

# ICE Trust U.S. LLC Response

## Questionnaire for CDS CCPs on Protection of Customer Initial Margin

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## I. ICE Trust Solution Development Approach

ICE Trust U.S. LLC, (“ICE Trust” or the “Clearinghouse”) has developed a framework for providing segregation of initial margin of non-members and portability of non-member positions (the “Non-Member Framework”). In developing its framework, ICE Trust has consulted extensively with numerous buy-side participants, its existing members, as well as with its principal regulators.

As an initial matter, ICE Trust notes that there is no formal regulatory framework under existing commodities and futures, banking or securities law that directly addresses the issues of customer margin segregation and portability in the context of a clearinghouse for over-the-counter derivatives. ICE Trust looked at the securities and commodities law frameworks and determined that organizing as a bank would be the best possible solution for the existing CDS market. The approach described herein has been designed to achieve segregation and portability within the constraints of existing insolvency and other laws (which were not necessarily drafted with OTC derivatives clearing in mind).

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## II. Factual Matters

### A. Structure of ICE Trust U.S. LLC

ICE Trust is a limited purpose, limited liability Trust Company organized under the laws of the State of New York and is a member of the Federal Reserve System. ICE Trust is regulated/supervised by the Federal Reserve and the New York State Banking Department and operates pursuant to an exemption from the Securities and Exchange Commission. ICE Trust is in the process of applying for Registered Overseas Clearing House status with the UK FSA. The implementation of the Non-Member Framework will require approvals of the New York State Banking Department and Federal Reserve as well as additional exemptive relief from the Securities and Exchange Commission and the Department of the Treasury.

### B. Structure of Clearing Members

ICE Trust limits its Clearing Members (“**CM**” or “**Member**”) to those who are able to meet the required membership criteria outlined below. ICE Trust does not otherwise limit participants based on legal entity type (i.e., participants do not have to be a Dealer) or jurisdiction.

ICE Trust membership criteria:

- \$5Bn+ Tangible Net Worth (Tangible Net Worth is equal to the Fed Reserve’s definition of “Tier 1 capital”)
  - If an Applicant does not meet this criteria, it may submit a parent guarantee, at ICE Trust’s discretion, provided its parent satisfies the criteria
- A minimum long-term rating “A” or equivalent from S&P/Moody’s/Fitch or equivalent
  - At the discretion of ICE Trust, this requirement could be met by the Applicant’s parent
  - If the clearing participant applicant does not have a rating, the ICE Trust, in its discretion, may allow an applicant to demonstrate compliance with this requirement by demonstrating that it meets stringent credit criteria through other means, subject to confirmation by an examination of its books and records

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- The Applicant must be regulated as to capital adequacy by competent authority such as the Fed, the SEC, CFTC, OCC, FSA or other regulators as determined by ICE Trust
  - This requirement could be met by an affiliate of the Applicant provided the participant would be subject to holding company group supervision
- Demonstrates operational competence, including:
  - Ability to process expected volumes
  - Adequate systems, equipment and experienced personnel
  - Ability to submit pricing
- Demonstrates risk management competence based on satisfactory completion of a risk questionnaire and a risk interview

ICE Trust also requires CMs to provide a legal opinion establishing the enforceability of ICE Trust rules in the CM's jurisdiction.

As noted above, ICE Trust does not limit CMs by jurisdiction, legal entity type or type of regulatory or supervisory authority, although each CM (either itself or as part of a holding company group) must be subject to regulation as to capital adequacy by a competent authority. For CMs based in the United States, regulatory and supervisory authorities generally include the Federal Reserve as supervisory authority at the holding company level and, for CMs that are banks, the OCC or another appropriate banking supervisor. For CMs licensed in the United Kingdom, the FSA would generally be the principal regulatory and supervisory authority. CMs organized in other jurisdictions may be subject to banking authorities in those jurisdictions.

## **C. Structure of Custodians**

### **1. ICE Trust Custodians**

Currently, ICE Trust uses The Bank of New York Mellon, a New York banking corporation (BNYM), as custodian for certain assets. (As such a banking corporation, BNYM is subject to regulation by the New York Banking Department and Federal Reserve.) ICE Trust may from time to time use other custodians.

ICE Trust's rules do not restrict the custodians that ICE Trust may use, but ICE Trust anticipates that any custodian holding IM would be a banking

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organization organized under U.S. law that is not a Member or an affiliate of a Member.

## **2. Clearing Member Custodians**

ICE Trust rules will require that CM's post the full amount of Clearinghouse-required margin to the CCP; as a result, Members will not have custodians for holding Clearinghouse-required margin.

## **D. Structure of Customers**

ICE Trust's rules do not restrict the organizational type or jurisdiction of organization of customers. ICE Trust does not monitor the various regulatory or supervisory authorities to which customers may be subject.

## **E. Expansion/Restriction of Permitted Entity Types**

ICE Trust considered netting implications, regulatory capital implications, operational impacts, adverse pass through effects, legal regime impacts and other factors in drafting its rules applicable to eligible CMs. As a general matter, ICE Trust has drafted its rules to assure that firms have the resources, controls and sophistication to participate in the central clearing function. CMs are required to meet membership criteria designed to ensure each participant has sufficient operational capabilities, financial resources, risk management experience and regulatory oversight to be permitted to participate in ICE Trust's central clearing facility. This requirement is in keeping with regulatory guidance from the Bank of International Settlements ("BIS")<sup>1</sup>.

This approach is intended to protect the Clearinghouse and its participants from the risk of default and to minimize operational disruptions in moving positions to the Clearinghouse. ICE Trust focused on the legal framework, particularly the insolvency framework, applicable to CMs in relevant jurisdictions.

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<sup>1</sup> The BIS Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions (IOSCO) published "Recommendations for Central Counterparties" Recommendation 2 states "A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligation arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met on an ongoing basis. A CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access."

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In accordance with its rules for admission of new CMs, ICE Trust expects that it would focus on these factors, including the appropriate legal and insolvency framework, in the event that new types of CM or CMs in other jurisdictions seek to become members of ICE Trust. As noted above, ICE Trust would seek a legal opinion as to relevant matters under the law applicable to the new CM or type of CM, including in the event of its insolvency.

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### III. Segregation and Safekeeping of Initial Margin

#### A. Initial Margin Held at or for ICE Trust

##### 1. Composition of ICE Trust Margin

ICE Trust's policies regarding the acceptable forms of non-cash collateral for Initial Margin and their associated haircuts are designed to provide protection for liquidity risk management. In establishing acceptable collateral, ICE Trust considered the liquidity of funds in the event of a CM default and evaluated how quickly funds would be available to cover CM losses. The principal consideration in determining eligible CCP Required Margin was the protection of the clearinghouse and the clearing system as a whole. In coordination with its regulators, ICE Trust established the following acceptable collateral for Initial Margin:

##### i. Acceptable Collateral

Acceptable Forms of Non-Cash Collateral for Initial Margin include:

- US Treasury Securities (Bills, Notes and Bonds)
- G7 Government Securities (Canada, France, Germany, Italy, Japan, United Kingdom, and United States )

All forms of collateral must continue to meet the criteria below to be considered for approval by ICE Trust:

- There must be adequate demand for acceptance of the collateral form among current Clearing Participants;
- An active secondary market with reasonable sized bids must exist;
- An accurate, reliable and timely price information source must be available to ICE Trust from an independent third party vendor; and
- ICE Trust must be capable of obtaining a perfected security interest in the collateral type.

##### ii. Initial Margin Collateral Thresholds

Given the ability to move cash immediately and the ability to liquidate US Treasuries same day, ICE Trust has established the first threshold for

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Initial Margin with respect to these asset types. This first threshold ensures that ICE Trust has immediate, intraday access to cash. The remaining Initial Margin contributions can be met with other forms of acceptable collateral as defined, subject to the defined haircuts. The thresholds are defined in the figure below.

***ICE Trust Collateral Thresholds***

Asset Type	Minimum Percentage* of Requirement	Comments
US dollar cash	45%	45% is equivalent to the maximum assumed one day margin movement (assuming a 5-day risk horizon)
US dollar denominated assets (Cash and/or US Treasuries)	+ 20% (for a total 65%)	65% is equivalent to the maximum assumed two day margin movement (assuming a 5-day risk horizon)
All eligible collateral (includes G7 cash and Sovereign Debt)		The remaining percentage can be any form of acceptable collateral

Additional margin will be called if the Clearing Participant does not maintain the appropriate minimums by asset type (regardless of whether the total sum of eligible collateral meets the total margin obligation).

## **2. Relationship Between CCP, CM and Customer**

CMs are acting as principals vis a vis both the CCP and customers. This approach is consistent with, and builds on, the existing structure of the OTC CDS market. As is the case with most Clearinghouses, ICE Trust has a direct,

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principal relationship only with its CMs. As between CMs and their customers, the ICE Trust approach expands upon the existing bilateral ISDA relationship between those parties. As noted herein, in accepting margin from customers, CMs are acting as agent and custodian for customers. In addition, in the case of payments made by ICE Trust in respect of the termination of Client Positions, CMs will receive such payments on behalf of and for the benefit of Clients, for distribution as described in Section B.11 below.

The Rules do not currently contemplate that customers will be permitted to clear transactions through non-CM affiliates of CMs.

## **B. Proposed Clearing Structure**

The basic methodology of ICE Trust's proposed clearing structure is outlined in Sections 1 to 11 below.

### **1. Clearing of CDS**

In accordance with its rules (the "Rules"), the Clearinghouse operates as a multilateral clearing organization for over-the-counter credit default swap ("CDS") transactions for purposes of Section 409 of the Federal Deposit Insurance Corporation Improvement Act of 1991, as amended ("FDICIA"). In general, the Clearinghouse accepts for clearing qualifying index (and, in the future, plans to accept single-name) credit default swap transactions entered into between Members. Upon acceptance of a transaction for clearing, the transaction is novated to the Clearinghouse, such that the Clearinghouse becomes the protection seller to the Member that is the protection buyer and the protection buyer to the Member that is the protection seller. The Clearinghouse requires Members to post initial margin (or collateral in lieu thereof), variation margin and special margin to secure their obligations to the Clearinghouse under cleared transactions.

### **2. Basic Non-Member Framework**

Pursuant to the Rules, the Clearinghouse is establishing a framework that provides certain protections of clearing for CDS transactions entered into by clients of Members ("Clients"), including the segregation of at least the minimum required initial margin posted by Clients in segregated accounts and

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provisions to enhance the transferability, or “portability,” of such transactions in the event of a Member insolvency (the “Non-Member Framework”).<sup>2</sup>

Under the Non-Member Framework, the Rules generally distinguish between Client-generated positions (“Client Positions”) and house positions (“House Positions”) for each Member. Client Positions are cleared CDS transactions between the Clearinghouse and the Member that are offset or mirrored on a back-to-back basis by a CDS transaction between the Member and a Client (a “Client-Member Transaction”). House Positions are all other cleared CDS transactions between the Member (or any affiliate of a Member) and the Clearinghouse (including so-called “house” or “proprietary” transactions).

Notwithstanding this distinction, both Client and House Positions are principal-to-principal transactions between the Member and the Clearinghouse. In addition, Client-Member Transactions are principal-to-principal transactions between the Member and the Client. The Clearinghouse will have no direct relationship with, or liability to, Clients, in respect of Client Positions, Client-Member Transactions or otherwise, except as described herein.

The Clearinghouse will record each Client Position submitted by a Member to the Clearinghouse, and will permit Members to identify and close out offsetting Client Positions that reflect positions corresponding to the same Client. Notwithstanding that the Clearinghouse may in this manner retain records of “gross” Client Positions across different Clients, the obligations of each of the Clearinghouse and the Member to the other at any time in respect of Client Positions shall be determined on a net basis.

