvency proceedings are opened with respect to a CM that is a German financial institution, such proceedings will, in principle, relate to all assets and liabilities of the German financial institution, irrespective of where such assets and liabilities are located and what law governs them (Section 335 of the German Insolvency Code).[142] Deviating from such principle, Section 340(3) of the German Insolvency Code provides that the rights and duties of insolvent participants in a "system" within the meaning of Section 1(16) of the German Banking Act (a "System") are governed by the laws of the jurisdiction applicable to the System.[143] Section 1(16) of the German Banking Act was enacted in connection with

141 The security interest would be granted to secure the French CM's obligation to return margin and proceeds of positions to the CM's customers. Since these obligations could be viewed as resulting from transactions on financial instruments (under French law, CDS generally qualify as financial instruments) and the French CM would be a regulated financial institution, the obligations secured by the security interest should qualify as financial obligations under French law.

142 An English Branch of a German CM that is a credit institution cannot become subject to English insolvency proceedings, and therefore no liquidation or administration proceedings may be taken in England in respect of these entities, so English law will not be relevant.

implementing Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems ("SFD").

We understand from ICE Clear Europe that it is a System within the meaning of Article 2 of the SFD.[144] Thus, in principle, Section 340(3) of the Insolvency Code will apply if a German CM becomes subject to German insolvency proceedings. Accordingly, in principle, the laws of England and Wales (including insolvency laws) would govern the relationship of the insolvent German CM with ICE Clear Europe and the effect of the CM's insolvency on such relationship. However, whether the customers' rights with respect to margin would also be governed by the laws of England and Wales would in particular depend on whether the scope of Section 340(3) of the German Insolvency Code comprises matters of segregation of margin by customers within the meaning of Section 47 of the German Insolvency Code.

There is no German case law on point as to whether the segregation by customers of margin falls under Section 340(3) of the German Insolvency Code. Some legal commentators state that the purpose of Section 340(3) of the German Insolvency Code is to ensure that the transactions within a System are not impaired by any restrictions in the national laws of the participants. Accordingly, Section 340(3) should be interpreted broadly. Even such a comprehensive approach, however, does not necessarily encompass a claim for segregation of customer margin from the CM's insolvency estate, because an argument could be made that the segregation of assets does not form part of the System itself. The purpose of the SFD, which is aimed at minimizing the disruption to a System caused by the applicable insolvency provisions of the member states concerned, does itself not contain any explicit rules on the protection of a customer's rights as to the collateral security provided in case of the insolvency of the CM. Article 9 of the SFD only deals with the protection of the rights of the holder of collateral security and not the provider of such collateral security. Accordingly, although the applicability of Section 340(3) of the German Insolvency Code might provide a legal basis for the segregation of customer margin, we have set out below an analysis of the principles that would be applicable if the question of segregation of customer margin was not governed by Section 340(3) of the German Insolvency Code.

Under Section 47 of the German Insolvency Code, a customer is entitled to the segregation (*Aussonderung*) of an asset from the insolvency estate of the debtor if it holds a right *in rem* or, in very limited circumstances, a right *in personam* pursuant to which the creditor can claim that the asset does not belong to the insolvency estate. In this regard, German insolvency law, in general, would respect and give effect to rights under non-German law that the creditor has validly acquired in accordance with German conflict of law rules,

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[143] Section 340(3) of the German Insolvency Code does not apply to German CMs that are not credit institutions to the extent they are participants in a System located in a EU member state. In such a case, the European Insolvency Regulation would apply. However, Article 9(1) of the European Insolvency Regulation contains an exemption similar to Section 340(3) of the German Insolvency Code.

[144] Pursuant to the European Commission's website (http://www.ec.europa.eu/internal_market/financial-markets/settlement/dir-98-26-art10-national_en.htm), Eurex Clearing AG, ICE Clear Europe, LCH.Clearnet Limited / NYSE Liffe and LCH.Clearnet SA each qualifies as a securities settlement system.

provided that such rights are comparable to German law rights entitling creditors to segregation.

Thus, in order to be entitled to claim the segregation of margin posted by the customers to the CM and ICE Clear Europe and held in the ICE Customer Omnibus Account or the ICE Excess Omnibus Account, as applicable, in an insolvency of the CM, the customers must have validly acquired in accordance with German conflict of law rules an *in rem* or *in personam* right which is comparable to German law rights entitling creditors to segregation.

According to ICE Clear Europe, customers are required to transfer any margin to the CM pursuant to a "title transfer collateral arrangement". The CM must segregate such margin pending transfer to ICE Clear Europe. The CM has the right to rehypothecate the margin to ICE Clear Europe, and will be required to transfer any ICE Net Margin to the ICE Customer Omnibus Account pursuant to a "title transfer collateral arrangement" with ICE Clear Europe. Such "title transfer collateral arrangement" will be governed by English law and provide for the margin to be returned to the CM upon certain events including the discharge of the secured obligations. In addition, the CM would be required to transfer the ICE Excess Margin to the ICE Excess Omnibus Account. Although the legal structure of such transfer is still under consideration, any rights to the return of the ICE Excess Margin held in the ICE Excess Omnibus Account would also be governed by English law. ICE Clear Europe will hold the margin with a custodian in the segregated ICE Customer Accounts, and no proprietary assets of the CMs will be commingled in these accounts. Each CM will create an English law trust over its contractual rights against ICE Clear Europe for the return of customer margin for the benefit of its customers. Under English law, the creation of the trusts over the rights to the return of customer margin deposited in the ICE Customer Accounts and any related receivables would result in such rights and receivables not forming part of the respective CM's insolvency estate, despite the fact that such rights and receivables are only contractual. Accordingly, under English law, the customers would have proprietary rights in such rights and receivables as beneficiaries of the trust.

Although German law recognizes certain trust arrangements (*Treuhand*), *e.g.*, in connection with the transfer of assets for security purposes, the concept of creating a proprietary interest in trust property by merely entering into a trust arrangement (without certain further criteria being fulfilled) is not generally recognized under German law. Therefore, it is unclear whether German law would recognize the beneficiary's position as a right *in rem*. Rather, from a German law perspective, the customers' position under the proposed arrangements would constitute a contractual right. In general, contractual rights do not entitle parties to segregation. However, under certain circumstances, German law gives effect to contractual trust arrangements recognizing the beneficiary's position as a creditor being entitled to segregation pursuant to Section 47 of the German Insolvency Code. If the English law trust arrangement created by the respective CM and ICE Clear Europe for the benefit of the customer with respect to the ICE Gross Margin deposited in the ICE Customer Accounts were comparable to a German law trust arrangement that entitles parties to segregation, a German court would likely recognize the arrangement and allow segregation.

Under German law, a trust arrangement, in principle, only entitles a party to segregation when the asset to be held "on trust" is directly transferred from the trustor's estate to the trustee's estate (*Unmittelbarkeitsprinzip*). The English law trust structure does not satisfy this requirement because margin is first posted by the customer to the CM, who then transfers it on to ICE Clear Europe. However, in the case of escrow accounts, German courts do not apply the *Unmittelbarkeitsprinzip* in its strictest sense. In such case, it is sufficient if it is evident that the assets transferred to the escrow account are attributed to the trustor's estate, provided that such assets can be identified and are not commingled with assets of the trustee. Under German law, these conditions are satisfied in particular if the trustee opens a so-called "open" trust account containing only the trustor's assets which is maintained with a third-party account bank. The trustee would be the account holder, but inform the account bank that the trustor is the beneficiary of the funds in the account. For the purposes of segregation, it is then irrelevant whether the escrow account is held for more than one trustor.

According to our understanding, any margin deposited in the ICE Customer Accounts will always be segregated and not commingled with the CM's assets. Furthermore, we assume that the custodian of ICE Clear Europe, as account bank, will be made aware that the margin so posted does not belong to either the CM nor ICE Clear Europe, but, due to the trust arrangement, to the customers. We believe that such a structure should satisfy the German principles set out above. However, as German law generally does not recognize the concept of creating trusts by agreement, this analysis would likely only be valid if the margin is held in an account subject to English law and the trust is created for contractual rights to the return of margin that are governed by English law, as is the case here. An English law trust over any rights that are not subject to English law, in the case of contractual rights, or over assets not located in England, in the case of tangible assets, would almost certainly not be recognized. Further uncertainty results from the fact that the CM as trustee has the right to realize margin to satisfy obligations of the customer vis-à-vis the CM. German law, as a matter of principle, requires that an escrow account is held in the sole interest of the trustor. Giving the trustee the right to satisfy its own claims out of the escrow account's funds might, under certain circumstances, prejudice the recognition of the trust arrangement under German law, although there are exceptions from this rule. In addition, any funds released to the insolvency representative of the CM might be subject to setoff if the CM has counterclaims against the respective customer and setoff is possible under applicable law, or might be otherwise realized to the extent required to cover the respective customer's positions, in accordance with applicable security arrangements.

In sum, it is thus uncertain, at least in the case of ICE Net Margin, whether a German court would give effect to the trust arrangement as a right *in personam* entitling to segregation under Section 47 of the Insolvency Code. In any case, if the CM becomes insolvent before it passes the assigned margin on to ICE Clear Europe, the customer's claim for the return of the margin would only constitute an unsecured contractual claim not entitling the customer to segregation.

CMs That Are Swiss Financial Institutions (Including English Branches of Swiss Banks)

As ICE Clear Europe mandates the segregation of clients' assets and money on the CM level in certain situations, the CM would have the contractual obligation to segregate in such way, even though there is no Swiss statutory duty as set forth in Part II.C.6.(b) above.

In respect of segregation requirements in relation to an English branch of a CM which is incorporated in Switzerland (or indeed, any non-EU country), it is expected that any such branch conducting regulated activities in the U.K. would be regulated by the FSA. As a result, the segregation requirements would be similar to that of CMs that are English FSA-regulated entities as set out above.

(b) Portability Analysis

ICE Clear Europe is considering introducing new procedures that would enable client margin to be transferred directly from the defaulting CM's ICE Customer Accounts to the receiving CM's ICE Customer Accounts in connection with portability of customer positions. However, the precise legal framework as to how this would be effected is currently being developed and the following is an outline of their present plan.

It is intended the Standard Annex will specify procedures for the exercise of remedies in case of a CM's default. If Default Portability Rules apply, the Standard Annex will include an agreement and consent on the part of the customer for ICE Clear Europe to transfer CM-customer transactions to a new CM, which has to consent to the transfer, following a CM default. If ICE Clear Europe moves customer positions of an insolvent CM to a new solvent CM, related customer margin in the ICE Customer Accounts will be moved in tandem to the new CM. Therefore, so long as the margin has been adequately segregated in an account that ICE Clear Europe has the ability to access (notwithstanding the CM's insolvency), ICE Clear Europe should be able to facilitate the transfer of customer margin to a transferee CM.

However, the likelihood that a successful transferee can be found under the portability framework may be impeded by several factors. First, issues may arise from the fact that the underlying CM-customer transaction will be subject to an ISDA Master Agreement, the details of which may significantly differ in any particular instance (other than with respect to the terms of the Standard Annex). In the event a transferee CM and a customer have not entered into an existing ISDA Master Agreement, the relationship between the new CM and the customer will be subject to the terms of the ISDA Master Agreement in effect between the defaulted CM and the customer. The possibility of assuming an unfavorable ISDA Master Agreement may present an unacceptably high level of documentation risk for potential transferee CMs. This concern may be mitigated by customers having, prior to a CM default, entered into a back up arrangement, including a negotiated ISDA Master Agreement, with a second CM which could be activated should its principal CM default.

Second, since ICE Clear Europe is not party to the underlying CM-customer transactions, it will be reliant upon CMs to provide accurately the identity, positions and related margin entitlements of each customer. In the event the CM has provided inaccurate information on the underlying CM-customer transaction (e.g., informing that a particular transaction is a proprietary transaction when in fact it is a customer transaction), such positions might not be transferred and could in fact be closed out by ICE Clear Europe as it would do in relation to other proprietary transactions. ICE Clear Europe is currently developing various operational solutions to reduce the risk of inaccurate information being provided by the CM.

Third, depending on the jurisdiction of the defaulting CM (as set out below), there may be a risk that the transfer or termination of an "in-the-money" position in favor of the defaulting CM and the agreement of the parties that no termination amounts will be payable to the defaulting CM in respect thereof may be viewed as a forfeiture of property belonging to the insolvent CM's estate. To the extent that English law applies or the matter is brought before an English court, the protections provided by Part VII of the Companies Act 1989 in respect of the default rules of ICE Clear Europe should apply and therefore limit this risk.

Fourth, CMs and customers in certain jurisdictions (e.g., those requiring automatic early termination or mandatory setoff upon insolvency) may be limited in their ability to elect for ICE Clear Europe's Default Portability Rules to be applicable as the Default Portability Rules would require a standstill period after the onset of an insolvency event relating to the CM and no setoff to apply. To the extent that English law applies or the matter is brought before an English court, the protections provided by Part VII of the Companies Act 1989 in respect of the default rules of ICE Clear Europe should apply and therefore limit this risk.

Fifth, where portability is possible, a customer may only transfer all, but not part, of its positions with the defaulting CM to a new CM, so the customer would have to find a new CM who would be willing to accept that customer's entire portfolio with the defaulting CM.