### **3. Submission of Client Positions to ICE Trust**

Client Positions may be submitted for clearing in two ways. In order to have related Client Positions registered in the Clearinghouse, the Client is required to have one or more designated Members that have agreed to act as the Client’s clearing member.

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<sup>2</sup> Clearinghouse rules will not preclude a Client from trading with a Member on a strictly bilateral, non-cleared basis.

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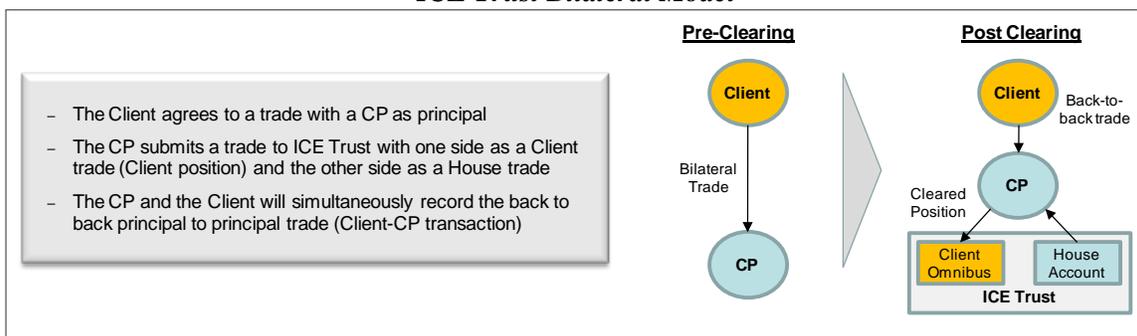
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i. Bilateral Model

The Client would execute a trade with a Member as principal. The Member submits a back-to-back trade to the Clearinghouse. Upon acceptance, this would be treated by the Clearinghouse as two positions, a Client Position that mirrors that Client-Member Transaction and an exactly offsetting House Position.

**ICE Trust Bilateral Model**



ii. Member as a Prime Broker

The Client agrees to a trade with a Member (the “Executing Dealer”) other than the Client’s clearing Member. Pursuant to a give-up agreement, the Client’s clearing Member, as prime broker, and the Executing Dealer enter into the trade, which is submitted to the Clearinghouse for clearing. The Member and the Client would simultaneously enter into an offsetting principal trade, which would be a Client-Member Transaction. The leg of the cleared transaction between the Clearinghouse and the Client’s Member would be treated as a Client Position.<sup>3</sup>

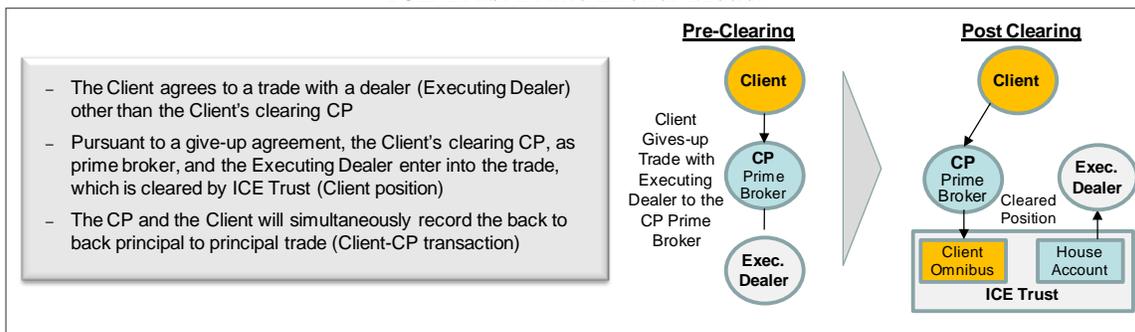
<sup>3</sup> In this scenario, the opposite leg between the Clearinghouse and the Executing Dealer would be a House Position. If the Executing Dealer were clearing through another Member, the leg between the Clearinghouse and the Executing Dealer’s Member would be a Client Position. If the Executing Dealer is the same legal entity as the prime broker, the result would be the same as in the bilateral model.

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**ICE Trust Prime Broker Model**



House Account.<sup>4</sup> The Client Omnibus Account may contain property of Clients that has been transferred or rehypothecated by the CM or proprietary assets of the CM transferred in lieu of Client property.

The Client Omnibus Account consists of a cash collateral subaccount for cash margin and a custody subaccount for securities collateral. The cash collateral subaccount will be maintained by the Clearinghouse and will contain initial margin posted as cash by the Member in respect of Client Positions (including cash posted to the Member by the Member's Clients in respect of related Client-Member Transactions and transferred by the Member to the Clearinghouse in respect of such Client Positions). Cash in the cash collateral subaccount may be applied by the Clearinghouse to the obligations of the Member in respect of Client Positions. The custody subaccount of the Client Omnibus Account will hold any non-cash assets posted by the Member in respect of Client Positions (including non-cash assets posted by the Member's Clients in respect of related Client-Member Transactions to the Member as margin and rehypothecated by the Member to the Clearinghouse in respect of such Client Positions). It will be held by the Clearinghouse, as custodian, or by one or more outside financial institutions as subcustodian for the Clearinghouse. The Client Omnibus Account and the assets therein will secure the Member's obligations to the Clearinghouse in respect of Client Positions.

The Clearinghouse will also maintain a separate omnibus segregated excess margin custodial account (the "Excess Margin Account"), which will hold certain margin provided by Clients to Members in excess of the net minimum margin required by the Clearinghouse. Assets in the Excess Margin Account will not be applied to satisfy or otherwise secure amounts owed by the Member to the Clearinghouse, except as described below. The Excess Margin Account will be maintained by ICE Trust or its subcustodian and will be held for the benefit of Clients of the relevant Member (or the Member as agent and custodian of such Clients), subject to a lien in favor of the Member. The

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<sup>4</sup> In the circumstance where a Member collects margin from a Client and posts different margin to the Clearinghouse in respect of the related Client Position, the Member would retain an interest in such margin. Members will be required under the Rules to maintain records of any such interest.

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Excess Margin Account will also consist of a cash subaccount and a custodial subaccount.

As described below, a Member will be required to transfer or rehypothecate to the Client Omnibus Account or Excess Margin Account, as applicable, required initial margin posted to the Member by the Client under the related Client-Member Transaction.

Pursuant to the Rules, each Member will be deemed to agree that with respect to Client property transferred or rehypothecated to the Client Omnibus Account or Excess Margin Account, (i) cash so transferred will become property of the Clearinghouse (with the Clearinghouse being obligated to return such cash as provided in the Rules for the benefit of the relevant Client (or the Member as agent or custodian thereof)) and (ii) non-cash assets so rehypothecated will remain the property of the relevant Clients, subject to a security interest in favor of the Member (and the Clearinghouse, in the case of the Client Omnibus Account).

The CM will be required to maintain records showing the amount and form of excess margin held in the Excess Margin Account for the benefit of each relevant Client (the "Client Excess Margin Amount").<sup>5</sup> Upon the termination of a Client-Member Transaction, the CM will be permitted to withdraw up to the Client Excess Margin Amount for that Client and apply it to amounts owed by the Client under the Client-Member Transaction.<sup>6</sup> Only that Client's Client Excess Margin Amount may be so used; margin posted by other Clients may not be used by the CM. The CM will also be permitted to withdraw amounts from the Excess Margin Account (not to exceed the Client Excess Margin Amount) when required to be returned to the Client under the Client-Member Transaction. The CM may transfer amounts in the Excess Margin Account (taken from Client Excess Margin Amounts of different Clients on a pro rata basis (determined excluding any CP Excess held in the Excess Margin Account)) to the Client Omnibus Account as necessary to satisfy the ICE Net

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<sup>5</sup> CMs will be required to provide reports or otherwise make information available as to such amounts to both ICE Trust and the relevant Clients.

<sup>6</sup> Where the CM is also in default, ICE Trust will be permitted to make such withdrawal and application.

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margin requirement for Client Positions. The CM will not otherwise be permitted to use or rehypothecate amounts in the Excess Margin Account.

In the case of a default by a CM, ICE Trust will be permitted to apply excess margin of a defaulting Client (but not other Clients) held in the Excess Margin Account to satisfy amounts owed by the defaulting CM in respect of Client Positions (to the extent of the defaulting Client's obligation to the CM)<sup>7</sup>. In addition, margin in the Excess Margin Account of Clients whose positions are not transferred to another CM as part of the Default Portability Rules may be transferred by ICE Trust to the Client Omnibus Account (pro rata based on such Clients' gross margin contributions) to satisfy any increase in the ICE Trust net initial margin requirement as a result of the transfer of some, but not all, positions.

## 5. Clearinghouse Margining

Each Member will be required to post to the Clearinghouse in the Client Omnibus Account initial margin on a "net" basis across all Client Positions ("ICE Net"), whether for the same or different Clients, in the same manner as generally required for House Positions.<sup>8</sup> The Rules do not specifically limit the Clearinghouse's ability to demand additional, special margin at any time from a CM.

For purposes of margining Clients, however, each Member will be required to obtain margin on a "gross" basis (that is, the Member will be permitted to net across multiple Client-Member Transactions of the same Client, but not across different Clients. Such margin will be pledged by the relevant Client in favor of the Member. Under ICE Trust Rules, such margin must not be subject to liens or other encumbrances in favor of third parties, including affiliates of the CM. Each Member will be required to transfer to the Excess Margin Account the difference between the aggregate "gross" margin required from Clients

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<sup>7</sup> Such excess margin will also be deemed applied to the obligation of the defaulting Client to the defaulting CM under its Client-Member Transaction.

<sup>8</sup> We note in this regard that the Clearinghouse's exposure to the Member, and the Member's exposure to the Clearinghouse, in respect of Client Positions will also be determined on a net basis across all Client Positions.

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and the net margin required by the Clearinghouse to be posted to the Client Omnibus Account (such excess, the “ICE Excess”). As noted above, the Clearinghouse will not be entitled to use such ICE Excess Margin, and will hold it merely as custodian.<sup>9</sup>

## 6. Client-Member Transaction Documentation

Client-Member Transactions will be documented pursuant to a negotiated ISDA Master Agreement between the Client and Member, together with a standard annex in the form approved by the Clearinghouse under the Rules (the “Standard Annex”). Under the Standard Annex, Client-Member Transactions will for certain purposes be treated separately from other derivatives between the Client and the Member (“Other Trades”). Specifically, Client-Member Transactions will be subject to the separate Clearinghouse margin requirements discussed below. In addition, the Standard Annex will include a standard definition of Member default, which will be based on a determination by the Clearinghouse under the Rules that a Member is in Default.<sup>10</sup> The Standard Annex will also specify procedures for the exercise of remedies in case of a Member default. If Default Portability Rules are to apply, the Standard Annex will include an agreement and consent on the part of the Client, for the benefit of ICE Trust, for ICE Trust to transfer Client-Member Transactions to a new Member following default or otherwise reestablish replacement transactions with the new Member. The Client will also agree not to exercise termination rights during the Transfer Period (as defined below). In the event the Client-Member Transaction is terminated as

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<sup>9</sup> Members may require Clients to post additional margin beyond the Clearinghouse “gross” minimum (“CP Excess”), which may be held as agreed between the Member and the Client. CP Excess may be transferred to the Excess Margin Account.

<sup>10</sup> The Standard Annex would not have a standard definition for Client defaults, which would be subject to bilateral agreement between the parties, as is current practice for OTC derivatives.

The Standard Annex will also provide that a failure by the CM to perform a payment or delivery obligation under a Client-Member Transaction will constitute an event of default with respect to the CM, regardless of whether the CM is otherwise determined to be in default under the ICE Trust Rules. Such a failure would, however, permit ICE Trust to declare the CM in default under the ICE Trust Rules. If ICE Trust makes such a declaration, the default procedures described herein would apply. If ICE Trust does not declare the CM to be in Default, the Client will be permitted to exercise its bilateral contractual termination remedies against the CM, although the default procedures of the Rules would not apply. In any event, the Client would not have any direct remedy against the Clearinghouse.

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a result of a Member default, the termination value will be equal to the termination value of the related Client Position as determined by ICE Trust. To facilitate portability, in the event of a Member default, termination amounts owed in respect of Client-Member Transactions will not be netted against termination amounts owed in respect of Other Trades.

## **7. Client-Member Transaction Margining**

Under the Rules and the Standard Annex, each Member must obtain initial, variation and any special margin from its Client for Client-Member Transactions in an amount at least equal to the Clearinghouse requirement for the related Client Positions (determined on a gross basis).

In the case of initial and any special margin, the Member will be required to receive such margin as agent or custodian for the Client and transfer such margin to either the Client Omnibus Account or the Excess Margin Account at the Clearinghouse. Such margin in the Excess Margin Account will be pledged to the Member.<sup>11</sup>

The Rules do not limit a CM's ability to require additional margin from a customer beyond the CCP requirement ("CP Excess"). Treatment of any CP Excess required of the Client by the Member beyond Clearinghouse requirements would be as agreed between the Client and Member.<sup>12</sup>

Variation margin posted by a Client may be transferred freely, and it would be expected that such margin may be used to satisfy the Member's variation margin requirements at the Clearinghouse in respect of Client Positions.

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<sup>11</sup> The Member will be required to reflect such margin in its books and records as being received in a custodial capacity and held in segregation from other assets of the Member, in a manner generally consistent with CFTC Rule 1.20. In the case of any delay in transferring margin to the Clearinghouse, such margin must be segregated by the Member and may not be otherwise used pending transfer to the Clearinghouse.

<sup>12</sup> CP Excess could be held in the Excess Margin Account if agreed by Member and Client. As noted below, there may be limitations on the ability of the Clearinghouse to effect a transfer of margin not held at the Clearinghouse.

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The Clearinghouse would make available to Members information sufficient for Members to determine their Clients' minimum margin requirements in respect of Client-Member Transactions.

The Member will be required under the Rules to maintain accurate records as of the identity of Clients, the margin assets posted by each such Clients and the transfer of such assets to the Client Omnibus Account and Excess Margin Account at the Clearinghouse.

## **8. Default Rules**

The Rules provide for separate treatment of Client and House Positions in the case of a Default<sup>13</sup> by a Member. The determination of whether a Member is in Default under the Rules is the same with respect to both types of position. The definition of Default under the Rules principally includes objective events (e.g., insolvency filings and failures to transfer margin when required) but does permit ICE Trust to find a Member to be in Default if it determines that the Member appears, in the judgment of ICE Trust, to be likely to fail to meet its obligations to ICE Trust. Depending on the type of event, different levels of management approval and/or regulatory consultation may be required before determining that a Member is in default. Notably, in cases other than an insolvency event or failure to satisfy payment, delivery or margin obligations, holding a Member in default requires a 2/3 majority vote of the ICE Trust board and consultation with the staff of the New York Fed.

The Clearinghouse will undertake the Close-Out Process under the Rules separately in respect of House Positions and Client Positions, such that a separate net termination amount will be calculated in respect of the close-out of Client Positions and House Positions.

The Rules would prohibit netting between Client Positions and House Positions, except as described below. If a net amount was owed to the Member in respect of Client Positions, the Clearinghouse would not offset that amount against any amount owed by the Member to the Clearinghouse in respect of House Positions. On the other hand, if a net amount was owed by

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<sup>13</sup> See Rule 20-605(a).

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the Member in respect of Client Positions, the Clearinghouse would be entitled to offset against that obligation any amount owed to the Member in respect of House Positions.

Pursuant to the Rules, net losses to the Clearinghouse arising from Client Positions may be paid from the following sources, in order: (i) the defaulting Member's House margin, (ii) the defaulting Member's Guaranty Fund contribution, (iii) the defaulting Member's Client Omnibus Account together with any excess margin of a defaulting Client of the Member held in the Excess Margin Account<sup>14</sup> and (iv) other Guaranty Fund contributions.<sup>15</sup> Net losses to the Clearinghouse arising from House Positions may be paid from the following sources, in order: (i) the defaulting Member's House margin, (ii) the defaulting Member's Guaranty Fund contribution, and (iii) other Guaranty Fund contributions.

Thus, the Clearinghouse only will be permitted to apply margin in a Client Omnibus Account to satisfy obligations of the Member in respect of Client Positions. Such margin could not be used to satisfy obligations in respect of House Positions. Margin in the House Account could potentially be applied to satisfy obligations to the Clearinghouse in respect of Client Positions.

The risk waterfall would not vary based on whether the default arises from an insolvency event.

i. Identification of Client or House Default

ICE Trust will identify in its books and records each position as a Client Position or House Position, based on information provided by the CM. In the event of a CM default, ICE Trust will conduct a separate closing-out process for Client Positions and House Positions and as a result will

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<sup>14</sup> Pursuant to the Rules and the Standard Annex, any loss in the Client Omnibus Account resulting from application of margin therein by the Clearinghouse under the Rules as a result of a Member default would be allocated among Clients as described in Section 11 below. The appropriate sequence of using the defaulting Client's margin is under consideration.

<sup>15</sup> Of course, to the extent the Clearinghouse, pursuant to its Close-Out Process, is able to close out and/or replace transactions of the defaulting Member without loss to the Clearinghouse, application of these assets would not be necessary.

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determine a separate loss for each type of position. Such losses will be satisfied as described in the risk waterfall above.

## **9. Certain Rules Regarding Portability of Positions and Margin**

### **i. Pre-Default Portability**

The Rules require a Member, at a Client's request, to agree to transfer Client-Member Transactions and related Client Position to another Member, subject to the satisfaction of certain conditions under the Rules. The Client is responsible for obtaining a new Member to accept the positions to be transferred, and a Member is not required to accept the transfer of positions to it upon a Client request. Under Clearinghouse procedures, the old Member, Client and new Member must enter into a written novation confirmation as to the Client-Member Transactions to be transferred, the date and time the transfer is to be effective, the amount of margin held in the old Member's Client Omnibus Account and/or Excess Margin Accounts that relates to the related Client Positions to be transferred. Upon submission of such agreement to the Clearinghouse and acceptance of it by the Clearinghouse, the Clearinghouse will terminate the related Client Positions and reestablish new Client Positions with the new Member at the same time the Client-Member Transactions are transferred. The Clearinghouse will also transfer the appropriate amount of margin from the Client Omnibus Account and/or Excess Margin Account of the old Member to the Client Omnibus Account and/or Excess Margin Account, as applicable, of the new Member. Each of the old Member, new Member and Client will be responsible for ensuring that their respective margin requirements remain satisfied upon the transfer of positions.

ICE Trust Rules do not permit it to mandate that a CM transfer any or all of its customer positions and initial and variation margin (and any associated contractual relationships) to another clearing member, if such CM is not in default, regardless of whether ICE Trust perceives that the CM is in a state of impending financial distress.

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ii. Post-Default Portability

The Rules also include certain procedures to enhance portability of Client Positions, Client-Member Transactions and margin in the case of a Member default (“Default Portability Rules”). As a general matter, pursuant to these rules, the Clearinghouse would seek to find a replacement transaction for Client Positions of the defaulting Member (the “Defaulting Member”) with another Member (the “New Member”) also willing to take on the related Client-Member Transactions.<sup>16</sup> Members will not be obligated to accept a transfer, or enter into a replacement, of Client-Member Transactions.

The Rules will permit the Clearinghouse to transfer, or arrange the transfer of, Client Positions of a Defaulting Member together with related Client-Member Transactions (and margin) to a New Member as part of the Close-Out Process, to the extent such a transfer by the Clearinghouse is permissible under applicable law (including the insolvency law applicable to the relevant Defaulting Member). In such case, following a Member Default, the Clearinghouse would exercise its rights in the Close-Out Process to terminate the relevant Client Positions with the Defaulting Member and seek to obtain replacement transactions with a New Member. In addition to the other provisions of the Close-Out Process, the Rules permit the Clearinghouse, within a specified period (the “Transfer Period”) following a Defaulting Member’s default and the termination of its related Client Positions by the Clearinghouse, to transfer the relevant Client-Member Transactions (and related margin) of the Defaulting Member to a New Member. The Clearinghouse would be expected to transfer these rights to the New Member taking on the exposure for the related Client Positions through the Close-Out Process. Clearinghouse Rules would require the New Member accepting transfer of these rights to assume the related obligations in favor of the Client. Pursuant to the Rules, the Defaulting Member would agree to the Clearinghouse’s right to effect any such transfer. The Client would also consent to such

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<sup>16</sup> These procedures would only apply in situations where the Defaulting Member’s regulator, receiver, trustee or other applicable insolvency administrator did not otherwise transfer or arrange the transfer of the relevant positions.

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procedures in the Standard Annex for the Client-Member Transactions. The result of these actions (collectively, the “Clearinghouse Transfer Procedures”), in effect, would be to allow the Clearinghouse to transfer the Client-Member Transactions from the Defaulting Member to the New Member. If such a transfer were effected, the Clearinghouse would transfer the appropriate initial margin for the related Client Positions from the defaulting Member’s Client Omnibus Account to the New Member’s Client Omnibus Account, and also transfer the related margin in the Excess Margin Account.

Alternatively, the Clearinghouse would have the right under the Rules to achieve effectively the same result through procedures for the termination of existing transactions and establishment of new positions with the New Member (“Clearinghouse Termination/Replacement Procedures”). In the case of a Member default, the Clearinghouse may exercise its rights to terminate the Client Positions with the Defaulting Member, and enter into a replacement transaction with a New Member as part of the Close-Out Process. Both the Clearinghouse Rules and the Standard Annex for Client-Member Transactions would permit the Clearinghouse to procure such New Member to re-establish the Client-Member Transactions on the same terms (the “Replacement Client-Member Transactions”). Upon the entry into of the Replacement Client-Member Transactions, (i) the old Client-Member Transaction would be automatically terminated under the terms of the Standard Annex and (ii) under the terms of both the Clearinghouse Rules and the old Client-Member Transaction, no net termination payment would be owed by the Clearinghouse to the defaulting Member in respect of the related Client Position, or by the defaulting Member to the Client in respect of such Client-Member Transaction.<sup>17</sup> The net result would be the reestablishment of the relevant

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<sup>17</sup> In effect, the obligation of ICE Trust to pay the termination amount in favor of the CM, the obligation of the CM to pay the identical termination amount in favor of the Client, the obligation of the Client to pay an identical amount in favor of the new CM with respect to the establishment of the replacement Client-Member Transaction and the obligation of the new CM to pay an identical amount in favor of ICE Trust in respect of the establishment of the related Client Position would be netted and offset. These obligations could be collapsed further to a bilateral netting between the old and new CMs. For example, the Client would assign its rights against the defaulting Member in respect of the termination payment directly to the DISCLAIMER

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Client Position and related Client-Member Transaction with a New Member. In that case, the Clearinghouse would transfer the appropriate initial margin from the Client Omnibus Account and/or Excess Margin Account to the applicable accounts for the New Member.

Under ICE Trust rules, it is expected that the timeline for the transfer or replacement would be approximately [3] business days. If the Clearinghouse did not effect a transfer or termination and replacement under the Default Portability Rules within the Transfer Period (including because no Member was willing to accept transfer or enter into replacement transactions), the Standard Annex would permit the Client to terminate the relevant Client-Member Transactions in accordance with their terms. In that case, remaining assets in the Client Omnibus Account and Excess Margin Account would be returned to the defaulting Member's receiver or trustee for distribution to Clients.