CMs That Are U.S. Entities

Subsequent to a CM default, the failed CM's insolvency representative may attempt to transfer its CDS positions and related margin. In the case of a CM that is an insured U.S. bank, the FDIC, if it were acting as receiver of the failed CM, would have the ability to transfer all (but not fewer than all) of the CM's "qualified financial contracts" (which includes CDS positions) and related margin with any particular counterparty (and such counterparty's affiliates) to a single entity (including to certain existing financial institutions or to a newly-created "bridge bank).[145] From the time the FDIC is appointed as receiver until the earlier of (a) the time customers receive notice from the FDIC of the transfer of the CM's qualified financial contracts, and (b) 5:00 p.m. on the business day following the appointment of the

[145] This statutory requirement—that if any of a customer's (or its affiliates') CDS or other qualified financial contracts with the defaulting CM are transferred, all such qualified financial contracts with the defaulting CM (whether cleared or uncleared) must also be transferred—would (absent legislative change) hinder the FDIC's ability to transfer only Cleared Customer Positions and Mirror Customer Positions. As a practical matter, however, the FDIC has always transferred all qualified financial contracts to a single successor entity.

FDIC as receiver, customer payment or delivery obligations under its qualified financial contracts with the CM could be suspended in accordance with any contractual rights the customer may have. Subsequent to the one-day standstill period imposed under the FDIA (and any additional standstill agreed to by the customers pursuant to the Standard Annex), customers could exercise their contractual liquidation rights under the ISDA Master Agreement if there were no transfer.

In the case of a U.S. CM that is not an insured U.S. bank, there are no provisions for the transfer of qualified financial contracts (such as CDS positions) and related margin by the insolvency representative itself. For this reason, it is unclear how the failed CM's insolvency representative would, in this instance, have the ability to arrange for the transfer of customer positions and related margin, except in cooperation with ICE Clear Europe and the relevant customers.

As noted above, attempts by ICE Clear Europe to transfer positions that are "in-the-money" to the failed CM without payment to the failed CM (including by terminating transactions with the failed CM and replacing them with transactions with a new CM) may conflict with provisions of the U.S. insolvency laws prohibiting "walk-away clauses" or preventing forfeitures of the debtor's assets, to the extent those laws are applicable. The enforceability of such an arrangement is also subject to doubt because the structure may also be viewed as a multilateral netting arrangement, which raises concerns over mutuality—e.g., the requirement that one person's claim must not be used to pay another person's debt—thereby raising potential enforceability issues.[146]

CMs That Are English FSA-Regulated Entities

ICE Clear Europe is a "recognised clearing house" for the purposes of the Companies Act 1989. It will therefore be able to take advantage of the protections offered by that law, which should allow it to give effect to its portability procedures without restriction by the liquidator or administrator of an English CM's estate. Part VII of the Companies Act 1989 has the effect of disapplying the parts of English insolvency law that could be used to challenge or restrict actions taken by a "recognised clearing house" under its default rules. In general terms, these provisions are intended to allow "recognised clearing houses" to conduct a quasi-liquidation in respect of the CM's open contracts and margin assets and, once complete, to certify a net sum due to or from the defaulter's administrator or liquidator. In addition, because ICE Clear Europe is a "designated system" within the meaning of The Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "Settlement Finality

[146] The Bankruptcy Court for the District of Delaware recently held that Section 553 of the Bankruptcy Code prohibits "triangular setoff" as a matter of law because the debts and claims being setoff are between different parties and therefore not "mutual". In re SemCrude, 2009 WL 68873 (Bankr. D. Del. Jan. 9, 2009). Because the advocates of the setoff did not raise the issue, the court expressly did not consider arguments that triangular setoff would be protected by Section 362(b)(17), 560 or 561 of the Bankruptcy Code when the debts and claims involved arise from swap agreements. In addition, because no clearing corporation was involved, the court did not consider the effect of the clearing organization netting provisions of 12 U.S.C. § 4401 et seq, which may be helpful (at least for certain CMs) to the enforceability of the Termination/Replacement Procedures.

Regulations"), its portability procedures will be further protected because Regulation 14 of the Settlement Finality Regulations provides that ICE Clear Europe's default arrangements are to take precedence over general insolvency proceedings of the English CM.

In respect of English CMs that are deposit-taking institutions, the Banking Act 2009 has introduced a Special Resolution Regime which would allow the U.K. government to stabilize certain institutions in distress. The U.K. government may in certain circumstances transfer some or all of the property, rights and liabilities of a bank (including any CDS positions (and potentially customer margin[147])) to a private sector purchaser or to a bridge bank. However, secondary legislation[148] has been implemented with the objective of ensuring that partial transfers of a bank's assets by the government do not interfere with netting and collateral arrangements. This secondary legislation makes a partial transfer of an insolvent bank's assets invalid if it conflicts with the Settlement Finality Directive, Part VII of the Companies Act 1989, or the legal protections afforded to title transfer financial collateral arrangements. Security arrangements are dealt with separately, by providing that no partial transfer of secured assets may be made without also transferring the secured liability. Given the relative novelty of the Banking Act 2009 and related legislation (and the fact that they have not been used to date) it is not possible to say how interventionist the U.K. government would seek to be in respect of a relevant CM's CDS arrangements with its customers and a CCP.

CMs That Are French Financial Institutions (Including English Branches of French Banks)

As mentioned above, ICE Clear Europe qualifies as a System and French law provides that when a French CM (including an English branch of a French bank) becomes subject to insolvency proceedings in France, the rights and obligations arising from, or in connection with, its participation in a System regulated in the EEA are governed by the law governing such System.

Therefore, in the event that a French CM becomes subject to insolvency proceedings in France, English law should govern the CM's rights and obligations arising from, or in connection with, its participation in ICE Clear Europe. This should include any provisions applicable in the event of a CM's default such as the liquidation of positions, the determination of close-out amounts and the application of collateral, as well as any provisions relating to the transfer of the CM-CCP positions and related margin. French insolvency law should therefore not be applicable to these matters and French insolvency courts should respect without restriction the transfer arrangements made in accordance with English law.

With respect to the transfer of the customer-CM positions and related margin corresponding to the ICE Clear Europe-French CM positions transferred to a new CM, in particular if the customers' rights with respect to margin are determined to be part of the

[147] Although there are provisions in the Banking Act 2009 that deal with "property held on trust", it is unclear what the term means as it could mean property held by the bank as trustee or property in which the bank is the beneficiary.

[148] The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009.

French CM's "rights and obligations arising from, or in connection with, its participation" in ICE Clear Europe, the above rule should apply and such transfers should also be governed by English law and French insolvency courts should respect them without restrictions.

There is, however, no French case law or other guidance available as to what extent a "portability framework" of a System would be upheld in a French participant's insolvency, in particular with respect to the possibility to port the customer-CM positions and related margin. This remains therefore subject to uncertainty and would require further analysis.

If a CM that is a French financial institution (or an English branch of a French bank) becomes subject to French insolvency proceedings and the CM's business activities are continued, the insolvency representative has discretionary power to terminate any contract entered into by the insolvent CM if he determines that such contract is not necessary for the continuation of the CM's business. If the insolvency representative makes such a decision, the CM's open positions with ICE Clear Europe and the corresponding customer's open positions with the CM would be liquidated thereby preventing any transfer of such positions to a new CM.

CMs That Are German Financial Institutions (Including English Branches of German Banks)

If a CM became subject to German insolvency proceedings, the portability of customer-CM positions and CM-ICE Clear Europe positions would be subject to some uncertainty.

First, generally, upon the opening of insolvency proceedings, the right to administer the insolvency estate passes to an insolvency representative (unless self-administration is ordered by the insolvency court), and any advance consent by the debtor to disposals which would occur after the opening of insolvency proceedings would become invalid. Thus, any transfer of a CM position will likely require the insolvency representative's consent.

Second, as discussed above, ICE Clear Europe qualifies as a System, in which case the law governing the System would govern the relationships of the "participants" of the System (Section 340(3) of the German Insolvency Code), and German insolvency law would not be applicable. In such case, there are also good arguments that the portability of positions is not affected by the opening of the insolvency proceedings because the System is governed by English law, provided that such portability would not be affected if English insolvency proceedings were opened with respect to the CM. In particular, any provisions providing for the termination of transactions, the determination of close-out amounts, the application of collateral and the transfer of CM-CCP positions are likely to remain unaffected by German insolvency law. However, there is no German case law or commentary available discussing to what extent a "portability framework" of a System would be upheld in a participant's insolvency, in particular as regards the possibility to port customer-CM positions. This matter therefore remains subject to some uncertainty and is a topic for further legal analysis.

CMs That Are Swiss Financial Institutions (Including English Branches of Swiss Banks)

As set forth in Part II.C.6.(e) above, a transfer of a transaction after the CM has been made subject to protective measures by FINMA or adjudicated bankrupt would be subject to the cooperation of FINMA or the receiver in insolvency, respectively, as the CM will have lost some or all (as the case may be) capacity to dispose of its assets.

In respect of an English branch of a CM which is incorporated in Switzerland (or indeed, any non-EU country), in certain circumstances it can be possible for insolvency proceedings to be commenced in England, where the protection offered by Part VII of the Companies Act 1989 would be available.[149] Section 221 of the Insolvency Act 1986 allows the English courts to wind up an insolvent non-English company. The presence of a branch and assets in England will be relevant criteria for the court in deciding to exercise jurisdiction under Section 221. In practice, the most likely scenario is that the defaulting CM's "home" state would commence main insolvency proceedings, and an English court would commence ancillary proceedings (applying English law) in respect of the English branch, in which the protections of Part VII of the Companies Act 1989 would apply.

(c) Applicable Sharing Rules in the Event of a Shortfall

In the event of a shortfall in customer property held at a CM, the analysis set forth in Part II.C. above would apply.

(d) CCP Requests for Legal Change or Clarification

ICE Clear Europe is not at present lobbying for U.S., U.K. or European legislative reforms specific to customer clearing of CDS, although the requests for legal change in the U.S. suggested by ICE Trust would be relevant to ICE Clear Europe.

(e) Discussion of Outstanding Issues

ICE Clear Europe's clearing framework allows participants to leverage the existing market infrastructure for OTC derivatives transactions through the same entities in which they currently conduct their CDS business. At the same time, the flexibility that ICE Clear Europe has afforded to its CMs has presented it with the challenge of accommodating CMs of differing organizational types across multiple jurisdictions—e.g., U.S. banks, English FSA-regulated entities, French, German and Swiss financial institutions and English branches of French, German and Swiss banks. Particularly in the context of our inquiry into segregation and portability of customer CDS positions and related margin upon a CM default, this flexibility has rendered the analysis especially lengthy.

[149] For a discussion on the protections offered by Part VII of the Companies Act 1989, see the portability analysis in relation to CMs that are English FSA-regulated entities above.

Although the legal framework of ICE Clear Europe is still under development, its general proposals for the segregation and portability of CDS customer positions and related margin have the potential to provide customers with substantial protections that they may not otherwise have had. One of the primary structural protections offered by ICE Clear Europe is that CMs will be required to hold "on trust", for the benefit of customers, any margin to which CMs may be entitled after positions have been closed out or ported. However, one of the key concerns is that, because margin is transferred from the customer to the CM pursuant to a "title transfer collateral arrangement", any margin that is posted by the customer, but not transferred on by the CM to ICE Clear Europe, might be absorbed into the CM's general estate in the event of the CM's insolvency. Diligence will also need to be done on a jurisdiction-by-jurisdiction basis as to whether the trust in favor of the customer in the title transfer collateral will affect the CM's rights on a default or insolvency of the customer; the CMs will need to have clear rights in the margin in a customer default.

For U.S. CMs (other than FCMs, of which there are currently none for ICE Clear Europe), the segregation analysis is unclear due to the title transfer/trust arrangement. In addition, questions may arise as to the range of custodial claimants with whom customers would be required to share in any shortfalls in a worst-case scenario. The portability analysis is also unclear, in light of certain issues arising from the back-to-back principal trade structure, and questions surrounding the enforceability of ICE Clear Europe's portability framework. The robustness of the segregation and portability analysis would be significantly enhanced if the legislative changes suggested by ICE Trust for U.S. entities were enacted.

For English CMs, the segregation analysis is generally clear as a legal matter and should not, of itself, be a cause for concern for customers as to their right to recover their margin eventually. Although the legal framework of ICE Clear Europe is still under development, its general proposals for the segregation and portability of CDS customer positions and related margin have the potential to provide customers with substantial protections that they may not otherwise have had (for example, if the framework had not included the trust (in favor of customers) over the CM's right to the return of customer margin after customer positions have been closed out or ported). The porting of margin is not an established practice for clearing houses regulated in the U.K. and legal certainty with respect to that aspect of the operation of the ICE Clear Europe default rules might be enhanced by specific legislative amendments (particularly if it is intended that CM excess margin will be included in the customer margin that would be ported by the CCP to the new CM).

ICE Clear Europe does not currently have any CMs that are French financial institutions (or English branches of French banks). However, to the extent any French financial institutions (or English branches of French banks) clear customer positions through ICE Clear Europe in the future, our analysis of the rights of such customers would be as follows. The analysis regarding segregation is unclear because the scope and applicability of certain regimes overriding general principles of French insolvency law are uncertain. However, the envisaged trust over the CM's right to the return of the margin posted with ICE Clear Europe in favor of customers, although subject to some legal uncertainty with respect to its qualification by French insolvency courts, would offer customers protection that they would otherwise not have, provided that all relevant aspects are governed by English law. When French banks are acting through their English branch and securities margin is held in an account opened in England, the rights and effect of the French CM's insolvency on such securities should, under certain conditions, be determined under English law. With respect to the portability of positions and related margin, French insolvency law should defer to and respect any portability procedures applicable to CM-ICE Clear Europe positions and related margin available under English law, although this result is more uncertain with respect to customer-CM positions and related margin.

For CMs that are German financial institutions (including English branches of German banks), the envisaged structure of holding the CM's retransfer claim in relation to customer margin at the ICE Clear Europe level "on trust", although subject to some legal uncertainty, offers customers protection that they would otherwise not have, provided that all relevant aspects including the claim for the retransfer of customer margin are governed by English law. Although there are good arguments that ICE Clear Europe's portability procedures would be given effect in German insolvency proceedings opened with respect to a CM that is a German financial institution, this is a topic for further legal analysis.

For CMs that are Swiss Banks, while there is no Swiss statutory duty to segregate client money and assets, such CM would, as ICE Clear Europe mandates such segregation, have a contractual obligation to do so. Client assets held by the CM or a sub-custodian will by law be segregated upon the bankruptcy of the CM, while there is no such segregation upon bankruptcy in respect of client money. The analysis regarding portability of positions and related margin is subject to considerable uncertainty due to mandatory rules of Swiss regulatory and insolvency law.

3. LCH.C

(a) Segregation Analysis

LCH.C enters into transactions with CMs on a principal-to-principal basis. LCH.C is not a party to any CM-customer arrangements and accordingly does not "know" the customers. LCH.C rules do not regulate the relationship between the CMs and their customers.

LCH.C's margin requirements only relate to the CCP-CM relationship. However, margin received by the CCP from a CM is segregated between margin for its customer positions and related margin for its proprietary position. Margin for the CM's customers is calculated on a net basis and will be placed by LCH.C in that CM's customer omnibus account.

LCH.C requires the relevant CM to be the sole legal and beneficial owner of the securities or other assets furnished or deposited with LCH.C as CCP margin or, if the CM is not the sole legal and beneficial owner, those securities or other assets are so furnished or deposited with the legal and beneficial owner's unconditional consent and free of such owner's interest.[150] Cash margin is transferred outright from CMs to LCH.C whereas securities are held with ICSDs or certain banks subject to an English law charge in favor of LCH.C. Securities margin posted by CMs cannot be rehypothecated by LCH.C.

At the CM level, LCH.C does not regulate how CMs hold their customer margin, which may or may not be rehypothecated to LCH.C as clearing house margin. LCH.C's clearing house rules do not contain provisions requiring segregation of customer margin at the CM level. As such, margin held by a CM is likely to be regulated in accordance with its home country rules.

CMs That Are U.S. Entities

(i) U.S. Banks and Unregulated U.S. Entities

Whether a CM that is a U.S. bank or unregulated U.S. entity is under an obligation to segregate margin received from a client for a LCH.C cleared CDS transaction will depend on the nature of the collateral arrangement between such client and the CM. LCH.C does not mandate any specific form of collateral arrangement between the client and the CM, and therefore the client and CM are free to agree to any form of collateral arrangement between themselves. Major variations include:

- Tri-party security arrangement: The CM is granted a security interest in the client's margin, but the margin is held in an account at a third-party custodian. The CM will have control of the client's margin, but no right to remove the margin prior to a default by the client. This provides the client with strong assurance of the eventual return of its margin following discharge of its secured obligations.

- Pledge with a right of re-use: The client pledges margin to the CM and grants the CM the right to rehypothecate the margin to LCH.C. Although the client may retain rights in the margin even after the CM rehypothecates the margin to LCH.C, those rights would depend on the client's ability to trace the margin to LCH.C (a task which would be aided by the segregation of margin for customer positions from margin for proprietary positions) and would be subject to the CM's obligations to LCH.C.

- Title transfer arrangement: The client transfers margin to the CM with the intent to retain only a contractual right to the return of the margin. The client

[150] According to the rules of LCH.C, each CM is required to represent and warrant to LCH.C as at each date on which such CM furnishes or deposits securities or other assets to or with the LCH.C (a) that such CM is the sole legal and beneficial owner of those securities or other assets or, as the case may be, those securities or other assets are so furnished or deposited with the legal and beneficial owner's unconditional consent and free of such owner's interest and (b) that the provision to LCH.C of such securities or other assets pursuant to the rules of LCH.C will not constitute or result in a breach of any trust, agreement or undertaking whatsoever.

> may retain no proprietary rights in the margin and would have only an unsecured creditor claim an insolvency of the CM.

The extent to which the client of the U.S. bank or unregulated entity benefits from segregation will vary significantly depending on which of these variations (or the many possible other alternatives) is elected and on the extent to which the CM complies with the contractual limitations.

(ii) U.S. FCMs

U.S. FCMs are generally required by U.S. law and regulation to segregate assets received from customers to margin, purchase, guarantee, or secure commodity futures or commodity option transactions.[151] It is not clear, however, whether CDS cleared by LCH.C are commodity futures or commodity options transactions for this purpose.[152] U.S. FCMs will therefore be faced with uncertainty about whether they are subject to a segregation requirement under U.S. law or regulation. Moreover, it is unclear whether the LCH.C-cleared CDS constitute "commodity contracts" under the Bankruptcy Code and the related CFTC rules.[153]

In a liquidation of the U.S. FCM under the Bankruptcy Code,[154] if the court determines that the LCH.C-cleared CDS transactions are "commodity contracts", then (i) these contracts and the related margin provided by the customers should be included in the calculation of the customers' "net equity", (ii) the margin related to these contracts provided by the customers will be considered "customer property" available for distribution to all members of the relevant "account class",[155] and (iii) the cleared CDS customers will share, together with all other

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[151] An exception to this general rule relates to assets received from persons located outside the U.S. to margin, purchase, guarantee, or secure foreign futures or options. As a consequence, even if the cleared CDS were to be a commodity future or commodity option transaction, the U.S. FCM may not have a segregation requirement under U.S. law or regulation with respect to customers located outside the U.S. if the cleared CDS is determined to be foreign futures or options transactions.

[152] As described in Part II.C.2 above, the CFTC has issued an interpretation that certain "cleared-only contracts" are "commodity contracts" within the meaning of the Bankruptcy Code and, in that interpretation, also stated that such contracts are "contracts for the purchase or sale of a commodity for future delivery" within the meaning of the Bankruptcy Code. This interpretation addressed the status of "cleared-only contracts" that are (i) executed over-the-counter and cleared by a registered derivatives clearing organization and (ii) the subject of a CFTC order pursuant to Section 4d(a)(2) of the CEA. However, although LCH.C is a registered derivatives clearing organization, it has not indicated that it intends to seek an order under Section 4d(a)(2). Moreover, this interpretation addressed the status of these contracts for purposes of the Bankruptcy Code and will not necessarily apply to the meaning of the related terms under the CEA.

[153] See Part II.C.2 above.

[154] A U.S. FCM can also be subject to a federal equity receivership, rather than liquidation under the Bankruptcy Code. Such proceedings are governed by principles of equity and the ultimate outcome of such a proceeding is not clear.

[155] 17 C.F.R. § 190.01(a) identifies the following five account classes: futures accounts, foreign futures accounts, leverage accounts, commodity option accounts and delivery accounts. It is unclear into what account class LCH.C-cleared CDS would be classified.

customers of the same account class, on a pro rata basis in any shortfalls in customer property of the account class. Although not completely clear, this treatment is likely to occur regardless of whether the U.S. FCM had held the margin collected in relation to the LCH.C-cleared CDS separately from the assets segregated for the other members of the relevant account class.

However, if the court in a Bankruptcy Code liquidation determines that the LCH.C-cleared CDS transactions are not "commodity contracts" under the Bankruptcy Code, then the outcome may depend on whether the FCM commingled the margin for the LCH.C-cleared CDS together with the customer property of commodities customers (e.g., because the FCM believed the LCH.C-cleared CDS were commodity futures or options contracts). If the margin for the LCH.C-cleared CDS is deposited into an account designated for the segregated customer property of commodities customers, the result is unclear. In the worst case, the margin for the LCH.C-cleared CDS may be treated as customer property of the commodities customers[156] and distributed to the commodities customers (to the extent of their net equity claims) before being made available to the cleared CDS customers or any other creditors.[157] This treatment would only matter if there were a shortfall in customer property, but could have the consequence that the LCH.C-cleared CDS customers absorb the entire shortfall even if it was caused by the commodities customers. On the other hand, if the FCM did not commingle the margin for the LCH.C-cleared CDS with the customer property of the commodities customers, then the rights of the LCH.C-cleared CDS customers would depend on the contractual arrangements between the CM and the customer, as described above for U.S. banks and unregulated U.S. entities.

CMs That Are English FSA-Regulated Entities

Whether a CM that is an English firm regulated by the FSA is required to segregate margin received from the client would depend on the nature of the collateral arrangement between the CM and the client. LCH.C does not mandate any specific form of collateral arrangement and therefore the CM and its client are free to agree to any form of collateral arrangement between them.

Generally, CMs which are English firms regulated by the FSA are required to segregate margin received only if the margin falls under the category of "client money" or "client assets" in accordance with CASS Rules as set out in Part II.C.3. above. If the margin is transferred outright from the customer to the CM pursuant to a "title transfer collateral arrangement", such margin will not be considered "client asset" or "client money" under the CASS Rules and is therefore not required to be segregated by the CM. In the event of the CM's insolvency, the customer whose margin was transferred pursuant to a "title transfer collateral arrangement"

156 Under 17 C.F.R. § 190.08(a)(ii)(A), "customer property" includes all cash, securities or other property segregated on the filing date.

157 There is also a chance that, in such a case, the court would treat the cleared CDS customers as commodities customers of the same class based on an argument that the CDS transactions themselves and the related margin do or could constitute margin for other commodities contracts between the cleared CDS customers and the FCM. See 73 Fed. Reg. 65514, 65515-16 (Nov. 4, 2008).

will only have a non-proprietary contractual unsecured claim against the CM for equivalent margin to be returned.

Where a CM has received full title or full ownership to money under a collateral arrangement, the fact that the CM has also taken a security interest over the rights of the customer to redelivery of that margin would not result in the money being “client money”. This can be compared to a situation in which a CM takes a charge or other security interest over money held in a client bank account, where that money would still be client money as there would be no absolute transfer of title to the CM. However, if that security interest includes a “right to use arrangement”, under which the client agrees to transfer all of its rights to money in that account to the CM upon the exercise of the right to use, the money may cease to be client money, but only once the right to use is exercised and the money is transferred out of the account to the CM.

If the margin is transferred by the customer to the CM as “client money” or “client assets”, then the CM must hold such client money as a trustee pursuant to a statutory trust.[158] FSA-regulated CMs are required to segregate “client money” from their own house funds promptly upon receipt by placing them in a central bank, certain authorized credit institutions or qualifying money market funds.[159] In relation to “client assets”, FSA-regulated CMs must when holding safe custody assets (e.g., initial margin in the form of securities) belonging to clients make adequate arrangements to safeguard clients’ ownership rights[160] and have adequate organizational arrangements to minimize the risk of the loss or diminution of clients’ safe custody assets.[161] These are principle-based requirements, so the CMs have a certain amount of discretion as to how they segregate client assets in practice.

It is at present unclear how the broad powers granted to the U.K. government pursuant to the Banking Act 2009 will affect the existing regime dealing with “client money” and “client assets” as it applies to CMs which carry on the regulated activity of accepting deposits. On insolvency of such a CM, the U.K. government could, in certain circumstances, transfer to a private sector purchaser some or all of the CM’s property, rights and liabilities. These powers are expressed to extend to “property held on trust” but it is not clear whether this means property held by the CM as trustee, or property held by a third party “on trust” for the CM. The Banking Act 2009 is relatively new and therefore it remains to be seen whether the U.K. government would exercise the wide-ranging powers available to it under the Act to effect transfers of customer margin from an insolvent CM to a new solvent CM.

[158] CASS 7.7.

[159] CASS 7.4.1R.

[160] CASS 6.2.1R.

[161] CASS 6.2.2R.

CMs That Are French Financial Institutions (Including English Branches of French Banks)

If French insolvency proceedings are opened with respect to a French financial institution (i.e., licensed credit institutions, including banks, and investment firms licensed to provide investment services, including broker dealers), such proceedings will, in principle, relate to all assets and liabilities of the French financial institution, irrespective of where such assets and liabilities are located and what law governs them.

Deviating from such principle, French law provides that the rights and obligations of insolvent participants in a "System" within the meaning of Article L.330-1 of the French Monetary and Financial Code are determined by the law governing the System, provided that this is the law of an EEA jurisdiction. Article L.330-1 of the French Monetary and Financial Code was enacted in connection with implementing the SFD under French law.

We understand from LCH.C that it is a System within the meaning of Article 2 of the SFD. Thus, in principle, Article L.330-1 of the French Monetary and Financial Code will apply if a French CM becomes subject to French insolvency proceedings. Accordingly, English law would govern the rights and obligations of the insolvent French CM "arising from, or in connection with, its participation" in LCH.C, as well as the effect of the French CM's insolvency on such rights and obligations. However, whether the customers' rights with respect to margin would also be governed by English law would in particular depend on whether such customers' rights are determined to be part of the French CM's "rights and obligations arising from, or in connection with, its participation" in LCH.C. There is no case law or other guidance on point. However, the fact that LCH.C's rules generally leave it to CMs and their customer to implement measures for the protection of customer margin could constitute an argument against such a determination.