ICE Trust will determine the close-out price for Client Positions pursuant to its close-out procedures, which may involve auction or allocation of the relevant positions. Under the Standard Annex, the same close-out price will apply to the related Client-Member Transaction. Because the close-out process for customer positions is conducted separately from the close-out process for house positions, the same close-out price will not necessarily apply to house and customer positions.

#### **Additional Portability Considerations:**

The Rules permit the Clearinghouse to attempt to use the Default Portability Rules for some or all of the relevant Client-Member Transactions. In addition, the Standard Annex will permit Clients to request, at the time they enter into the Standard Annex, whether they want

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New Member in satisfaction of the Client's initial payment obligation for the Replacement Client-Member Transaction. ICE Trust would similarly assign its rights against the New Member in respect of its initial payment in respect of the establishment of the new Client Position directly to the Defaulting Member in satisfaction of ICE Trust's obligation to make the termination payment to the Defaulting Member. The resulting payment obligations between the Defaulting Member and New Member would be netted in accordance with the Rules.

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their Client-Member Transactions to be subject to the Default Portability Rules.<sup>18</sup> The Clearinghouse may, but will not be obligated to, take into account such requests as well as requests from Clients to have positions transferred to, or not to, specific Members and any prearrangements among Members and Clients as to the transfer of positions. Depending on the circumstances, such elections and arrangements may facilitate or complicate any attempt by the Clearinghouse to move Client-Member Transactions. In addition, it is not clear that the Clearinghouse will be able to move, or cause the relevant Member to move, CP Excess not held in the Excess Margin Account. This may affect the willingness of a Member to accept transfer of Client-Member Transactions.

With respect to documentation, if the New Member and Client have entered into an ISDA Master Agreement, the transferred or replaced Client-Member Transactions will be subject to that agreement, together with the Standard Annex. If those parties have not entered into an ISDA Master Agreement, the transferred or replaced Client-Member Transactions will be subject to the terms of a standard form ISDA Master Agreement specified in the Rules, which the Client and New Member would have to replace with a negotiated ISDA within a specified period. A New Member may be less willing to accept transferred or replaced Client-Member Transactions if it has not previously entered into an ISDA Master Agreement with the Client.

In order to implement the Default Portability Procedures, ICE Trust will rely on information provided by Members as to the identity, positions and margin of Clients, although ICE Trust will not generally have a direct relationship with those Clients. Members will be required to provide such information to ICE Trust on a daily basis.

Portability is enhanced by having IM held at the CCP on a gross basis through the combination of the Client Omnibus Account and Excess Margin Account (such that the CCP can move the margin together with

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<sup>18</sup> Clients or CMs in jurisdictions requiring automatic termination or providing for automatic setoff upon insolvency may be limited in their ability to have default portability rules apply.

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the related positions). Under ICE Trust rules and documentation, the existence of non-cleared trades (whether in or out of the money) should not significantly affect portability given the contractual separation of such trades from cleared trades (although they may affect a customer's desire to have portability rules apply).

#### **10. Investment of Excess Margin Account**

Subject to regulatory approvals, assets in Excess Margin Account could be invested in a broader range of assets than assets in the Client Margin Account (which the Clearinghouse may need to access in the event of a Member default). ICE Trust would propose a range of permitted investment consistent with investments permitted under CFTC Rule 1.25.

The nature of investments within those permitted under Clearinghouse rules, and allocation of any income from investments, will be subject to agreement between the Member and its Clients.

#### **11. Allocation of Losses Among Clients**

In the case of the liquidation of a Client's positions as a result of a CM default, the Rules and Standard Annex will provide for the determination and allocation of losses and gains among Clients on a CM default as follows: As noted above, the termination value of each Client's Client-Member Transactions will be calculated on the basis of the termination values determined by ICE Trust with respect to the related Client Positions. Where a Client owes the CM on a net basis in respect of the Client's Client-Member Transactions, that Client's margin (whether in the Client Omnibus Account or the Excess Margin Account) will be applied to satisfy that obligation (and will thereupon be available to pay amounts owed to ICE Trust in respect of the related Client Positions and to other Clients in respect of their Client-Member Transactions). Clients owed by the CM on a net basis will have a claim for that amount, together with the portion of their margin contributed to the Client Omnibus Account (a "Net Termination Claim"). An amount of proceeds equal to the sum of (i) the remaining amount in the Client Omnibus Account (including any net amounts paid by ICE Trust in respect of the termination of Client Positions), plus (ii) any termination amounts paid by Clients plus (iii)

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the amount of any Client's excess margin applied to a Client's obligations will be available for distribution to Clients in respect of their Net Termination Claims. In the event such proceeds are insufficient to pay all Net Termination Claims, Clients will share in such proceeds pro rata based on their respective Net Termination Claims.

Each Client will be separately entitled to the return of its excess margin in the Excess Margin Account, except to the extent such margin is applied to satisfy its obligations to the CM.

To facilitate these arrangements, ICE Trust is considering requiring that each CM will pledge its rights against its Clients under the related Client-Member Transactions (together with related credit support and proceeds thereof) (i) first in favor of ICE Trust to secure its obligations in respect of the related Client Positions and (ii) second in favor of Clients of the CM to secure amounts owed to such Clients upon termination of their Client-Member Transactions.

### **C. Transfer of Margin from Clearing Members to ICE Trust**

CMs are required to post margin to ICE Trust for the Client Omnibus Account within the strict timelines set forth in Section III-E-5, whether they are on-posting customer margin or using their own assets. Failure to provide margin within such timelines will constitute a default by the CM under the Rules. While there is no specific requirement about how quickly a CM must transfer margin posted by customers, to the extent a CM does not do so within the required margin timeframe it will be required to post its own assets.

ICE Excess Margin will be required to be transferred to the Excess Margin Account promptly upon receipt by the Member.

To the extent a CM has received customer margin and not transferred it to ICE Trust, the margin must be held by the CM in segregation from the CM's assets.

ICE Trust has considered having Clients post margin directly to ICE Trust. To ICE Trust's knowledge, it would be unusual for a clearing organization for futures, securities or other derivatives to accept CCP Margin directly from, or otherwise have a direct

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contractual relationship with, customers that are not themselves CMs. Such an approach could expose the Clearinghouse to additional liability to customers, result in additional compliance obligations and could raise various operational considerations, including as to margin timing.

#### **D. Economic Effects of Proposed Clearing Structure for CCP Margin**

In evaluating the proposed clearing structure, ICE Trust analyzed the economic costs/benefits of the segregation model.

##### **1. Return on Investment**

If IM is held at ICE Trust, the Clearinghouse will pass through the return on that property. However, as noted above, there are significant limitations on the types of eligible margin assets at ICE Trust, and the return may be correspondingly limited. ICE Trust plans to permit a wider range of investments for assets in the Excess Margin Account, as such amounts will not be used to pay Member liabilities to the Clearinghouse.

##### **2. Allocation of Risk and Returns**

The risk and return on investment of customer margin would be allocated by agreement between the CM and its customer. ICE Trust rules would not prevent the risk and return from being passed through to customers.

#### **E. Determination of Required Margin and Related Considerations**

##### **1. Required Margin Collection for Customer Segregation**

ICE Trust will determine ICE Gross Margin to be collected by Members from Clients based on a single client portfolio (gross exposure) and will not net multiple customer portfolios. Positions within the single Client's portfolio will be netted for margining purposes providing offsets for a particular Client portfolio.

##### **2. Protection Against Collecting Insufficient or Excess Margin**

The ICE Trust Risk Management Framework ensures that the Clearinghouse has sufficient funds to cover potential Clearing Participant default losses under distressed market conditions. ICE Trust collects conservative, but not excessive, margins to collateralize risk.

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- i. **Potential Impact of Collecting Insufficient or Excess Margin**  
Collection of excess margin could result in loss of liquidity and investment return for customers and CMs, as compared to other potential uses for those assets. Collection of insufficient margin may increase the risk of a CM or customer default and/or result in a shortfall in the event of such a default. Because customer margin will be held on an omnibus basis, customers are exposed to the risk of a shortfall in customer funds, even if caused by the default of another customer. Collection of insufficient margin may also increase the likelihood that losses from a default would be charged against guaranty fund contributions, which could cause other CMs to share in losses from another CM's default.

### **3. Addition of New Products to Clearing**

Prior to accepting a new product type for clearing, ICE Trust must consult with the Risk Committee and may consult with the non-member Advisory Committee to evaluate the acceptability of the new product. The ultimate decision to add a new product lies with the ICE Trust Board. ICE Trust must also gain approval from its regulators prior to clearing a new product.

### **4. Margin Methodology**

ICE Trust employs a robust methodology that accounts for instrument risk, hedging benefits and concentration charges. The methodology identifies all risk factors, generates plausible market scenarios for all risk factors, allows for a wide range of portfolio strategies and financial instruments and estimates portfolio replacement value in response to generated scenarios.

ICE Trust provides robust margin reporting to CMs through a web report distribution system.

To enable customer segregation, ICE Trust is in the process of developing a margin calculation tool for CMs and Clients that provides access to ICE Trust margin requirement determination. CMs will be able to enter Client portfolios into the tool to establish margin requirements. Clients will be able to view margin requirements upon demand.

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## **5. Margin Calls/Collection**

In the normal course of business, ICE Trust will publish margin requirements by 4 AM EST (via SWIFT Messaging). Payments are due no later than 9:00 AM EST. Clearing Participants will be considered in default if full payment is not received by 9:00 AM EST (barring technical difficulties).

## **6. Mark-to-Market**

ICE Trust utilizes a dynamic price collection and settlement price calculation process to determine the mark-to-market. On a daily basis, each clearing member must submit a bid/offer for each instrument for which it has an open position. ICE Trust uses a pricing algorithm to calculate an End of Day (EOD) Settlement Price per product. To ensure accuracy of bid/offers submitted by CMs, ICE Trust requires CMs, on a frequent basis, to trade at the calculated EOD Settlement Price.

ICE Trust monitors intra-day pricing to evaluate market conditions and manage its risk. ICE Trust does not anticipate providing intra-day pricing to its CMs or CM's Clients.

## **7. Guaranty Fund Contributions**

While CM Guaranty Fund requirements will take into account both Client and House positions, ICE Trust does not anticipate that Client funds will be applied to Guaranty Fund contributions for the CM. Therefore, portability of Client Guaranty Funds is not relevant.

## **F. Clearing Cycle**

Client Positions will be cleared within the same weekly clearing cycle in use today for CM-CM transactions. ICE Trust's weekly clearing cycle leverages the industry standard DTCC's Deriv/SERV trade matching capabilities and the Trade Information Warehouse ("TIW"). The weekly cycle begins each Monday and concludes with the clearing-eligible trades booked on Friday. The process is broken down into three main parts:

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- I. **Identification of the Trades for Clearing:** ICE Trust and CMs will exchange files to identify which trades will be cleared. ICE Trust will then provide each firm a preliminary file of instructions for the trades for which the firm and its counterparty have both agreed to clear. Both the CM and the Client have to flag the trade for clearing in order for ICE Trust to clear the trade.
- II. **Dress Rehearsal:** Each firm will make sure that any post- trade amendments have not affected the trades already selected for clearing and confirm the clearing instructions for those trades. During this review period, ICE Trust will receive a file update from DTCC and will reconcile it with the proposed cleared trades to identify any trades that will no longer be eligible for clearing.
- III. **Action:** The action phase will begin when all clearing participants approve the final clearing instruction files. ICE Trust will then do the following:
  - Send a notice that the input of the final instructions can begin.
  - Confirm the version of the instruction file to be used.

Margin collection will also occur within the established weekly clearing cycle timeline. ICE Trust will collect margin by 9:00AM on the Monday following the clearing cycle for both House and Client Positions.

ICE Trust will provide technology to facilitate clearing of Client trades by CM. Clients will be able to request clearing of trades and track the status of the trades (e.g., cleared, uncleared) through the technology provided by ICE Trust. ICE Trust will be able to deliver trade instructions to DTCC on behalf of Clients to enable the clearing of Related Client Transactions.