Since it is legally uncertain whether French insolvency courts would consider that English law should govern the customers' rights with respect to margin, we have set out below an analysis of the principles that would be applicable if the question of segregation of customer margin was governed by French insolvency law.

Article L.330-2 of the French Monetary and Financial Code provides that creditors of any participant, whether direct or indirect, in a System shall not have any right on the margin posted in accordance with the System's rules to secure any payment obligations arising from the participation in such System, whether or not insolvency proceedings have been commenced against the participant.[162] This rule is primarily intended to protect the Systems' rights with respect to margin posted with them by any participant against such participant's insolvency. Absent any case law or other guidance on point, it is uncertain whether this rule would apply to protect the customers' rights on the margin return. If, however, this were the case, in order to benefit from this rule, customers would need to qualify as an indirect participant in the relevant System. Under Regulation 9 of the English Financial Markets and Insolvency (Settlement

[162] Article L.330-2 of the French Monetary and Financial Code applies to French Systems but, in the event of an insolvency proceeding commenced in France against a French CM, although this is not free from doubt, the French insolvency court is likely to apply this rule to margin posted with another EEA System.

Finality) Regulation of 1999, the competent authority may treat an indirect participant (such as a customer) as a participant of a System if it considers this to be required on grounds of systemic risk. It is therefore not possible to determine in advance whether a customer would be so treated.

Accordingly, although the applicability of Article L.330-2 of the French Monetary and Financial Code might provide a legal basis for the segregation of the customer margin, we have set out below an analysis of the principles that would be applicable if Article L.330-1 was not applicable. Since LCH.C does not allow the direct posting of margin by customers with it and does not mandate any specific form of collateral arrangement, the customer's rights on the margin posted with the French CM would depend on the nature of the collateral arrangement between such customer and the CM.

Title transfer arrangements

French law provides for a specific segregation and loss-sharing regime applicable to margin (cash or securities) posted by way of title transfer with a French CM in France. Under this regime, (i) the margin posted with a French CM to cover positions in a market in financial instruments (which would include, although this is not entirely free from doubt, any positions on financial instruments traded on the OTC market such as CDS) is dedicated to cover (i) any loss resulting from the liquidation of the customer's open positions and (ii) any amount due to the French CM; and (ii) creditors of the French CM have no right in such margin so that in the event that an insolvency proceeding is commenced against the French CM in France, the customer would recover the margin (after deduction of any above-mentioned losses and amounts due) ahead of the French CM's creditors. It is, however, doubtful that this special regime would apply to margin posted by way of title transfer with a French CM in connection with the clearing of CDS positions with any non-French CCP.

If this special regime is not applicable to French CMs of LCH.C, then the segregation and loss sharing rules applicable to margin transferred via title transfer to such CMs (whether deposited with the CM directly or in an account opened in the CM's name with a custodian) would be as follows:

(x) with respect to margin which consists of cash: the cash transferred to the CM by the customer would be commingled with other cash held by the CM and therefore the customer would not be entitled to segregate any such cash and, in case of the CM's insolvency, would be an unsecured creditor of the CM in this respect; the customer would thus share in any shortfall on a pro rata basis with other unsecured creditors of the CM; and

(y) with respect to margin which consists of securities: to the extent that the securities so transferred are booked in an account opened in the name of the CM, French insolvency courts would consider that the customer would be an unsecured creditor of the CM in respect of such margin and therefore would share in any shortfall on a pro rata basis with other unsecured creditors of the

> CM. By exception to the foregoing, in the event that the account in which the securities posted as margin is maintained at the English branch of the French bank CM, French insolvency courts would to the extent that the existence or transfer of the securities so deposited as margin with the English branch of the French bank requires their recording in that account, defer to English law to determine the rights of the customer, the French bank and third parties (including creditors of such French bank) as well as the effect of the French bank's insolvency on such rights.[163]

Security Interest Arrangements

Cash

If the customer deposits and pledges any cash margin with the CM that is a French financial institution (or an English branch of a French bank) and such French CM becomes subject to insolvency proceedings in France,[164] French insolvency courts would certainly consider that the cash deposited with the French CM by the customer would be commingled with other cash held by the French CM. Accordingly, the customer would not be entitled to segregate any such cash and would rather be an unsecured creditor of the French CM in this respect.

Securities

If the securities margin is deposited and pledged with the French CM and such securities would be booked in an account opened with the French CM in the name of the customer in France, French segregation rules should apply. Under such rules, the securities held by the insolvent French CM on behalf of customers are shared among them on a pro rata (and security per security) basis (i.e., among all claimants, regardless of whether they have or have not allowed rehypothecation). Once the allocation among customers has been made, customers may require that the securities allocated to them be transferred to another financial institution. For the remainder of the shortfall, they become unsecured creditors of the French CM.

As mentioned above, as an exception to the foregoing, in the event that the account in which the securities posted as margin is maintained at the English branch of the French bank, French insolvency law could point to English law to determine the rights in such securities as well as the effect of the French bank's insolvency on such rights.

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163 French law would also point to English law if the securities posted as margin are recorded in another securities account, a register or a centralized deposit system held or located in England, provided that such recording is required for the existence or transfer of such securities.

164 Assuming that all French CMs would be credit institutions, an English branch of such a credit institution cannot become subject to English insolvency proceedings, and therefore the protections of Part VII of the Companies Act 1989 will not be available.

CMs That Are German Financial Institutions (Including English Branches of German Banks)

If German insolvency proceedings are opened with respect to a CM that is a German financial institution, such proceedings will, in principle, relate to all assets and liabilities of the German financial institution, irrespective of where such assets and liabilities are located and what law governs them (Section 335 of the German Insolvency Code).[165] Deviating from such principle, Section 340(3) of the German Insolvency Code provides that the rights and duties of insolvent participants in a "system" within the meaning of Section 1(16) of the German Banking Act (*Kreditwesengesetz*) (a "System") are governed by the laws of the jurisdiction applicable to the System.[166] Section 1(16) of the German Banking Act was enacted in connection with implementing Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (the "SFD").

We understand from LCH.C that it is a System within the meaning of Article 2 of the SFD.[167] Thus, in principle, Section 340(3) of the Insolvency Code will apply if a German CM becomes subject to German insolvency proceedings. Accordingly, in principle, the laws of England and Wales (including insolvency laws) would govern the relationship of the insolvent German CM with LCH.C and the effect of the CM's insolvency on such relationships. However, whether the customers' rights with respect to margin would also be governed by the laws of England and Wales would in particular depend on whether the scope of Section 340(3) of the German Insolvency Code comprises matters of segregation of margin by customers within the meaning of Section 47 of the German Insolvency Code.

There is no German case law on point as to whether the segregation of margin by customers falls under Section 340(3) of the German Insolvency Code. Some legal commentators state that the purpose of Section 340(3) of the German Insolvency Code is to ensure that the transactions within a System are not impaired by any restrictions in the national laws of the participants. Accordingly, Section 340(3) should be interpreted broadly. Even such a comprehensive approach, however, does not necessarily encompass a claim for segregation of customer margin from the CM's insolvency estate, because an argument could be made that the segregation of assets does not form part of the System itself. The purpose of the SFD, which is aimed at minimizing the disruption to a System caused by the applicable insolvency provisions of the member states concerned, does itself not contain any explicit rules

165 An English Branch of a German CM that is a credit institution cannot become subject to English insolvency proceedings, and therefore no liquidation or administration proceedings may be taken in England in respect of these entities, so English law will not be relevant.

166 Section 340(3) of the German Insolvency Code does not apply to German CMs that are not credit institutions to the extent they are participants in a System located in a EU member state. In such a case, the European Insolvency Regulation would apply. However, Article 9(1) of the European Insolvency Regulation contains an exemption similar to Section 340(3) of the German Insolvency Code.

167 Pursuant to the European Commission's website (http://www.ec.europa.eu/internal_market/financial-markets/settlement/dir-98-26-art10-national_en.htm), Eurex Clearing AG, ICE Clear Europe, LCH.Clearnet Limited / NYSE Liffe and LCH.Clearnet SA each qualifies as a securities settlement system.

on the protection of a customer's rights as to the collateral security provided in case of the insolvency of the CM. Article 9 of the SFD only deals with the protection of the rights of the holder of collateral security and not the provider of such collateral security. Accordingly, although the applicability of Section 340(3) of the German Insolvency Code might provide a legal basis for the segregation of customer margin, we have set out below an analysis of the principles that would be applicable if the question of segregation of customer margin was not governed by Section 340(3) of the German Insolvency Code.

Under Section 47 of the German Insolvency Code (*Insolvenzordnung*), a creditor is entitled to the segregation (*Aussonderung*) of an asset from the insolvency estate of the insolvent entity if it holds a right *in rem* or, in very limited circumstances, a right *in personam* pursuant to which the creditor can claim that the asset does not belong to the insolvency estate. In this regard, German insolvency law, in principle, would respect and give effect to non-German law rights that the creditor has validly acquired in accordance with German conflict of law rules, provided that such rights are comparable to German law rights entitling creditors to segregation.

Thus, in order to be entitled to claim the segregation of customer margin posted by the customer to the CM, the position of the customer in respect of such customer margin under its arrangements with the CM (i) must have been validly acquired in accordance with German conflict of law rules and (ii) must be comparable to German law rights entitling creditors to segregation.

LCH.C Level

Under the present structure, all margin posted by a CM to LCH.C will be the property of the respective CM, free of any interests of the customers, and LCH.C will not have any relationship with the CM's customers. Accordingly, customers would not have any ownership interest in any margin posted to LCH.C. Although we understand that LCH.C would, based upon information provided to it by the CM, segregate dealer margin and customer margin, no arrangements would be in place pursuant to which LCH.C would hold customer margin posted to it by the CMs "on trust" (or under similar arrangements) for the CMs' customers. Accordingly, customers are not directly entitled to receive customer margin segregated at the level of LCH.C. However, LCH.C does not use customer margin to meet shortfalls in the CM's proprietary positions.

CM Level

At present, LCH.C does not intend to mandate the segregation of customer margin at the CM level leaving it to CMs and their customers to implement measures for the protection of customer margin. To the extent that CMs are their own custodians, their customers may only have an unsecured claim for return of margin posted by them even if transfer of margin to the CM is not by way of outright transfer (especially in the case of cash). Although we have not been provided with information on how CMs hold margin for their customers, the following should generally apply if a CM becomes subject to German insolvency proceedings:

If margin was posted to the CM by way of an outright transfer, with an unsecured claim of the customer to the return of the margin, irrespective of what law governs such outright transfer, the customer would not be entitled to segregate any margin posted to the CM.

If cash margin was posted to the CM in accounts with the CM, the customer would most likely have an unsecured claim for the repayment of such cash margin even if, under applicable substantive law, tracing and segregation is possible under certain circumstances. Any arrangement, however structured, where cash margin is held by the CM itself would almost certainly not be recognized by German courts as entitling the customer to segregation because, from a German law perspective, any cash transferred by the customer to the CM would be commingled with other cash held by the CM. On the other hand, if cash margin in accordance with client money rules was deposited by the CM with a third party custodian in a trust account for the benefit of the customer, such cash margin would not form part of the CM's insolvency estate and could be segregated.

If securities margin was posted to the CM and such securities margin, in accordance with client money rules, was deposited with a third party custodian who held the securities margin "on trust" for the customer, such securities margin would not form part of the CM's insolvency estate and could be segregated.

If securities margin was posted to the CM and such securities margin was not deposited with a third party custodian, the customer should nevertheless be entitled to segregate the securities margin from the insolvency estate of the German CM if the customer remains the legal and beneficial owner of, or holds a proprietary interest in the securities, and these rights, if acquired under non-German law, are equivalent to a German law right entitling the owner of such right to the segregation of the relevant asset.

CMs That Are Swiss Financial Institutions (Including English Branches of Swiss Banks)

As LCH.C does not mandate segregation on the CM level, Swiss Banks are not required to segregate client money and assets as there is, as set out in Part II.C.6.(b) above, no corresponding Swiss statutory duty.

In respect of segregation requirements in relation to an English branch of a CM which is incorporated in Switzerland (or indeed, any non-EU country), it is expected that any such branch conducting regulated activities in the U.K. would be regulated by the FSA. As a result, the segregation requirements would be similar to that of CMs that are English FSA-regulated entities as set out above.

(b) Portability Analysis

The specifics of LCH.C's transfer process from a defaulting CM to a non-defaulting CM are currently subject to ongoing consultation by LCH.C. Currently, it is intended that in the event of a CM insolvency LCH.C may transfer that CM's customer positions to a solvent CM. However, neither the initial margin posted by the insolvent CM nor the related contracts between the CM and the customers will be ported in tandem with the CM-CCP customer positions to the solvent CM. As a result, the new CM may have to post new initial margin to the CCP in respect of the transferred customer positions. It is likely that the new CM will call upon the relevant customers whose positions were transferred to post at least equivalent margin to the new CM in order for it to meet the initial margin requirements of the CCP in respect of the transferred customer positions.

The initial margin originally posted by the insolvent CM will be returned by LCH.C to the insolvent CM's estate after the transfer or termination process. Considering that a CM is generally required transfer its own proprietary assets to LCH.C to meet the CCP's initial margin requirements,[168] depending on the specific arrangements between the CM and its customers, there is a risk that any initial margin returned by LCH.C to the insolvent CM would be available for distribution to that CM's creditors generally and the insolvent CM's customers will not have a specific proprietary claim to the returned margin.

CMs That Are U.S. Entities

It not possible to analyze the portability of customer positions cleared by a U.S. CM through LCH.C without more details of the structure of LCH.C's transfer process.

CMs That Are English FSA-Regulated Entities

LCH.C is a "recognised clearing house" for the purposes of the Companies Act 1989. Should it in the future decide to implement procedures that would facilitate portability of customer positions and related margin, it will therefore be able to take advantage of the protections offered by that law, which should, depending on the specifics of the new portability procedures, allow it to give effect to such provisions without restriction by the liquidator or administrator of an English CM's estate. Part VII of the Companies Act 1989 has the effect of disapplying the parts of English insolvency law that could be used to challenge or restrict actions taken by a "recognised clearing house" under its default rules.

In addition, because LCH.C is a "designated system" within the meaning of The Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "Settlement Finality Regulations"), its portability procedures will be further protected because Regulation 14 of the Settlement Finality Regulations provides that LCH.C's default arrangements are to take precedence over general insolvency proceedings of the English CM.

In respect of English CMs that are deposit-taking institutions, the Banking Act 2009 has introduced a Special Resolution Regime which would allow the U.K. government to stabilize certain institutions in distress. The U.K. government may in certain circumstances transfer some or all of the property, rights and liabilities of a bank (including any CDS

168 According to the rules of LCH.C, if the CM is not the sole legal and beneficial owner of those securities or other assets deposited with LCH.C, those securities or other assets must be so furnished or deposited with the legal and beneficial owner's unconditional consent and free of such owner's interest and that the provision to LCH.C of such securities or other assets pursuant to the rules of LCH.C will not constitute or result in a breach of any trust, agreement or undertaking.

positions (and potentially customer margin[169])) to a private sector purchaser or to a bridge bank. However, secondary legislation[170] has been implemented with the objective of ensuring that partial transfers of a bank's assets by the government do not interfere with netting and collateral arrangements. This secondary legislation makes a partial transfer of an insolvent bank's assets invalid if it conflicts with the Settlement Finality Directive, Part VII of the Companies Act 1989, or the legal protections afforded to title transfer financial collateral arrangements. Security arrangements are dealt with separately, by providing that no partial transfer of secured assets may be made without also transferring the secured liability. Given the relative novelty of the Banking Act 2009 and related legislation (and the fact that they have not been used to date) it is not possible to say how interventionist the U.K. government would seek to be in respect of a relevant CM's CDS arrangements with its customers and a CCP.

CMs That Are French Financial Institutions (Including English Branches of French Banks)

As mentioned above, we have assumed that LCH.C either qualifies or will likely qualify as a System and French law provides that when a French CM (including an English branch of a French bank) becomes subject to insolvency proceedings in France, the rights and obligations arising from, or in connection with, its participation in a System regulated in the EEA are governed by the law governing such System.

Therefore, in the event that a French CM becomes subject to insolvency proceedings in France, English law should govern the CM's rights and obligations arising from, or in connection with, its participation in LCH.C. This should include any provisions applicable in the event of a CM's default such as the liquidation of positions, the determination of close-out amounts and the application of collateral, as well as any provisions relating to the transfer of the CM-CCP positions and related margin. French insolvency law should therefore not be applicable to these matters and French insolvency courts should respect without restriction the transfer arrangements made in accordance with English law.

With respect to the transfer of the customer-CM positions and related margin corresponding to the LCH.C-French CM positions transferred to a new CM, in particular if the customers' rights with respect to margin are determined to be part of the French CM's "rights and obligations arising from, or in connection with, its participation" in LCH.C, the above rule should apply and such transfers should also be governed by English law and French insolvency courts should respect them without restrictions.

There is, however, no French case law or other guidance available as to what extent a "portability framework" of a System would be upheld in a French participant's insolvency, in particular with respect to the possibility to port the customer-CM positions and related margin. This remains therefore subject to uncertainty and would require further analysis.

[169] Although there are provisions in the Banking Act 2009 that deal with "property held on trust", it is unclear what the term means as it could mean property held by the bank as trustee or property in which the bank is the beneficiary.

[170] The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009.

If a CM that is a French financial institution (or an English branch of a French bank) becomes subject to French insolvency proceedings and the CM's business activities are continued, the insolvency representative has discretionary power to terminate any contract entered into by the insolvent CM if he determines that such contract is not necessary for the continuation of the CM's business. If the insolvency representative makes such a decision, the CM's open positions with LCH.C and the corresponding customer's open positions with the CM would be liquidated thereby preventing any transfer of such positions to a new CM.

CMs That Are German Financial Institutions (Including English Branches of German Banks)

If a CM became subject to German insolvency proceedings, the portability of customer-CM positions and CM-LCH.C positions would be subject to some uncertainty.

First, generally, upon the opening of insolvency proceedings, the right to administer the insolvency estate passes to an insolvency representative (unless self-administration is ordered by the insolvency court), and any advance consent by the debtor to disposals which would occur after the opening of insolvency proceedings would become invalid. Thus, any transfer of a CM position will likely require the insolvency representative's consent.

Second, as discussed above, LCH.C qualifies as a System, in which case the law governing the System would govern the relationships of the "participants" of the System (Section 340(3) of the German Insolvency Code), and German insolvency law would not be applicable. In such case, there are also good arguments that the portability of positions is not affected by the opening of the insolvency proceedings because the System is governed by English law, provided that such portability would not be affected if English insolvency proceedings were opened with respect to the CM. In particular, any provisions providing for the termination of transactions, the determination of close-out amounts, the application of collateral and the transfer of CM-CCP positions are likely to remain unaffected by German insolvency law. However, there is no German case law or commentary available discussing to what extent a "portability framework" of a System would be upheld in a participant's insolvency, in particular as regards the possibility to port customer-CM positions. This matter therefore remains therefore subject to some uncertainty and is a topic for further legal analysis.

CMs That Are Swiss Financial Institutions (Including English Branches of Swiss Banks)

As set forth in Part II.C.6.(e) above, a transfer of a transaction after the CM has been made subject to protective measures by FINMA or adjudicated bankrupt would be subject to the cooperation of FINMA or the receiver in insolvency, respectively, as the CM will have lost some or all (as the case may be) capacity to dispose of its assets.

In respect of an English branch of a CM which is incorporated in Switzerland (or indeed, any non-EU country), in certain circumstances it can be possible for insolvency proceedings to be commenced in England, where the protection offered by Part VII of the

Companies Act 1989 would be available.[171] Section 221 of the Insolvency Act 1986 allows the English courts to wind up an insolvent non-English company. The presence of a branch and assets in England will be relevant criteria for the court in deciding to exercise jurisdiction under Section 221. In practice, the most likely scenario is that the defaulting CM's "home" state would commence main insolvency proceedings, and an English court would commence ancillary proceedings (applying English law) in respect of the English branch, in which the protections of Part VII of the Companies Act 1989 (if available) would apply.

(c) Applicable Sharing Rules in the Event of a Shortfall

Considering that LCH.C does not mandate any customer margin segregation requirement at the CM level and that such customer margin segregation requirements are likely to be governed by the relevant home country rules of the CM, the applicable sharing rules in the event of a shortfall of customer margin held at the CM or its custodians should be as set out in Part II.C. above.

(d) CCP Requests for Legal Change or Clarification

None requested.

(e) Discussion of Outstanding Issues

LCH.C rules do not regulate the relationship between the CMs and their customers. In particular, there are no requirements as to segregation of customer margin at the CM level or provisions to facilitate portability of customer positions and customer margin (although there are also no restrictions imposed by LCH.C on customers and CMs agreeing to implement measures relating to the protection of customer initial margin). In the event of a CM insolvency, customers would be reliant on the home country rules of the CM to recover any margin posted and/or port or terminate any outstanding positions. Since the clearing conditions of LCH.C basically leave it to the customer to protect their interests with respect to margin themselves, the LCH.C system itself—as opposed to individual arrangements—offers relatively low protection for customers.

Furthermore, as explained in the Portability Analysis above, the initial margin originally posted by the insolvent CM will be returned by LCH.C to the insolvent CM's estate after the transfer or termination process. Considering that the CM could only transfer its own proprietary assets to LCH.C to meet the CCP's initial margin requirements, any initial margin returned by LCH.C to the insolvent CM is likely to be available for distribution to its creditors generally. It would be highly unlikely that the insolvent CM's customers will have a specific proprietary claim to the returned margin. Therefore, an insolvent CM's customer whose margin had not been segregated and held "on trust" would only have an unsecured contractual claim against the insolvent CM for the return of equivalent margin.

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[171] For a discussion on the protections offered by Part VII of the Companies Act 1989, see the portability analysis in relation to CMs that are English FSA-regulated entities above.

LCH.C has indicated to the Group that they are willing to be flexible in terms of the structures that they offer and, to the extent they are able to, they are willing to provide solutions that the CMs and customers may require. In particular, they have pointed out that they are able to add specific provisions to their rules (such as including a requirement for gross margin to be held at LCH.C, adding rules for the porting of margin or preventing the CM's house positions from including positions held by customers who have chosen to not have their positions segregated by the CM or LCH.C), subject to the agreement of the relevant regulator(s) and, because LCH.C is a "recognised clearing house", Part VII of the Companies Act 1989 should ensure the enforceability of LCH.C's default rules and provides protection in the event of the insolvency of an English CM. We encourage existing and potential CMs and customers to work with LCH.C in this endeavor.

4. LCH.Clearnet SA

(a) Segregation Analysis

LCH.Clearnet SA is targeting the start of its CDS clearing activities by the end of 2009. Therefore its CDS clearing infrastructure remains subject to ongoing design changes until then. At the present time, LCH.Clearnet SA is at the "detailed design stage" and reviewing its clearing processes relating to CDS with its supervisory authorities, and the membership implementation and testing stage have not been completed yet. As such, LCH.Clearnet SA is not, at this stage, in a position to address in full detail the issues raised by the questionnaire.

LCH.Clearnet SA intends to enter into transactions with CMs on a principal-to-principal basis. LCH.Clearnet SA will not be a party to any CM-customer arrangement and will have no contractual relations with customers of the CMs, although the latter will have to inform LCH.Clearnet SA if it is entering into a trade on behalf of its customers or on a proprietary basis.

The transfer of collateral from CMs to LCH.Clearnet SA will be governed by French law. Under French law, the posting of collateral to LCH.Clearnet SA is regarded as an outright transfer of title. Under current rules applicable to existing clearing activities, CMs transfer margin to LCH.Clearnet SA on a net basis. Margin transferred to LCH.Clearnet SA by each CM is segregated between margin for the CM's proprietary positions and related margin for the CM's customer positions. On the insolvency of a CM, margin posted by that CM for customer positions cannot be used to cover losses resulting from that CM's proprietary positions; however, we understand that margin posted by the insolvent CM for proprietary positions may in certain circumstances be used to cover shortfalls resulting from that CM's customer positions.

Margin relating to customer positions which is posted by CMs to LCH.Clearnet SA is held by LCH.Clearnet SA in a segregated customer omnibus account. LCH.Clearnet SA is currently considering holding customer margin posted by CM with LCH.Clearnet SA in separate individual customer accounts.

Segregation of margin at the CM level will be agreed upon by the CM and its customers. However, although LCH.Clearnet SA is not a party to the agreements between the CM and its customers, LCH.Clearnet SA requires the CMs to account for the positions of each customer in an individual manner at the CM level.

CMs That Are U.S. Entities

(i) U.S. Banks and Unregulated U.S. Entities

Whether a CM that is a U.S. bank or unregulated U.S. entity is under an obligation to segregate margin received from a client for a LCH.Clearnet SA cleared CDS transaction will depend on the nature of the collateral arrangement between such client and the CM. LCH.Clearnet SA does not mandate any specific form of collateral arrangement between the client and the CM, and therefore the client and CM are free to agree to any form of collateral arrangement between themselves. Major variations include:

- Tri-party security arrangement: The CM is granted a security interest in the client's margin, but the margin is held in an account at a third-party custodian. The CM will have control of the client's margin, but no right to remove the margin prior to a default by the client. This provides the client with strong assurance of the eventual return of its margin following discharge of its secured obligations.

- Pledge with a right of re-use: The client pledges margin to the CM and grants the CM the right to rehypothecate the margin to LCH.Clearnet SA. Although the client may retain rights in the margin even after the CM rehypothecates the margin to LCH.Clearnet SA, those rights would depend on the client's ability to trace the margin to LCH.Clearnet SA (a task which would be aided by the segregation of margin for customer positions from margin for proprietary positions) and would be subject to the CM's obligations to LCH.Clearnet SA.

- Title transfer arrangement: The client transfers margin to the CM with the intent to retain only a contractual right to the return of the margin. The client may retain no proprietary rights in the margin and would have only an unsecured creditor claim an insolvency of the CM.

The extent to which the client of the U.S. bank or unregulated entity benefits from segregation will vary significantly depending on which of these variations (or the many possible other alternatives) is elected and on the extent to which the CM complies with the contractual limitations.