ICE Trust plans to implement an accelerated clearing cycle in the future. Pursuant to ICE Trust Rules, CMs will be required to segregate Client margin posted in connection with Client-Member Transactions prior to the completion of the clearing cycle.

## G. **Amendments to Clearing Structure**

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Pursuant to its Rules, ICE Trust is required to consult with its Risk Committee prior to making certain material modifications to its Rules and/or clearing structure. The Risk Committee includes representatives appointed by CMs. ICE Trust also is in the process of establishing a non-member advisory committee, which will include representatives of buy-side firms. ICE Trust expects that it would consult with the non-member advisory committee as well in connection with material modifications to the Rules and/or the clearing structure that would affect buy-side firms.

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## IV. Legal Considerations

The following discussion is based principally on U.S., English and German law. Additional detail will be subsequently provided for other potentially relevant jurisdictions.

### A. Segregation Requirements under Applicable Law

There is no formal U.S. regulatory or governmental segregation requirement applicable to ICE Trust or its members with respect to cleared CDS transactions.<sup>19</sup> In consultation with, and subject to the approval of, its principal regulators, however, ICE Trust will adopt rules providing for segregation of customer IM by the Clearinghouse and by members. To the extent ICE Trust, any CM or any custodian accepts margin in a custodial capacity as required under ICE Trust rules, it will be subject to the requirements applicable to such custodial property under applicable law, including the UCC.

CMs that are regulated by the FSA will be subject to the UK's Client Asset Rules or similar express trust arrangements when they deposit client assets or money with ICE Trust. Under these arrangements, a CM that transfers client assets as Margin to ICE Trust, is required, before a client transaction account is first opened with ICE Trust, to: (a) notify ICE Trust that the CM is under an obligation to keep client assets separate from the CM's own assets, by placing client assets in a client account; (b) instruct ICE Trust that any assets paid to ICE Trust in respect of client transactions are to be credited to the CM's client transaction account. A written acknowledgement of the requirement of the CM to segregate client assets must be given by ICE Trust.

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<sup>19</sup> While there is no formal segregation requirements applicable to ICE Trust, under current U.S. law, ICE Trust's segregation plan offers the greatest protection for OTC credit default swaps in the event of a clearing member default. As stated earlier, ICE Trust came to this conclusion after looking at the bankruptcy protection schemes under securities and commodities law. For example, in order for CDS market participants to claim favorable bankruptcy treatment pursuant to the Commodity Exchange Act, credit default swaps must be segregated pursuant to CEA section 4d. Segregating an OTC swap pursuant to 4d would require the CFTC to expand the definition of commodity contract as defined in the bankruptcy code. It is unclear whether the CFTC has this power, and it is possible that commingling CDS with futures with this legal uncertainty would delay transfer of customer funds (futures and CDS customer funds) until a court decided whether the CFTC had the authority to redefine commodity contract.

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CMs that are German credit institutions regulated by the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* or "**BaFin**") are subject to applicable German law and the BaFin rules with regard to the treatment of client money and assets. In general, German law and the BaFin rules do not require that any client assets or money be segregated from the CM's own assets in connection with cleared CDS transactions. However, German law recognizes segregation of client assets held with a defaulting institution in certain circumstances, including where assets are held in a segregated trust account. ICE Trust rules will require such segregated trust arrangements with respect to client assets or money deposited by a German CM with ICE Trust.

## **B. Customer Rights to CCP Margin**

The Clearinghouse will not directly have a contractual or legal relationship with the customers of a CM. However, the CCP will hold IM for the benefit of the customers of the CM (or for the CM as agent or custodian for such customers), rather than for the CM itself in its principal capacity. IM will be transferred by the customer to the CM on a custodial basis such that such IM remains the property of the customer. Further transfer of such IM to the Clearinghouse in the manner provided for in the Rules and the Standard Annex should not change the rights of the customer under this framework. However, because such IM will be held by the Clearinghouse on an omnibus basis, it will be necessary for the customer to claim return of such IM through the defaulting CM or its receiver or trustee, and the ability of a customer to obtain such margin will depend on the records of the CM.

### Considerations:

- Customers should hold *proprietary* (i.e., ownership) rights in the non-cash IM held at the CCP (or the CCP's custodian), and not merely contractual rights to recovery of the IM vis-à-vis the defaulted CCP (or the CCP's custodian).
- With respect to cash IM held at the CCP, the CCP will have a contractual obligation to repay such IM as provided in the Rules. That obligation will be held by the CM as agent and custodian for the Clients. Accordingly, as between the Client and the CM, the Client should have proprietary rights in such claim against the CCP.
- The principal relevant U.S. legal standard with respect to tracing or other requirements necessary to demonstrate proprietary rights in the IM is set forth in UCC article 8.

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- The principal relevant legal standard under English law with respect to tracing or other requirements necessary to demonstrate proprietary rights in IM collected by English CMs is set forth in the UK client asset rules and applicable English trust law.
- The principal relevant legal standard under German law with respect to tracing or other requirements necessary to demonstrate proprietary rights in IM collected by German CMs is based on (i) IM being held in a segregated trust account as described in Section IV.A. above and (ii) the German CM keeping accurate books and records with respect to the IM that reflect the correct attribution of IM in the segregated trust account to the relevant customer.
- By Clients maintaining proprietary rights, IM should not be subject to the insolvency estate of the defaulting CM, and accordingly should not be subject to the claims of general creditors of the defaulting CM.
  - By the terms of the Rules and Standard Annex, Client margin will be held solely for the benefit of Clients with respect to cleared CDS transactions and not other custodial customers.
  - Nonetheless, if the CM (or any custodian) were to become insolvent and there were a shortfall in custodial assets of a particular type (i.e., a particular CUSIP for securities assets), it is possible that Clients that have deposited that asset with a CM may share losses with other custodial customers of the CM that had deposited the same asset. Under article 8 of the UCC, such sharing would generally be on a pro rata basis. Article 8 requires a custodian (technically, a “securities intermediary”) to maintain sufficient assets to cover all claims of custodial customers to the relevant asset. Although there is no specific regulatory regime that limits the claims on Client assets of other custodial customers, the custodial business of banks and other financial institutions is subject to regulatory supervision and examination, which may help limit the risk of such a shortfall. In fact, there are few cases where U.S. financial institution failures have resulted in a loss to custodial or trust customers from a shortfall in custodial or trust assets.
  - In practice, the possibility of other custodial claims on Client assets may depend on the books and records of the CM in its trust or custodial

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business.<sup>20</sup> If there are inaccuracies in such books and records (including because of a failure to properly reflect the rehypothecation of securities of other custodial customers as required by the UCC), claims of Clients may be adversely affected. Clearinghouse rules will require Members to keep accurate books and records with respect to segregated, custodial assets (among other matters), although the Clearinghouse itself would have limited ability to police this.

- Under ICE Trust Rules and the Standard Annex, a shortfall in CCP margin in the Client Omnibus Account will be allocated first to any defaulting customer of the relevant CM and thereafter to other CDS customers on a pro rata basis.

### **C. Customer Rights to CM Margin**

The CM will be required to transfer all IM (other than CP Excess) to the Clearinghouse. As a result, such margin should not be held at the CM. To the extent any such IM is held at the CM pending transfer to the Clearinghouse, the Rules will require that be held by the CM on a segregated custodial basis such that such IM remains the property of the customer. A customer's rights to CP Excess will depend on the manner in which the customer and CM agree that such CP Excess is to be held.

### **D. Legal Enforceability of Portability Framework**

In summary, U.S. insolvency laws (including FDICIA, the FDIA and the Bankruptcy Code) generally uphold the enforceability of a clearing organization's rights to terminate and net contracts with, and apply security of, an insolvent CM.<sup>21</sup> By contrast, these laws do not specifically address the enforceability of rights of a clearinghouse to transfer positions (and related margin). Accordingly, there are uncertainties as to the enforceability of a general right of a clearinghouse to transfer positions on default. To enhance enforceability within the existing insolvency law framework, ICE Trust has established rules that provide ICE Trust a security interest in the rights of the insolvent

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<sup>20</sup> These risks exist with any custodian in the event of its insolvency, whether the CM itself, an affiliate or a third party.

<sup>21</sup> This would apply to a CM that is an insured U.S. bank, a NY-state chartered branch of a foreign bank, a federally chartered branch of a foreign bank or an unregulated entity eligible to be a debtor under the Bankruptcy Code. Under the Rules and the Standard Annex, Clients may not be permitted to exercise termination rights until the end of the specified transfer period for Default Portability Rules. This limitation should not be inconsistent with the various protections for termination rights under applicable insolvency law.

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CM against the relevant customers. In the event of a CM default, ICE Trust's ability to enforce such security and transfer or sell the defaulting CM's rights against the customer to a new member, should generally be respected. Alternatively, ICE Trust rules permit the termination of the relevant contracts and reestablishment of new contracts with a new CM, which generally should also be respected under existing law. As noted below, various regulatory or legislative actions could further enhance the enforceability of portability rules in the U.S.

As noted above, ICE Trust's default and portability rules would be subject to any rights of the CM's receiver or other insolvency trustee or similar party under applicable law to transfer positions. With respect to CMs that are insured U.S. banks, the FDIC would generally have the power within the one-business-day period following its appointment as receiver to transfer derivative contracts of the CM to a new financial institution, which may be an existing institution or a "bridge bank". (During that one-business-day period, ICE Trust would not be permitted to exercise remedies against the insolvent CM.) In making any such transfer, the FDIC is required to transfer all derivative transactions of the defaulting CM (whether cleared or uncleared) with a particular counterparty or its affiliate, or transfer none of such transactions. This requirement could in some circumstances hinder the FDIC's ability to transfer positions. Similar limitations on exercise of remedies may apply to CMs that are federally chartered branches of foreign banks, but generally would not apply to CMs that are NY-state chartered branches of foreign banks or unregulated U.S. entities.

Under English law, in summary, two separate pieces of legislation provide ICE Trust with a series of protections against the effects of insolvency of a CM:

- (a) Part VII of the Companies Act 1989, which provides protections for 'market contracts' to which a recognised overseas clearing house (ROCH) is party, certain collateral taken by a clearing house and the default rules and default procedures of a ROCH (ICE Trust intends is seeking to become a ROCH but does not yet have this status); and
- (b) Financial Collateral Directive (2002/47/EC) as implemented in the UK by the Financial Collateral Arrangements (No. 2) Regulations 2003 (S.I. 2003/3226), which provides protections to persons who take certain kinds of financial collateral. These protections are available regardless of ROCH status and allow for ICE Trust to enforce close-out netting provisions and realize collateral.

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In the event of a Clearing Member's default, ICE Trust's ability to use collateral and transfer or sell the defaulting CM's contracts and Client-Member Transactions should be protected by such legislation.

For the purposes of German law, ICE Trust is likely to be considered a "settlement system" for the purposes of the EU Settlement Finality Directive, although there is some uncertainty in this analysis because settlement systems are normally required to be notified to the European Commission by the EU member state whose laws are applicable to it and ICE Trust is subject to the laws of a non-EU member state. In such case, in the event of a German CM's default, ICE Trust will be entitled to rely on the protective effects of sec. 340 para. 3 InsO of the German Insolvency Code in recognizing that ICE Trust, as a settlement system, and its Rules (including those concerning, inter alia, netting, irrevocability of transactions, margin and collateral) will be binding on the German insolvency administrator of the insolvent German CM in order to prevent the invalidation of the operations of ICE Trust as a non-EU settlement system. Based on the above, the Rules should also be generally enforceable against a German CM irrespective of the issuance of any moratorium by the BaFin or the commencement of insolvency proceedings in Germany. The enforceability of the contemplated transfer of customer IM under the Rules is also dependent on the customer IM being held in a segregated trust account as described in Section IV.A. above.