(ii) U.S. FCMs

U.S. FCMs are generally required by U.S. law and regulation to segregate assets received from customers to margin, purchase, guarantee, or secure commodity futures or commodity option transactions.[172] It is not clear, however, whether CDS cleared by LCH.Clearnet SA are commodity futures or commodity options transactions for this purpose.[173] U.S. FCMs will therefore be faced with uncertainty about whether they are subject to a segregation requirement under U.S. law or regulation. Moreover, it is unclear whether the LCH.Clearnet SA-cleared CDS constitute "commodity contracts" under the Bankruptcy Code and the related CFTC rules.[174]

In a liquidation of the U.S. FCM under the Bankruptcy Code,[175] if the court determines that the LCH.Clearnet SA-cleared CDS transactions are "commodity contracts", then (i) these contracts and the related margin provided by the customers should be included in the calculation of the customers' "net equity", (ii) the margin related to these contracts provided by the customers will be considered "customer property" available for distribution to all members of the relevant "account class",[176] and (iii) the cleared CDS customers will share, together with all other customers of the same account class, on a pro rata basis in any shortfalls in customer property of the account class. Although not completely clear, this treatment is likely to occur regardless of whether the U.S. FCM had held the margin collected in relation to the LCH.Clearnet SA-cleared CDS separately from the assets segregated for the other members of the relevant account class.

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[172] An exception to this general rule relates to assets received from persons located outside the U.S. to margin, purchase, guarantee, or secure foreign futures or options. As a consequence, even if the cleared CDS were to be a commodity future or commodity option transaction, the U.S. FCM may not have a segregation requirement under U.S. law or regulation with respect to customers located outside the U.S. if the cleared CDS is determined to be foreign futures or options transactions.

[173] As described in Part II.C.2 above, the CFTC has issued an interpretation that certain "cleared-only contracts" are "commodity contracts" within the meaning of the Bankruptcy Code and, in that interpretation, also stated that such contracts are "contracts for the purchase or sale of a commodity for future delivery" within the meaning of the Bankruptcy Code. This interpretation addressed the status of "cleared-only contracts" that are (i) executed over-the-counter and cleared by a registered derivatives clearing organization and (ii) the subject of a CFTC order pursuant to Section 4d(a)(2) of the CEA. LCH.Clearnet SA, however, is not a registered derivatives clearing organization and has not indicated that it intends to so register, nor has it indicated that it intends to seek an order under Section 4d(a)(2). Moreover, this interpretation addressed the status of these contracts for purposes of the Bankruptcy Code and will not necessarily apply to the meaning of the related terms under the CEA.

[174] <u>See</u> Part II.C.2 above.

[175] A U.S. FCM can also be subject to a federal equity receivership, rather than liquidation under the Bankruptcy Code. Such proceedings are governed by principles of equity and the ultimate outcome of such a proceeding is not clear.

[176] 17 C.F.R. § 190.01(a) identifies the following five account classes: futures accounts, foreign futures accounts, leverage accounts, commodity option accounts and delivery accounts. It is unclear into what account class LCH.Clearnet SA-cleared CDS would be classified.

However, if the court in a Bankruptcy Code liquidation determines that the LCH.Clearnet SA-cleared CDS transactions are not "commodity contracts" under the Bankruptcy Code, then the outcome may depend on whether the FCM commingled the margin for the LCH.Clearnet SA-cleared CDS together with the customer property of commodities customers (e.g., because the FCM believed the LCH.Clearnet SA-cleared CDS were commodity futures or options contracts). If the margin for the LCH.Clearnet SA-cleared CDS is deposited into an account designated for the segregated customer property of commodities customers, the result is unclear. In the worst case, the margin for the LCH.Clearnet SA-cleared CDS may be treated as customer property of the commodities customers[177] and distributed to the commodities customers (to the extent of their net equity claims) before being made available to the cleared CDS customers or any other creditors.[178] This treatment would only matter if there were a shortfall in customer property, but could have the consequence that the LCH.Clearnet SA-cleared CDS customers absorb the entire shortfall even if it was caused by the commodities customers. On the other hand, if the FCM did not commingle the margin for the LCH.Clearnet SA-cleared CDS with the customer property of the commodities customers, then the rights of the LCH.Clearnet SA-cleared CDS customers would depend on the contractual arrangements between the CM and the customer, as described above for U.S. banks and unregulated U.S. entities.

CMs That Are English FSA-Regulated Entities

Whether a CM that is an English firm regulated by the FSA is required to segregate margin received from the client would depend on the nature of the collateral arrangement between the CM and the client. LCH.Clearnet SA does not mandate any specific form of collateral arrangement and therefore the CM and its client are free to agree to any form of collateral arrangement between them.

Generally, CMs which are English firms regulated by the FSA are required to segregate margin received only if the margin falls under the category of "client money" or "client assets" in accordance with CASS Rules as set out in Part II.C.3. above. If the margin is transferred outright from the customer to the CM pursuant to a "title transfer collateral arrangement", such margin will not be considered "client asset" or "client money" under the CASS Rules and is therefore not required to be segregated by the CM. In the event of the CM's insolvency, the customer whose margin was transferred pursuant to a "title transfer collateral arrangement" will only have a non-proprietary contractual unsecured claim against the CM for equivalent margin to be returned.

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177 Under 17 C.F.R. § 190.08(a)(ii)(A), "customer property" includes all cash, securities or other property segregated on the filing date.

178 There is also a chance that, in such a case, the court would treat the cleared CDS customers as commodities customers of the same class based on an argument that the CDS transactions themselves and the related margin do or could constitute margin for other commodities contracts between the cleared CDS customers and the FCM. See 73 Fed. Reg. 65514, 65515-16 (Nov. 4, 2008).

Where a CM has received full title or full ownership to money under a collateral arrangement, the fact that the CM has also taken a security interest over the rights of the customer to redelivery of that margin would not result in the money being "client money". This can be compared to a situation in which a CM takes a charge or other security interest over money held in a client bank account, where that money would still be client money as there would be no absolute transfer of title to the CM. However, if that security interest includes a "right to use arrangement", under which the client agrees to transfer all of its rights to money in that account to the CM upon the exercise of the right to use, the money may cease to be client money, but only once the right to use is exercised and the money is transferred out of the account to the CM.

If the margin is transferred by the customer to the CM as "client money" or "client assets", then the CM must hold such client money as a trustee pursuant to a statutory trust.[179] FSA-regulated CMs are required to segregate "client money" from their own house funds promptly upon receipt by placing them in a central bank, certain authorized credit institutions or qualifying money market funds.[180] In relation to "client assets", FSA-regulated CMs must when holding safe custody assets (e.g., initial margin in the form of securities) belonging to clients make adequate arrangements to safeguard clients' ownership rights[181] and have adequate organizational arrangements to minimize the risk of the loss or diminution of clients' safe custody assets.[182] These are principle-based requirements, so the CMs have a certain amount of discretion as to how they segregate client assets in practice.

It is at present unclear how the broad powers granted to the U.K. government pursuant to the Banking Act 2009 will affect the existing regime dealing with "client money" and "client assets" as it applies to CMs which carry on the regulated activity of accepting deposits. On insolvency of such a CM, the U.K. government could, in certain circumstances, transfer to a private sector purchaser some or all of the CM's property, rights and liabilities. These powers are expressed to extend to "property held on trust" but it is not clear whether this means property held by the CM as trustee, or property held by a third party "on trust" for the CM. The Banking Act 2009 is relatively new and therefore it remains to be seen whether the U.K. government would exercise the wide-ranging powers available to it under the Act to effect transfers of customer margin from an insolvent CM to a new solvent CM.

CMs That Are French Financial Institutions (Including English Branches of French Banks)

Margin posted by customers with French CMs and booked in an account opened with the French CM in France must be transferred via title transfer. Under French law, the margin posted with a French CM to cover positions in a market in financial instruments (which would include, although this is not entirely free from doubt, any positions on financial instruments

179 CASS 7.7.

180 CASS 7.4.1R.

181 CASS 6.2.1R.

182 CASS 6.2.2R.

traded on the OTC market such as CDS) is dedicated to cover (i) any loss resulting from the liquidation of the customer's open positions and (ii) any amount due to the CM. Such margin is held segregated from the French CM's estate and creditors of the French CM shall have no right in such margin. In the event that an insolvency proceeding is commenced against the CM in France,[183] the customer would have priority over the claims of unsecured and secured creditors of the insolvent CM to recover the margin (after deduction of any above-mentioned losses and amounts due).

CMs which are English branch of a French bank are required to segregate client money and assets in accordance with Part II.C.4 above.

CMs That Are German Financial Institutions (Including English Branches of German Banks)

If German insolvency proceedings are opened with respect to a CM that is a German financial institution, such proceedings will, in principle, relate to all assets and liabilities of the German financial institution, irrespective of where such assets and liabilities are located and what law governs them (Section 335 of the German Insolvency Code).[184] Deviating from such principle, Section 340(3) of the German Insolvency Code provides that the rights and duties of insolvent participants in a "system" within the meaning of Section 1(16) of the German Banking Act (*Kreditwesengesetz*) (a "System") are governed by the laws of the jurisdiction applicable to the System.[185] Section 1(16) of the German Banking Act was enacted in connection with implementing Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (the "SFD").

We understand from LCH.Clearnet SA that it is a System within the meaning of Article 2 of the SFD.[186] Thus, in principle, Section 340(3) of the Insolvency Code will apply if a German CM becomes subject to German insolvency proceedings. Accordingly, in principle, French law (including insolvency laws) would govern the relationship of the insolvent German CM with LCH.Clearnet SA and the effect of the CM's insolvency on such relationships.

183 Assuming that all French CMs would be credit institutions, an English branch of such a credit institution cannot become subject to English insolvency proceedings and are subject only to the insolvency rules and proceedings of its home member state (e.g., France), and therefore the protections of Part VII of the Companies Act 1989 will not be available.

184 An English Branch of a German CM that is a credit institution cannot become subject to English insolvency proceedings, and therefore no liquidation or administration proceedings may be taken in England in respect of these entities, so English law will not be relevant.

185 Section 340(3) of the German Insolvency Code does not apply to German CMs that are not credit institutions to the extent they are participants in a System located in a EU member state. In such a case, the European Insolvency Regulation would apply. However, Article 9(1) of the European Insolvency Regulation contains an exemption similar to Section 340(3) of the German Insolvency Code.

186 Pursuant to the European Commission's website (http://www.ec.europa.eu/internal_market/financial-markets/settlement/dir-98-26-art10-national_en.htm), Eurex Clearing AG, ICE Clear Europe, LCH.Clearnet Limited / NYSE Liffe and LCH.Clearnet SA each qualifies as a securities settlement system.

However, whether the customers' rights with respect to margin would also be governed by French law would in particular depend on whether the scope of Section 340(3) of the German Insolvency Code comprises matters of segregation of margin by customers within the meaning of Section 47 of the German Insolvency Code.

There is no German case law on point as to whether the segregation of margin by customers falls under Section 340(3) of the German Insolvency Code. Some legal commentators state that the purpose of Section 340(3) of the German Insolvency Code is to ensure that the transactions within a System are not impaired by any restrictions in the national laws of the participants. Accordingly, Section 340(3) should be interpreted broadly. Even such a comprehensive approach, however, does not necessarily encompass a claim for segregation of customer margin from the CM's insolvency estate, because an argument could be made that the segregation of assets does not form part of the System itself. The purpose of the SFD, which is aimed at minimizing the disruption to a System caused by the applicable insolvency provisions of the member states concerned, does itself not contain any explicit rules on the protection of a customer's rights as to the collateral security provided in case of the insolvency of the CM. Article 9 of the SFD only deals with the protection of the rights of the holder of collateral security and not the provider of such collateral security. Accordingly, although the applicability of Section 340(3) of the German Insolvency Code might provide a legal basis for the segregation of customer margin, we have set out below an analysis of the principles that would be applicable if the question of segregation of customer margin was not governed by Section 340(3) of the German Insolvency Code.

Under Section 47 of the German Insolvency Code (*Insolvenzordnung*), a creditor is entitled to the segregation (*Aussonderung*) of an asset from the insolvency estate of the insolvent entity if it holds a right *in rem* or, in very limited circumstances, a right *in personam* pursuant to which the creditor can claim that the asset does not belong to the insolvency estate. In this regard, German insolvency law, in principle, would respect and give effect to non-German law rights that the creditor has validly acquired in accordance with German conflict of law rules, provided that such rights are comparable to German law rights entitling creditors to segregation.

Thus, in order to be entitled to claim the segregation of the securities margin posted by the customer with the CM, the position of the customer in respect of the securities under its arrangements with the CM (i) must have been validly acquired in accordance with German conflict of law rules and (ii) must be comparable to German law rights entitling creditors to segregation.

LCH.Clearnet SA level

According to the information provided to us, a CM would post margin (cash and securities) to LCH.Clearnet SA by way of outright transfer governed by French law, and LCH.Clearnet SA will not have any relationship with the CM's customers. Accordingly, customers would not have any ownership interest in any margin posted to LCH.Clearnet SA. Although we understand that LCH.Clearnet SA would, based upon information provided to it by the CM, segregate dealer margin and customer margin, no arrangements would be in place pursuant to which LCH.Clearnet SA would hold customer margin posted to it by the CMs "on trust" (or under similar arrangements) for the CMs' customers. Accordingly, customers would not be entitled to the segregation of customer margin at the level of LCH.Clearnet SA. However, LCH.Clearnet SA does not use customer margin to meet shortfalls in the CM's proprietary positions

CM level

At present, LCH.Clearnet SA does not intend to mandate the segregation of margin at the CM level leaving it to CMs and their customers to implement measures for the protection of customer margin. To the extent that CMs are their own custodians, their customers may only have an unsecured claim for return of margin posted by them even if transfer of margin to the CM is not by way of outright transfer (especially in the case of cash). Although we have not been provided with information on how CMs hold margin for their customers, the following should generally apply if a CM becomes subject to German insolvency proceedings:

If margin was posted to the CM by way of an outright transfer, with an unsecured claim of the customer to the return of the margin, irrespective of what law governs such outright transfer, the customer would not be entitled to segregate any margin posted to the CM.

If cash margin was posted to the CM in accounts with the CM, the customer would most likely have an unsecured claim for the repayment of such cash margin even if, under applicable substantive law, tracing and segregation is possible under certain circumstances. Any arrangement, however structured, where cash margin is held by the CM itself would almost certainly not be recognized by German courts as entitling the customer to segregation because, from a German law perspective, any cash transferred by the customer to the CM would be commingled with other cash held by the CM. On the other hand, if cash margin in accordance with client money rules was deposited by the CM with a third party custodian in a trust account for the benefit of the customer, such cash margin would not form part of the CM's insolvency estate and could be segregated.

If securities margin was posted to the CM and such securities margin was deposited with a third party custodian who held the securities margin "on trust" for the customer, such securities margin would not form part of the CM's insolvency estate and could be segregated.

If securities margin was posted to the CM and such securities margin was not deposited with a third party custodian, the customer should nevertheless be entitled to segregate the securities margin from the insolvency estate of the German CM if the customer remains the legal and beneficial owner of, or holds a proprietary interest in, the securities, and these rights, if acquired under non-German law, are equivalent to a German law right entitling the owner of such right to the segregation of the relevant asset.

CMs That Are Swiss Financial Institutions (Including English Branches of Swiss Credit Banks)

As LCH.C does not mandate segregation on the CM level, Swiss Banks are not required to segregate client money and assets as there is, as set out in Part II.C.6.(b) above, no corresponding Swiss statutory duty.

In respect of segregation requirements in relation to an English branch of a CM which is incorporated in Switzerland (or indeed, any non-EU country), it is expected that any such branch conducting regulated activities in the U.K. would be regulated by the FSA. As a result, the segregation requirements would be similar to that of CMs that are English FSA-regulated entities as set out above.

(b) Portability Analysis

The rules relating to the default procedure are subject to ongoing consultation and will be finalized prior to LCH.Clearnet SA starting its CDS clearing activities. It is expected that in case of a CM default, LCH.Clearnet SA may either allow settlement by the defaulting CM or transfer customer positions of the defaulting CM to another solvent CM. It is contemplated that the default rules applicable to CDSs will allow LCH.Clearnet SA to transfer open positions and related margin of a customer to another CM upon acceptance by both the customer and the new CM. If the customer positions cannot be transferred or settled, such customer positions will be liquidated. LCH.Clearnet SA does not have the power to mandate a solvent CM to accept the open positions and related margin of an insolvent CM. The liquidation of customer positions might be conducted by the defaulting CM or the insolvency representative under the supervision of LCH.Clearnet SA. However, if LCH.Clearnet SA cannot rely on the co-operation of the insolvency representative or the defaulting CM, it will handle the relevant liquidation procedures on its own.

CMs That Are U.S. Entities

It not possible to analyze the portability of customer positions cleared by a U.S. CM through LCH.Clearnet SA without more details of the structure of LCH.Clearnet SA's transfer process.

CMs That Are English FSA-Regulated Entities

At present, LCH.Clearnet SA is not a "recognised overseas clearing house" for the purposes of the Companies Act 1989, although we understand that it is currently in the process of applying for this status. This means that the protections of Part VII of the Companies Act 1989 are not at present available to protect the default portability procedures applicable on the insolvency of an English CM. LCH.Clearnet SA's ability to transfer open positions and margin from the insolvent English CM to a new CM could be significantly curtailed if LCH.Clearnet SA is not a "recognised overseas clearing house" because:

(a) mandatory insolvency set-off would, subject to certain exceptions, automatically apply in relation to mutual debts between LCH.Clearnet SA and the insolvent CM;

(b) the transfer of CDS contracts following the insolvency of the English CM would either be prohibited (if the defaulting CM is in liquidation) or require the consent of the defaulter's administrator or the court (if the defaulting CM is in administration or an administration application has been made);

(c) contracts between the LCH.Clearnet SA and the defaulting CM could be subject to insolvency clawback on the grounds of transactions at undervalue, preferences or transactions defrauding creditors or disclaimer by the liquidator; and

(d) common law rules against forfeiture and changes to the *pari passu* distribution principle would apply and could conflict with LCH.Clearnet SA's rules relating to the portability of positions and related margin.

LCH.Clearnet SA is currently in the process of applying for "recognised overseas clearing house" status, which, once obtained will protect LCH.Clearnet SA's contracts with its CMs from many of the English insolvency rules that would hamper the operation of its rules as currently envisaged. However, the porting of margin is not an established practice for "recognised overseas clearing houses" regulated in the U.K. and legal certainty with respect to portability of margin might be enhanced by specific legislative amendments (particularly if it is intended that CM excess margin will be included in the customer margin that would be ported by the CCP to the new CM). Even prior to LCH.Clearnet SA obtaining this status, close-out and netting rights (but less so mandatory portability rules) would generally be protected under the U.K. Financial Collateral Arrangements (No. 2) Regulations 2003.

Notwithstanding the foregoing, to the extent LCH.Clearnet SA is a "designated system" within the meaning of The Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "Settlement Finality Regulations"), depending on the details of its default procedures, its portability procedures may be protected because Regulation 14 of the Settlement Finality Regulations provides that LCH.Clearnet SA's default arrangements are to take precedence over general insolvency proceedings of the English CM.

In respect of English CMs that are deposit-taking institutions, the Banking Act 2009 has introduced a Special Resolution Regime which would allow the U.K. government to stabilize certain institutions in distress. The U.K. government may in certain circumstances transfer some or all of the property, rights and liabilities of a bank (including any CDS positions (and potentially customer margin[187])) to a private sector purchaser or to a bridge

[187] Although there are provisions in the Banking Act 2009 that deal with "property held on trust", it is unclear what the term means as it could mean property held by the bank as trustee or property in which the bank is the beneficiary.

bank. However, secondary legislation[188] has been implemented with the objective of ensuring that partial transfers of a bank's assets by the government do not interfere with netting and collateral arrangements. This secondary legislation makes a partial transfer of an insolvent bank's assets invalid if it conflicts with the Settlement Finality Directive, Part VII of the Companies Act 1989, or the legal protections afforded to title transfer financial collateral arrangements. Security arrangements are dealt with separately, by providing that no partial transfer of secured assets may be made without also transferring the secured liability. Given the relative novelty of the Banking Act 2009 and related legislation (and the fact that they have not been used to date) it is not possible to say how interventionist the U.K. government would seek to be in respect of a relevant CM's CDS arrangements with its customers and a CCP.

CMs That Are French Financial Institutions (Including English Branches of French Banks)

In the event of a CM's default, French CCPs (including LCH.Clearnet SA) are entitled by law to have the CM-CCP positions and related margin as well as the customer-CM positions and related margin transferred to another solvent CM. These transfers would, however, be subject to the prior acceptance of each customer and the new CM.

Any such transfer initiated by LCH.Clearnet would be respected and given effect by the relevant French insolvency court in the event that the insolvent CM is subject to insolvency proceedings in France.

CMs That Are German Financial Institutions (Including English Branches of German Banks)

If a CM became subject to German insolvency proceedings, the portability of customer-CM positions and CM-LCH.Clearnet SA positions would be subject to some uncertainty.

First, generally, upon the opening of insolvency proceedings, the right to administer the insolvency estate passes to an insolvency representative (unless self-administration is ordered by the insolvency court), and any advance consent by the debtor to disposals which would occur after the opening of insolvency proceedings would become invalid. Thus, any transfer of a CM position will likely require the insolvency representative's consent.

Assuming that, as discussed above, LCH.Clearnet SA qualifies as a System, in which case the law governing the System would govern the relationships of the "participants" of the System (Section 340(3) of the German Insolvency Code), and German insolvency law would not be applicable. In such case, there are also good arguments that the portability of positions is not affected by the opening of the insolvency proceedings because the System is governed by French law, provided that such portability would not be affected if French insolvency proceedings were opened with respect to the CM. In particular, any provisions providing for the termination of transactions, the determination of close-out amounts, the application of collateral and the transfer of CM-CCP positions are likely to remain unaffected by German insolvency law. However, there is no German case law or commentary available discussing to

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[188] The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009.

what extent a "portability framework" of a System would be upheld in a participant's insolvency. This matter therefore remains subject to some uncertainty and is a topic for further legal analysis.

CMs That Are Swiss Financial Institutions (Including English Branches of Swiss Banks)

As set forth in Part II.C.6.(e) above, a transfer of a transaction after the CM has been made subject to protective measures by FINMA or adjudicated bankrupt would be subject to the cooperation of FINMA or the receiver in insolvency, respectively, as the CM will have lost some or all (as the case may be) capacity to dispose of its assets.

In respect of an English branch of a CM which is incorporated in Switzerland (or indeed, any non-EU country), in certain circumstances it can be possible for insolvency proceedings to be commenced in England, where the protection offered by Part VII of the Companies Act 1989 would be available.[189] Section 221 of the Insolvency Act 1986 allows the English courts to wind up an insolvent non-English company. The presence of a branch and assets in England will be relevant criteria for the court in deciding to exercise jurisdiction under Section 221. In practice, the most likely scenario is that the defaulting CM's "home" state would commence main insolvency proceedings, and an English court would commence ancillary proceedings (applying English law) in respect of the English branch, in which the protections of Part VII of the Companies Act 1989 (if available) would apply.

(c) Applicable Sharing Rules in the Event of a Shortfall

Considering that LCH.Clearnet SA does not mandate any customer margin segregation requirement at the CM level and that such customer margin segregation requirements are likely to be governed by the relevant home country rules of the CM, the applicable sharing rules in the event of a shortfall of customer margin held at the CM or its custodians should be as set out in Part II.C above.

(d) CCP Requests for Legal Change or Clarification

None requested.

(e) Discussion of Outstanding Issues

Because margin would likely be required to be posted by CMs to the CCP on a net basis, in the event that the positions and related margin of the insolvent CM would be transferred in parts to various solvent CMs (instead of in its entirety to one solvent CM), there is a concern that the margin posted by the insolvent CM would not be sufficient to meet the aggregate margin requirements of those positions transferred to the new CMs. There could be therefore a mismatch in the value and also nature of the margin originally posted by the

[189] For a discussion on the protections offered by Part VII of the Companies Act 1989, see the portability analysis in relation to CMs that are English FSA-regulated entities above.

customer to the insolvent CM and the value and nature of the margin received by the new solvent CM, even though the customer may have a new contractual relationship with the new solvent CM in relation to the transferred positions.

LCH.Clearnet SA is dependent on the CM to inform them whether the CM is entering into a trade on behalf of its customers or on a proprietary basis. In the event that the CCP is wrongly informed that a "proprietary" trade was in fact a customer trade, such positions may be liquidated by the CCP instead of transferred to a new CM on the insolvency of such customer's CM.

LCH.Clearnet SA's rules do not regulate the relationship between the CMs and their customers. In particular, there are no requirements as to segregation of customer margin at the CM level (although there are also no restrictions imposed by LCH.Clearnet SA on customers and CMs agreeing to implement measures relating to the protection of customer initial margin). In the event of a CM insolvency, customers would be reliant on the home country rules of the CM to recover any margin posted. Since the clearing conditions of LCH.Clearnet SA basically leave it to the customer to protect their interests with respect to margin themselves, the LCH.Clearnet SA system itself – as opposed to individual arrangements – offers relatively low protection for customers.

INDEX OF DEFINED TERMS

Annex A – U.S. Legislative Amendments Suggested by the CME at Our Request

Section 761(4)(F) of the Bankruptcy Code (11 U.S.C. § 761(4)(F)) is amended to read as follows:

(4) "commodity contract" means—

…

(F) any other contract, option, agreement or transaction that is similar to a contract, option, agreement or transaction referred to in this paragraph; for this purpose, a similar contract, option, agreement or transaction shall include, without limitation, any contract, option, agreement or transaction cleared by a derivatives clearing organization that is registered with the Commission; …

Annex B – U.S. Legislative Amendments Suggested by ICE Trust at Our Request

1. Section 404 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. §4404) is amended by inserting the following new subsection (i):

(i) Enforceability of Position Transfer Provisions

(1) The rights of a clearing organization pursuant to one or more netting contracts—

(A) to transfer or cause the transfer of the failed member's rights and obligations under contracts or positions of the failed member with the clearing organization, together with related security agreements or arrangements or credit enhancements and property transferred thereunder, to one or more other members of the clearing organization; and

(B) to transfer or cause the transfer of the failed member's rights and obligations under related or offsetting contracts or positions between the failed member and a non-member, together with related security agreements or arrangements or credit enhancements and property transferred thereunder, to one or more other members of the clearing organization;

shall be enforceable in accordance with their terms, and shall not be stayed, avoided or otherwise limited by any State or Federal law.

(2) In the case of a failed member that is a depository institution subject to the Federal Deposit Insurance Act, the exercise by the clearing organization of rights pursuant to subsection (a) above shall be subject to the limitations set forth in Section 11(e)(10)(b) of the Federal Deposit Insurance Act to the same extent applicable to the exercise of termination rights for qualified financial contracts.