ICE Trust rules would not contemplate portability of positions of a customer that itself is insolvent.

#### **E. Legal Enforceability of Novation/Netting Framework**

In the U.S., in summary, FDICIA generally upholds the right of a clearing organization to terminate and net transactions under its rules in the event of a member insolvency and to apply related security. In the case of members that are insured U.S. banks, the FDIA generally also upholds such rights in the event of a receivership, provided that such rights cannot be exercised during the one-business-day period following the appointment of the receiver and are subject to the rights of the receiver to repudiate or transfer such positions during that time.

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In the case of a customer insolvency, the CM's rights to enforce its contractual rights to terminate and net transactions and apply related security would also generally be protected under the U.S. Bankruptcy Code, to the extent applicable.

The netting framework under English law is supported by the Companies Act 1989 and Financial Collateral Regulations, as noted above.

Under German law, the applicable conflict-of-laws provisions of the German Insolvency Code for netting arrangements such as the ISDA Master Agreement generally uphold the application of the governing law of the arrangement. Therefore, the enforceability of the termination of open positions, the determination of the close-out amounts and the netting thereof in accordance with the Rules would not be subject to substantive German insolvency law or any avoidance action by an insolvency administrator under the German Insolvency Code.

Such laws also generally protect contracts from challenge based on claims of preferential or fraudulent transfer in the period prior to an insolvency filing, absent actual intent to delay or hinder creditors.

#### **F. Legislative or Regulatory Reforms; Other Considerations**

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 UK.

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## 2. Legislative Changes:

- 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/part 190 framework under the CEA
- The FDIA could be amended to allow the FDIC to transfer cleared positions separately from non-cleared positions.

Attached in Part VI are sample provisions that would implement these legislative changes.

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## V. Appendix - Questionnaire

Please see the references in the questionnaire below for links to specific answers in the response.

### **Questionnaire for CDS CCPs on Protection of Customer Initial Margin**

This questionnaire has been prepared by an ad hoc group (comprising both buy-side and sell-side constituents)<sup>1</sup> to more fully understand the rights of “customers” – i.e., buy-side and other market participants proposing to clear CDS transactions through clearing members (“CM”) of a central CDS counterparty (“CCP”) – to initial margin (“IM”) posted in connection with the central clearing of certain CDS transactions.

The questions are divided into two sections. The first part solicits responses to several factual matters regarding the clearing structure of the CCP, the precise means by which IM is held by the CCP and CMs (and their custodians, if applicable), and the CCP’s proposals as to segregation and portability of customer positions and initial and variation margin (and any associated contractual relationships).<sup>2</sup> The second part solicits responses as to the legal treatment of the CCP’s proposed clearing structure. As the latter inquiry is largely dependent on the legal and contractual framework governing the CCP, the CMs and the customers (and the relationships between them), the questions in the second part should be considered under the laws of all jurisdictions relevant to the CCP (and its custodian, if applicable), the CMs (and their custodians, if applicable) and the customers. We note that although similar or identical questions are posed throughout certain portions of the questionnaire, this repetition arises from the need to consider the questions for each level at which IM is held: (i) IM held at the CCP (or the CCP’s custodian) – referred to in this questionnaire as “CCP Margin”, and (ii) IM held at a CM (or the CM’s custodian) – referred to in this questionnaire as “Dealer Margin”.

### **I. Factual Matters**

#### **A. Composition and Structure of the CCP, CMs, Custodians and Customers**

##### *Structure of the CCP*

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<sup>1</sup> This group was formed at the behest of the Federal Reserve Bank of New York, and consists of buy-side members Alliance Bernstein, Barclays Global Investors, Blue Mountain, Brevan Howard, D.E. Shaw, Goldman Sachs Asset Management, King Street and PIMCO, and sell-side members Barclays Capital, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Morgan Stanley and UBS. ISDA, the Asset Managers Group of SIFMA, and Managed Funds Association are facilitating and observing the group’s activities.

<sup>2</sup> If the CCP is envisioning a multi-step approach to implementation, please detail both the interim and final phases, and an approximate time frame for achievement of the latter. If customers or CMs may elect one of multiple options with respect to any aspect of the clearing structure, please describe all such options.

1. Please describe the legal structure (e.g., entity type, jurisdiction, governing structure, etc.) of the CCP. Include references to any required licenses or registration orders obtained in connection with the establishment of the CCP.

[See Section II, A.](#)

2. Please list all relevant regulatory and supervisory authorities of the CCP.
3. Please detail any legal or regulatory segregation requirements applicable to customer IM held at the CCP.

#### Structure of CMs

4. Please describe the legal structures applicable to the CMs.

[See Section II, B.](#)

- a. Does the CCP restrict either the (i) organizational type (e.g., banks, broker-dealers, futures commission merchants, unregulated entities, etc.) or (ii) jurisdictions of organization of CMs? (Note: This will be key, as much of the legal analysis will depend on the insolvency laws applicable to the CMs.)
5. Please list all relevant regulatory and supervisory authorities applicable to the CMs.
6. Please detail any legal or regulatory segregation requirements applicable to customer IM held at the CM.

#### Structure of Custodians (If Applicable)

7. Please describe the legal structures applicable to the custodians used by the CCP and CMs to hold IM.

[See Section II, C.](#)

- a. Does the CCP restrict either the (i) organizational type or (ii) jurisdictions of organization of entities that may serve as custodians of the CCP or CMs to hold IM? Are there any restrictions on whether such custodians may be affiliated with the CCP or CMs? (Note: This will be key, as much of the legal analysis will depend on the insolvency laws applicable to the respective custodians, to the extent IM is held by custodians.)
8. Please list all relevant regulatory and supervisory authorities applicable to the custodians.

9. Please detail any legal or regulatory segregation requirements applicable to customer IM held at the custodians.

Structure of the Customers

10. Please describe the legal structures applicable to the customers.

[See Section II, D.](#)

- a. Does the CCP restrict either the (i) organizational type or (ii) jurisdictions of organization of customers? (Note: This may be important, as some of the legal analysis may depend on the insolvency laws applicable to the customers.)
11. Please list all relevant regulatory and supervisory authorities applicable to the customers.

Expansion/Restriction of Permitted Entity Types

12. In weighing the relative benefits and drawbacks of expanding or restricting the entity types and jurisdictions of the CMs, customers and custodians, what factors did the CCP consider in its analysis? For example, to what extent did the CCP consider the following issues in reaching its proposed structure?

[See Section II, E.](#)

- a. Netting implications for CMs and their affiliates (from a credit, accounting and capital perspective);
  - b. Regulatory capital implications for CMs and their affiliates;
  - c. Operational efficiencies or inefficiencies, and other business implications of operating through the permitted entity types;
  - d. Adverse pass-through effects (e.g., unfavorable pricing) flowing from the CMs to customers as a result of the foregoing; and
  - e. The legal regime applicable to the proposed clearing framework upon an insolvency of a CM, customer or custodian.
13. What is the process for approval and consideration of risks presented by additional CM or custodian entity types (by way of inclusion of new CMs or custodians or mergers of existing CMs or custodians in a manner that changes the applicable legal structure)?

**B. Segregation and Safekeeping of IM**

**IM Held at or for the CCP (“CCP Margin”)**<sup>3</sup>

Composition of CCP Margin

1. Please describe the types of assets (e.g., Treasury securities, US dollars, non-US currencies, etc.) that may be deposited as CCP Margin to satisfy IM requirements imposed by the CCP (“Required Margin”). To what extent did customer protection considerations affect the CCP’s determination in this regard?

[See Section III, A, 1.](#)

Nature of Relationship Between CCP, CMs, Custodians and Customers

2. Please describe the nature of the legal and contractual relationship between the CCP, the CMs, custodians, the customers and any other relevant parties, specifically addressing the following:

[See Section III, A, 2.](#)

- a. Are CMs acting as agents or principals (or operating with aspects of both) vis-à-vis (i) the CCP and (ii) customers? Please elaborate.
- b. If customers are permitted to clear transactions through non-CM affiliates of the CM, who in turn clear through the affiliated CM, please describe in detail the mechanics of such an arrangement.

Description of Proposed Clearing Structure<sup>4</sup>

3. Please detail the manner in which customers will post CCP Margin.

[See Section III, B.](#)

- a. Will the CCP Margin be posted pursuant to pledge or title transfer arrangements?
- b. May the CCP Margin consist of property posted by customers and pledged or transferred to the CCP, or must it consist of the proprietary assets of the CM?

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<sup>3</sup> Please also answer the questions below with respect to excess variation margin (i.e., mark-to-market margin posted by customers in excess of the CCP’s requirements), to the extent excess variation margin is treated differently from CCP Excess Margin.

<sup>4</sup> Please address the relevant questions with respect to each proposed clearing structure. For instance, if the CCP has one clearing structure for transactions entered into directly between a customer and its CM / prime broker, and another for transactions originally entered into between a customer and an executing broker that are subsequently given up to the customer’s CM / prime broker, please respond to the questions with respect to each proposed clearing structure.

4. Please detail the manner in which CCP Margin will be held (noting any circumstances in which the default clearing structure may be modified by elections available to CMs or customers), distinguishing between various categories of margin to the extent appropriate – e.g., (i) Required Margin, (ii) margin in excess of that required by the CCP to secure performance obligations in connection with cleared transactions (“CCP Excess Margin”), (iii) margin posted in respect of requirements imposed by CMs on their customers in excess of the CCP’s margin requirements (“Dealer Excess Margin”), etc. – and specifically addressing the following:
  - a. CCP Margin Held Directly at a CCP (or at a Custodian Holding Solely for the Benefit of the CCP) – If the CCP will hold CCP Margin directly (without a custodian), or the custodian will hold CCP Margin only for the CCP (rather than for individual CMs or customers (individually or as a group)), please detail all aspects of the arrangement that are relevant from a customer protection standpoint, specifically addressing the following:
    - i. The manner in which the CCP holds the CCP Margin, distinguishing to the extent relevant between various categories and types of CCP Margin (e.g., securities or cash), and identifying in particular:
      1. On behalf of whom the CCP is holding the property – itself, the CMs or the customers (as a group or individually);
      2. Whether CCP Margin securing the positions of a particular CDS customer will be segregated from (i) the CCP Margin posted by other CDS customers and (ii) the property of other custodial claimants of the CCP or instead, commingled in a single omnibus account (either for CDS customers or custodial claimants of the CCP generally);
        - a. In whose name(s) has/have the account(s) been established?
      3. Whether CCP Margin securing customer positions will be segregated from the CCP Margin securing proprietary positions of CMs;
      4. Any operational practices (whether voluntary or mandated by regulators) relevant to the analysis of customer protection and the sharing of any shortfalls in custodial property;<sup>5</sup>

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<sup>5</sup> See clause (ii) of note 6.

5. Under what circumstances CCP Excess Margin held at the CCP may be (i) withdrawn by the CM or customers or (ii) applied by CMs or the CCP.
  - ii. Whether the CCP has the right to rehypothecate or cause liens to be placed on the CCP Margin – e.g., to potential lenders or liquidity providers to the CCP – and if so, whether any such liens have been subordinated or waived; and
  - iii. Whether investment of CCP Margin in interest-bearing instruments or vehicles (e.g., overnight sweeps into repos) is permitted or required, and if so, in what types of instruments or vehicles.
    1. Who obtains the economic benefit of investment of CCP Margin in permitted instruments? Who bears the risk of loss?
    2. How does the above response differ as between Required Margin and CCP Excess Margin posted to the CCP?
- b. CCP Margin Held at a Custodian (Whether the Custodian is Holding for the CCP, Individual CMs or Customers) – If the CCP will hold CCP Margin at a custodian, please detail all aspects of the custodial arrangement that are relevant from a customer protection standpoint, specifically addressing the following:
  - i. The manner in which the custodian holds the CCP Margin, distinguishing to the extent applicable between various types of CCP Margin (e.g., securities or cash), and identifying in particular:
    1. On whose behalf the custodian is holding the property – the CCP, the CMs or the customers (as a group or individually);
    2. Whether CCP Margin securing the positions of a particular CDS customer will be segregated from (i) the CCP Margin posted by other CDS customers and (ii) the property of other custodial claimants of the custodian, or instead, commingled in a single omnibus account (either for CDS customers or custodial claimants of the custodian generally);
      - a. In whose name(s) has/have the account(s) been established?