This provision is intended to provide certainty that a clearing organization can exercise rights under its rules to transfer positions of a defaulting member, in addition to terminating or liquidating those positions, which FDICIA currently addresses. It also would allow the clearing organization to cause the transfer of related positions between the defaulting member and customers to a new member, to the extent permitted under its rules. Clause (2) preserves certain limitations on the exercise of remedies against an insured depository institution in the event of a receivership or conservatorship.

2. Section 404 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. §4404) is amended by inserting the following new subsection (j):

(j) Notwithstanding any provision of State or Federal law, the [the applicable federal regulator] may provide, by rule or regulation—

(i) with respect to a member of a clearing organization (other than a clearing organization that is registered with the Securities and Exchange Commission as a securities clearing agency or with the Commodity Futures Trading Commission as a derivatives clearing organization), the manner in which cash, securities, or other property pledged or transferred to such member by non-members of the clearing organization (regardless of whether such cash, securities or property is held with the member, the clearing organization or a third party) in connection with contracts or positions between the non-member and the member that are offset by or related to contracts or positions between the member and the clearing organization shall be segregated and held and the manner in which such cash, securities or other property may be invested; and

(ii) with respect to a failed member of a clearing organization (other than a clearing organization that is registered with the Securities and Exchange Commission as a securities clearing agency or with the Commodity Futures Trading Commission as a derivatives clearing organization), where such failed member is the subject of a receivership or conservatorship under the Federal Deposit Insurance Act or similar proceeding under applicable state law, is a debtor in a proceeding under title 11 of the United States Code or is subject to other applicable insolvency or similar proceedings—

(1) that certain cash, securities or other property pledged or transferred to such failed member by non-members of the clearing organization in connection with contracts or positions between the non-member and the failed member that are offset by or related to contracts or positions between the failed member and the clearing organization (regardless of whether such cash, securities or property is held with the failed member, the clearing organization or a third party) shall not be the property of such failed member;

(2) that certain of the failed member's rights in such contracts or positions with the clearing organization, including payments received in respect thereof, shall not be the property of such failed member;

(3) the method by which the business of such failed member with respect to such contracts or positions and related cash, securities or property is to be conducted or liquidated after the appointment of a receiver, conservator, trustee or similar person or filing of a petition or proceeding under such title, including the manner in which property described in (1) or (2) is to be delivered or returned to non-members.

This provision would give the appropriate federal regulator authority to establish rules as to the manner in which segregated property is to be held by a clearing member and in which it may be invested. It would also allow the regulator to establish clear rules as to the segregated status of property pledged by customers of a failed clearing member and as to the customer's right to the return of any excess amounts posted, free of claims of unsecured creditors. The provision is similar to the grant of authority to the CFTC in Section 20 of the

Commodity Exchange Act to establish its Part 190 rules as to the treatment of customer property and positions.

3. Section 11(e) of the Federal Deposit Insurance Act (12 U.S.C. §1821(e)) is amended in subclause (9)(A) by adding the following new subclause (iii):

(iii) Notwithstanding clauses (i) and (ii) above, the conservator or receiver for a depository institution may transfer (or not transfer) cleared qualified financial contracts between any person or any affiliate and the depository institution in default separately from other qualified financial contracts between such person or its affiliate and the depository institution in default, provided that all such cleared qualified financial contracts between such person or its affiliate and the depository institution in default, together with any claims and related security or other credit enhancement, are transferred to the same financial institution or are not transferred.

"Cleared qualified financial contracts" means a qualified financial contract (A) entered into between the depository institution and a clearing organization of which it is a member or (B) entered into between the depository institution and a non-member of the clearing organization on terms that mirror or offset a qualified financial contract between the depository institution and the clearing organization.

This provision would modify the requirement in the Federal Deposit Insurance Act that all qualified financial contracts between a defaulting depository institution and any person or its affiliate be either transferred together or not at all, to allow cleared transactions to be transferred separately from non-cleared transactions. This would facilitate moving of cleared contracts carried with a failed clearing member to a new clearing member, for example.

Annex C – CME Response to Certain Questions Relating to the CFTC's Part 190 Interpretation on the Insolvency Treatment of Cleared-Only CDS Contracts

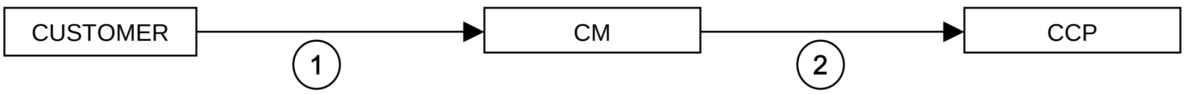
[Annex C is attached as two separate PDFs, one consisting of the CME's memorandum and the other containing the exhibits thereto.]

Appendix A – Final Questionnaire to CCPs & Final CCP Responses to Questionnaire

[Appendix A is attached as separate PDFs, one for each CCP's questionnaire response.]

Appendix B – Posting/Holding of Margin Required by CCPs

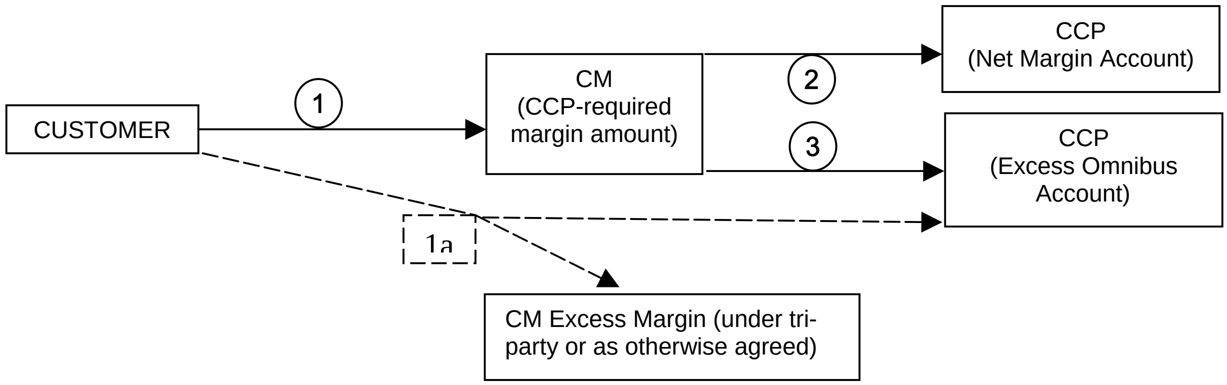
<u>CME—POSTING/HOLDING OF MARGIN</u>



1 Security interest. Gross Amount and CM Excess Margin is posted to CM's 4d Account or 30.7 Account, and CM has control.

2 Security interest. Gross Amount is pledged to CCP, and CCP has control. CM may on-pledge customer margin or post proprietary margin to satisfy CCP margin requirements. Gross Amount may be accessed by CCP in the event of a margin shortfall arising from customers of the same CM.

ICE TRUST—POSTING/HOLDING OF MARGIN



1 Security interest (for margin required by the CCP). CM has control.

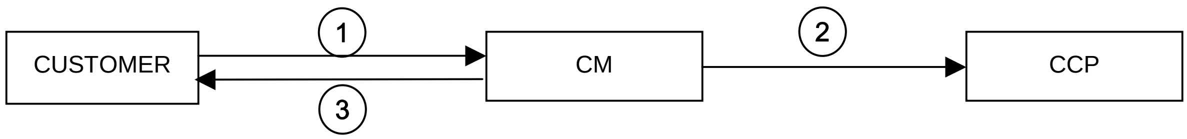
1a Security interest (for CM Excess Margin). CM Excess Margin may be held either in the Excess Omnibus Account or as otherwise agreed between the CM and its customer.

2 Security interest (securities) / deposit (cash). Net Amount is deposited in the Net Margin Account. CCP has control over Net Amount. CM may on-pledge customer margin or post proprietary margin to meet CCP net margin requirements.

3 Security interest (securities) / deposit (cash). Excess Amount is deposited in the Excess Omnibus Account. CM and CCP both have a lien on property in the Excess Omnibus Account, which is held by the CCP in an account in the name of the CM, as agent or custodian for the CM's customers.

CCP can access property in the Excess Omnibus Account only in two situations—(i) to satisfy obligations owing by customers to CCP when customer positions are liquidated, (ii) to reallocate margin from the Excess Omnibus Account to the Net Margin Account. CCP cannot access a particular customer's property in the Excess Omnibus Account to satisfy margin deficits arising from other customers.

EUREX—POSTING/HOLDING OF MARGIN



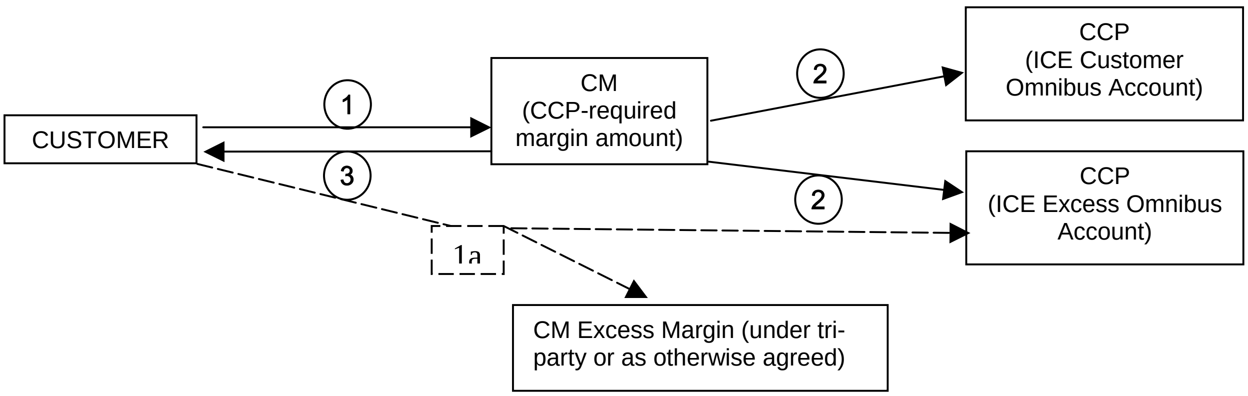
1 Title transfer or security interest, as agreed between customer and CM to satisfy CM gross margin requirements

2 Title transfer of cash or security interest in securities to satisfy CCP net margin requirements. Only proprietary assets of CM are transferred or pledged to CCP.

3 In the case of U.S. CMs and U.S. customers of non-U.S. CMs: customer margin posted to CM to be segregated by CM and a security interest in such segregated assets granted to secure the return of customer margin.

* Note: Eurex does not prescribe how CM Excess Margin is required to be held.

ICE CLEAR EUROPE—POSTING/HOLDING OF MARGIN



1 Title transfer (for margin required by the CCP).

1a Title transfer or security interest (for CM Excess Margin). CM Excess Margin may be held either in the ICE Excess Omnibus Account or as otherwise agreed between the CM and its customer.

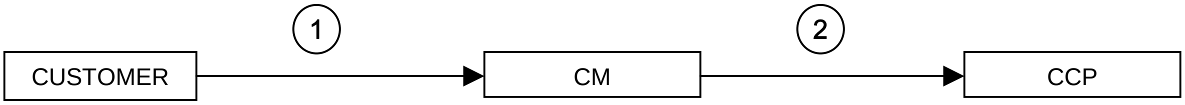
2 ICE Net Margin (which could be either cash or non-cash) is deposited in the ICE Customer Omnibus Account pursuant to title transfer.

ICE Excess Margin is deposited in the ICE Excess Omnibus Account. In relation to ICE Excess Margin, cash to be transferred outright to CCP and non-cash assets will be held by CCP (or the CCP's custodian) as custodian.

CCP can access property in the ICE Excess Omnibus Account only in two situations—(i) to satisfy obligations owing by customers to CCP when customer positions are liquidated, (ii) to reallocate margin from the ICE Excess Omnibus Account to the ICE Customer Omnibus Account. CCP cannot access property in the ICE Customer Omnibus Account to satisfy margin deficits arising from other customers.

3 Rights of CM to return of margin by CCP to be held in trust for customer.

LCH.C—POSTING/HOLDING OF MARGIN

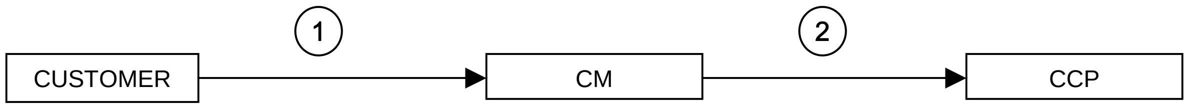


1 Title transfer or security interest to satisfy CM gross margin requirements, as agreed between CM and customer.

2 Title transfer of cash or security interest in securities to satisfy CCP net margin requirements. Margin provided by CM to CCP for customer positions as opposed to proprietary positions will be held in segregated customer omnibus accounts.

* Note: LCH.C does not prescribe how CM Excess Margin is required to be held.

LCH.CLEARNET SA—POSTING/HOLDING OF MARGIN



1. Title transfer or security interest to satisfy CM gross margin requirements, as agreed between CM and customer.

2. Title transfer of cash or security interest in securities to satisfy CCP net margin requirements. Margin provided by CM to CCP for customer positions as opposed to proprietary positions will be held in segregated customer omnibus accounts.

* Note: LCH.Clearnet SA does not prescribe how CM Excess Margin is required to be held.

Appendix C – List of Attorneys Who Worked on This Report

Matters Relating to English Law *(Cleary Gottlieb Steen & Hamilton LLP)*

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