3. Whether CCP Margin securing customer positions will be segregated from the CCP Margin securing proprietary positions of CMs;
  4. Any operational practices (whether voluntary or mandated by regulators) relevant to the analysis of customer protection and the sharing of any shortfalls in custodial property;<sup>6</sup> and
  5. Under what circumstances CCP Excess Margin held at the custodian may be (i) withdrawn by the CM or customers or (ii) applied by CMs or the CCP.
- ii. Whether the custodian has the right to rehypothecate or cause liens to be placed on the CCP Margin, and if so, whether any such liens have been subordinated or waived;
  - iii. Whether investment of CCP Margin in interest-bearing instruments or vehicles (e.g., overnight sweeps into repos) is permitted or required, and if so, in what types of instruments or vehicles; and
    1. Who obtains the economic benefit of investment of CCP Margin in permitted instruments? Who bears the risk of loss?
    2. How does the above response differ as between Required Margin and CCP Excess Margin posted to the CCP?
  - iv. How the risk of the custodian's insolvency is allocated among the CCP, the CMs and the customers (as a group and individually).

*Transfer of CCP Margin from CMs to the CCP*

5. If CCP Margin will be deposited by customers at their respective CMs, and subsequently transferred to the CCP, please address the following (distinguishing between various categories of CCP Margin (e.g., Required Margin, CCP Excess Margin, Dealer Excess Margin, etc.) and types of CCP Margin (e.g., securities or cash) to the extent relevant):
  - a. How long will it typically take for a CM to transfer CCP Margin posted by customers to the CCP?

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<sup>6</sup> For example, please consider, to the extent relevant, (i) whether the intermediary is a UCC securities intermediary that credits securities to a securities account in the name of a particular customer or customers generally, and whether the securities intermediary debits securities from the securities accounts of its customers upon any rehypothecation of such securities, and (ii) whether any cash held by the intermediary is maintained as a segregated "special deposit" that remains property of a particular customer or customers generally under applicable law (as distinguished from a "general deposit" in which legal title to the cash passes to the intermediary).

- b. In the intervening period, where at a CM will the CCP Margin be held?
- c. At what point is the CM deemed to be in default for failing to transfer CCP Margin to the CCP?
- d. What considerations militate in favor of, or against, allowing customers to deposit CCP Margin directly with the CCP?

*Economic Effects of Proposed Clearing Structure for CCP Margin*

[See Section III, D.](#)

6. Please describe the economic benefits or disadvantages (from the perspective of CMs and their customers) of the proposed clearing structure for holding IM at the CCP or its custodian (as opposed to at CMs or their custodians).
  - a. Do CMs have the ability to generate returns on customer property under the proposed structure?
  - b. To what extent do the benefits or disadvantages of the proposed structure flow through from CMs to their customers?

*Determination of Required Margin and Related Considerations*

[See Section III, E.](#)

7. Is Required Margin determined on the basis of net exposures (i.e., by netting offsetting positions across different customers) or gross exposures? Are offsetting positions within a particular customer-CM relationship netted for this purpose?
8. Please describe whether margin requirements will be reported and published, and whether calculations are replicable by the CCP upon demand from a CM or customer.
9. Are there any restrictions on the ability of the CCP to demand additional margin from a CM or customer?
10. Are there any restrictions on the ability of a CM to demand additional margin from its customer?
11. Is the required amount of CM guarantee fund contributions relating to customer positions at the CCP determined on the basis of net or gross clearing exposures? Are offsetting positions of a single customer netted for this purpose?

12. Please discuss the approximate timeline for trade execution, submission to the CCP and novation, and how the CCP's structure in this regard (together with any other operational efficiencies) affects the customer protection analysis.

*Allocation of Risk upon CM Default*

13. In the event of a CM default to the CCP, please detail the risk waterfall among guarantee fund contributions, Required Margin securing CM proprietary positions, Required Margin securing customer positions, and any other applicable source of funds (e.g., CCP Excess Margin, to the extent accessible by the clearinghouse), drawing distinctions between defaulting and non-defaulting parties where relevant.

[See Section III, B, 8.](#)

- a. How does the applicable risk waterfall vary (if at all) depending upon whether the default arises from an insolvency event, as opposed to a non-insolvency event?
  - b. How does the applicable risk waterfall vary (if at all) depending upon the nature of the IM being applied – i.e., is IM securing customer positions applied in a different manner from IM securing proprietary CM positions?
  - c. In the event of a CM default arising from a failure to post sufficient margin, how does the applicable risk waterfall vary (if at all) depending upon whether the failure to post sufficient margin arose in respect of customer positions, rather than proprietary positions?
    - i. Please explain (to the extent applicable) how the CCP's methodology for isolating the origins of the CM default permits the CCP to identify, in a sufficiently precise manner, which risk waterfall applies in any particular instance (especially in circumstances under which the CM default may have arisen from multiple complex and interlocking factors).
14. If a CM has defaulted on an obligation to its customer in respect of a cleared transaction (or a transaction related to a cleared transaction), but is not otherwise in default to the CCP, what are the customer's remedies against the CCP?

*IM Held at or for the CM ("Dealer Margin")*

*Permitted Asset Types for Customer Margin*

15. Do the types of assets that may be deposited as margin with the CM differ from the types of assets that qualify as Required Margin?

Description of Proposed Clearing Structure for Dealer Margin<sup>7</sup>

[See Section III, B, 4](#), [Section III, B, 5](#) and [Section III, B, 7](#).

16. Please detail the manner in which customers will post Dealer Margin.

- a. Will Dealer Margin be posted pursuant to pledge or title transfer arrangements?

17. Please detail the manner in which Dealer Margin will be held (noting any circumstances in which the default clearing structure may be modified by elections available to customers), specifically addressing the following and distinguishing between different types of margin (e.g., cash versus securities) and categories of margin (e.g., Required Margin, CCP Excess Margin, Dealer Excess Margin and any other applicable categories of margin) where appropriate:

- a. Dealer Margin Held Directly at a CM (or at a Custodian Holding Solely for the Benefit of the CM) – If the CM will hold Dealer Margin directly (without a custodian), or the custodian will hold Dealer Margin only for the CM (rather than for customers (individually or as a group)), please detail all aspects of the arrangement that are relevant from a customer protection standpoint, specifically addressing the following:

- i. The manner in which the CM holds the Dealer Margin, distinguishing to the extent applicable between various types of Dealer Margin (e.g., securities or cash), and identifying in particular:

1. Whether Dealer Margin securing the positions of a particular CDS customer will be segregated from (i) the Dealer Margin posted by other CDS customers and (ii) the property of other custodial claimants of the CM, or instead, commingled in a single omnibus account (either for CDS customers or custodial claimants of the CM generally);
  - a. In whose name(s) has/have the account(s) been established?
2. Whether Dealer Margin securing customer positions will be segregated from the margin securing proprietary positions of CMs;
3. Any operational practices (whether voluntary or mandated by regulators) relevant to the analysis of customer

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<sup>7</sup> See note 4.

protection and the sharing of any shortfalls in custodial property;<sup>8</sup> and

4. Under what circumstances Dealer Margin may be (i) withdrawn by customers or (ii) applied by CMs or the CCP.
- ii. Whether the CM has the right to rehypothecate or cause liens to be placed on Dealer Margin, and if so, whether any such liens have been subordinated or waived; and
  - v. Whether investment of Dealer Margin in interest-bearing instruments or vehicles (e.g., overnight sweeps into repos) is permitted or required, and if so, in what types of instruments or vehicles.
    1. Who obtains the economic benefit of investment of Dealer Margin in permitted instruments? Who bears the risk of loss?
- b. Dealer Margin Held at a Custodian (Whether the Custodian is Holding for the CM or the Customers) – If the CM will hold Dealer Margin at a custodian, please detail all aspects of the custodial arrangement that are relevant from a customer protection standpoint, specifically addressing the following:
- i. The manner in which the custodian holds the Dealer Margin, distinguishing to the extent applicable between various types of Dealer Margin (e.g., securities or cash), and identifying in particular:
    1. On whose behalf the custodian is holding the property – the CM or the customers;
    2. Whether Dealer Margin securing the positions of a particular CDS customer will be segregated from (i) the Dealer Margin posted by other CDS customers and (ii) the property of other custodial claimants of the custodian or instead, commingled in a single omnibus account (either for CDS customers or custodial claimants of the custodian generally);
      - a. In whose name(s) has/have the account(s) been established?

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<sup>8</sup> See note 6.

3. Whether Dealer Margin securing customer positions will be segregated from Dealer Margin securing the proprietary positions of CMs; and
4. Any operational practices (whether voluntary or mandated by regulators) relevant to the analysis of customer protection and the sharing of any shortfalls in custodial property.<sup>9</sup>
  - ii. Whether the custodian has the right to rehypothecate or cause liens to be placed on the Dealer Margin that is not posted to the CCP, and if so, whether any such liens have been subordinated or waived;
  - vi. Whether investment of Dealer Margin that is not posted to the CCP in interest-bearing instruments or vehicles (e.g., overnight sweeps into repos) is permitted or required, and if so, in what types of instruments or vehicles;
    1. Who obtains the economic benefit of investment of Dealer Margin in permitted instruments? Who bears the risk of loss?
  - vii. Under what circumstances Dealer Margin may be (i) withdrawn by customers or (ii) applied by CMs or the CCP; and
  - viii. How the risk of the custodian's insolvency is allocated among the CMs and the customers (as a group and individually).

### **C. Portability**

1. Please consider whether a customer's positions and initial and variation margin (and any associated contractual relationships) can be ported to another CM, under each of the following scenarios.

#### **See Section III, B, 9.**

- a. Can a customer effect a voluntary, pre-CM default transfer of its positions and margin (and any associated contractual relationships)? From which entities must the customer obtain consent before effecting such a transfer?
- b. Does the CCP have the authority to mandate that a CM transfer any or all of its customer positions and initial and variation margin (and any associated contractual relationships) to another clearing member, if such CM is not in "default" (as defined in the CCP's rules)?

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<sup>9</sup> See note 6.

- i. Does the answer change if the CM, although not in default, is perceived by the CCP to be in a state of impending financial distress?
  - ii. To what extent is a default under the CCP's rules the product of the CCP's subjective determination, rather than being determined by reference to objectively verifiable events?
- c. How does the CCP intend to transfer customer positions and initial and variation margin (and any associated contractual relationships) from a defaulting CM to a non-defaulting CM? Please elaborate on the following details (distinguishing between Required Margin, CCP Excess Margin, Dealer Excess Margin and any other categories of margin where relevant):
- i. The expected timeline from CM default to re-establishment of customer positions and initial and variation margin (and any associated contractual relationships) at a non-defaulting CM;
  - ii. The mechanism for transferring customer positions and initial and variation margin (and any associated contractual relationships) to a non-defaulting CM, including a description of:
    - 1. How customer positions and initial and variation margin (and any associated contractual relationships) are allocated and how transferee CMs are selected (including whether a non-defaulting CM and its customers can be forced by the CCP to accept a transfer of positions through auction, assignment or other allocation procedures);
    - 2. Whether customer positions and initial and variation margin (and any associated contractual relationships) in respect of cleared transactions can be effectively transferred separately from non-cleared transactions between the defaulting CM and its customers;
    - 3. Whether the treatment of CCP Margin differs from the treatment of Dealer Margin, from a portability perspective; and
    - 4. Any pledge or other arrangements designed to facilitate transfer of customer positions and initial and variation margin (and any associated contractual relationships).
  - iii. Any procedures designed to control the effect of market movements on the value of customer positions during the pendency of the transfer – e.g., institution of hedge positions subsequent to the CM default, or assigned allocation of customer

margin deficits to non-defaulting CMs – and the allocation of losses if the customer positions cannot be assigned to a non-defaulting CM.

1. Who determines the close-out price applicable to terminated positions? If the CCP, does the CCP's close-out price flow through to the customer? How is the close-out price determined? Does the same close-out price apply to CM-customer positions and offsetting CM-CCP proprietary positions?
  2. How does the CCP account for any unpaid variation margin obligations that may have accrued subsequent to the default of the CM?
- iv. Any limitations on the rights of customers to (a) terminate non-cleared transactions with CMs upon a CM default, or (b) set off their obligations under non-cleared transactions against obligations to CMs under cleared transactions;
  - v. Whether affiliate and third-party liens or cross-margining and netting arrangements in respect of non-cleared transactions affect the portability analysis;
  - vi. Whether the defaulting CM's contractual agreements with the customer are binding upon the transferee CM and such customer upon any transfer of the customer's positions and initial and variation margin, or whether the transferee CM and such customer can (or must) execute a new set of documentation;
  - vii. In connection with a transfer of customer positions and initial and variation margin (and any associated contractual relationships) to a non-defaulting CM, any rights of customers to elect not to transfer the associated margin, and instead, to apply such margin as a setoff against other amounts that may be payable to the defaulting CM (while separately posting new IM to the transferee CM); and
  - viii. The effects on the portability analysis of (a) IM at the CCP for customer positions being posted on a gross or net basis (as applicable), (b) the existence of Dealer Margin held at the defaulting CM, and (c) non-cleared trades between the defaulting CM and its customers being "in-the-money" or "out-of-the-money" (as applicable) to the CM.

## **D. Documentation**

### **Required Documentation**

1. What trading documentation will CMs (and their custodians, if applicable) and customers need to execute with the CCP (and its custodian, if applicable) in order to have customer transactions cleared?

[See Section III, B, 6.](#)

- a. Please discuss the extent to which the CCP “knows” the customers under the required documentation, and how this affects the customer protection analysis.
2. What trading documentation will customers need to execute with CMs (and their custodians, if applicable) in order to have their transactions cleared?
3. Please describe any legal, operational or other issues arising from the adoption by CMs and customers of a pledge arrangement (from an existing title transfer structure), or of a title transfer arrangement (from an existing pledge structure), for the provision of collateral security.

*Key Terms of Standardized Documentation*

4. Please describe the material terms of any documentation standardized by the CCP, including (but not limited to) terms relating to:
  - a. Circumstances under which posted margin may be returned to customers, and all related conditions and requirements;
  - b. Specification of events of default and termination events with respect to the CM (noting any distinctions drawn between insolvency and non-insolvency events) or customer;
  - c. Standstill upon the occurrence of a CM default;
  - d. Advance elections to liquidate or transfer cleared contracts;
  - e. Advance consents (particularly those obtained to enhance portability of cleared contracts);
  - f. Limitations on rehypothecation;
  - g. Limitations on setoff against non-cleared bilateral transactions between customers and their CMs; and
  - h. Close-out calculations.

*Modification of Proposed Clearing Structure*

5. Please state the circumstances in which the CCP has the ability to amend by rule or order any aspect of its proposed clearing structure.

## **II. Legal Considerations**

As stated in the introductory note to this questionnaire, the following questions should be considered under the laws of all jurisdictions relevant to the CCP (and its custodian, if applicable), the CMs (and their custodians, if applicable) and the customers. In the responses below, please highlight any areas of legal uncertainty. For matters requiring reasoned legal judgment, please state the level of legal comfort associated with the relevant response.

[See Section IV.](#)

### **Customer Rights to CCP Margin**

1. Please detail the ability of customers to recover IM held at the CCP (or the CCP's custodian) upon the insolvency of the CCP (or the CCP's custodian) – distinguishing between Required Margin, CCP Excess Margin, Dealer Excess Margin and any other categories of margin where relevant – in the event their positions are liquidated rather than transferred. Consider all relevant facts, including: (i) the manner in which the IM is held at the CCP or its custodian; (ii) the nature of the customer obligations secured by liens on the IM; (iii) the composition of the IM (e.g., whether the IM consists of securities or cash); (iv) in the event of the insolvency of the CCP's custodian, any restrictions (legal or otherwise) on the ability of the CCP to recover IM from the insolvent custodian; and (v) any other matters described in your responses to the questions above that are relevant to this analysis. Analyze how these facts ultimately affect the conclusions reached.
  - a. What is the legal nature of the customers' rights in the IM held at the CCP (or the CCP's custodian)?
    - i. To the extent relevant to this analysis, please consider whether customers hold proprietary (i.e., ownership) rights in the IM held at the CCP (or the CCP's custodian), or merely contractual rights to recovery of the IM vis-à-vis the defaulted CCP (or the CCP's custodian).
      1. How does the selection of pledge versus title transfer for the provision of collateral security affect this determination?
      2. What are the relevant legal standards with respect to tracing or other requirements necessary to demonstrate proprietary rights in the IM?

3. What is the practical effect of maintaining proprietary versus contractual rights?
  - ii. If the distinction between proprietary versus contractual rights to the IM held at the CCP (or the CCP's custodian) is irrelevant as a legal matter, please describe the legal framework that is relevant to the analysis.
- b. How is a shortfall in CCP Margin and other custodial property (i.e., property held in a custodial capacity for purposes unrelated to the clearing of CDS) held by the CCP (or its custodian) allocated as between the CCP (or the CCP's custodian), the CMs, the customers (as a group and individually) and other custodial claimants? Distinguish where relevant between Required Margin, CCP Excess Margin, Dealer Excess Margin and any other categories of margin.
  - i. With what other types of custodial claimants may the customers potentially be required to share with in the event of a shortfall in custodial property?
    1. Are there any applicable regulatory regimes that limit the claims of those who may share in CCP Margin?
    - ii. Is it possible to contractually vary the sharing regime that would otherwise apply in any particular instance (e.g., by holding CCP Margin at a third party custodian)?

Customer Rights to Dealer Margin

2. Please detail the ability of customers to recover IM held at the CM (or the CM's custodian) upon the insolvency of the CM (or the CM's custodian) – distinguishing between Required Margin, CCP Excess Margin, Dealer Excess Margin and any other categories of margin where relevant – in the event their positions are liquidated rather than transferred. Consider all relevant facts, including: (i) the manner in which the IM is held at the CM or its custodian; (ii) the nature of the customer obligations secured by liens on the IM; (iii) the composition of the IM (e.g., whether IM consists of securities or cash); (iv) in the event of the insolvency of the CM's custodian, any restrictions (legal or otherwise) on the ability of the CM to recover IM from the insolvent custodian; and (v) any other matters described in your responses to the questions above that are relevant to this analysis. Analyze how these facts ultimately affect the conclusions reached.
  - a. What is the legal nature of the customers' rights in the IM held at the CM (or the CM's custodian)?

- iii. To the extent relevant to this analysis, please consider whether customers hold proprietary (i.e., ownership) rights in the IM held at the CM (or the CM's custodian), or merely contractual rights to recovery of the IM vis-à-vis the CM (or the CM's custodian).
    1. How does the selection of pledge versus title transfer for the provision of collateral security affect this determination?
    2. What are the relevant legal standards with respect to tracing or other requirements necessary to demonstrate proprietary rights in the IM?
    3. What is the practical effect of maintaining proprietary versus contractual rights?
  - iv. If the distinction between proprietary versus contractual rights to the IM held at the CM (or the CM's custodian) is irrelevant as a legal matter, please discuss the legal framework that is relevant to the analysis.
- b. How is a shortfall in Dealer Margin and other custodial property (i.e., property held in a custodial capacity for purposes unrelated to cleared CDS) held by the CM (or its custodian) allocated as between the CMs, the customers (as a group and individually) and other custodial claimants? Distinguish where applicable between Required Margin, CCP Excess Margin, Dealer Excess Margin and any other categories of margin where relevant.
- i. Are there any applicable regulatory regimes that limit the claims of those who may share in Dealer Margin?
  - ii. Is it possible to contractually vary the sharing regime that would otherwise apply in any particular instance (e.g., by holding Dealer Margin at a third party custodian)?

Legal Enforceability of Portability Framework

3. Please discuss the legal enforceability of the CCP's portability framework in the event of either or both (i) a CM insolvency (or the insolvency of the CM's custodian) and/or (ii) a customer insolvency. In particular, consider how the enforceability of the portability framework is affected by the following:
  - a. Whether, if either the CCP or insolvency trustee/receiver of the CM transfers any cleared positions and margin (and any associated contractual relationships) of the defaulted CM with the CCP, it must also transfer the defaulting CM's (i) other cleared positions and margin (and any associated

contractual relationships) with the CCP, and (ii) non-cleared positions (and associated margin and contractual relationships) with customers of the defaulting CM;

- b. The effect of any standstill provisions upon default, and the interplay of such provisions with any statutorily protected termination rights;
- c. Any affiliate and third-party liens or cross-margining and netting arrangements;
- d. Any setoff rights or limitations between cleared and non-cleared trades;
- e. Any mandatory setoff requirements for CMs or customers under applicable law;
- f. Any pledge arrangements or other provisions for collateral security between CMs and customers related to cleared transactions; and
- g. Whether the CM is acting as principal (rather than as agent) vis-à-vis the CCP in respect of customer transactions.

#### Legal Enforceability of Novation/Netting Framework

- 4. Please discuss the legal enforceability of the CCP's novation and netting framework in the event of either or both (i) a CM insolvency (or the insolvency of the CM's custodian) or (ii) a customer insolvency, giving due regard to the CCP's ability (and, in the event of a customer insolvency, a CM's ability) to exercise its legal and contractual remedies on (a) IM held at the CCP (or the CCP's custodian) and (b) IM held at the CM (or the CM's custodian).
  - a. How would challenges to the validity or enforceability to an underlying bilateral transaction (prior to novation) – e.g., if a transaction was entered into in bad faith, fraudulently, or in contemplation of insolvency – affect the enforceability of the novated transaction, in the event of either or both (i) a CM insolvency or (ii) a customer insolvency?

#### Considerations Relating to Netting vis-à-vis the CCP

- 5. Please evaluate, from an accounting and regulatory capital perspective, the ability of CMs to net (i) proprietary positions against other proprietary positions and (ii) customer positions against proprietary positions, in each case vis-à-vis the CCP, upon a CCP default or insolvency.

#### Enforcement and Monitoring Mechanisms

- 6. Please describe any enforcement or monitoring mechanisms (imposed by the CCP, applicable regulatory authorities or otherwise) designed to ensure that CMs

(and their custodians, to the extent applicable) comply with their obligations in respect of any legal or contractual requirements described in your response above.

Legislative or Regulatory Reforms

7. As requested above, please identify in your responses above any areas of legal uncertainty and the level of legal comfort provided on various aspects of the proposed framework. Please consider whether there are any legislative or regulatory reforms that would be helpful to clarify or improve the legal framework governing any of the foregoing issues and areas of legal uncertainty identified above. If so, describe any such proposed reforms in detail.

Other Considerations

8. Please feel free to elaborate on any topic you deem to be relevant to the analysis of customer protection or systemic risk issues.

## **VI. Proposed Legislative Amendments Relating to Treatment of Customer Property and Positions**

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 general 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.*