

**DRAFT**

[ 24 February 2010]



**REPORT ON CENTRAL COUNTERPARTIES:  
MEMORANDUM TO THE EUROPEAN COMMISSION**

## Executive Summary and Conclusions

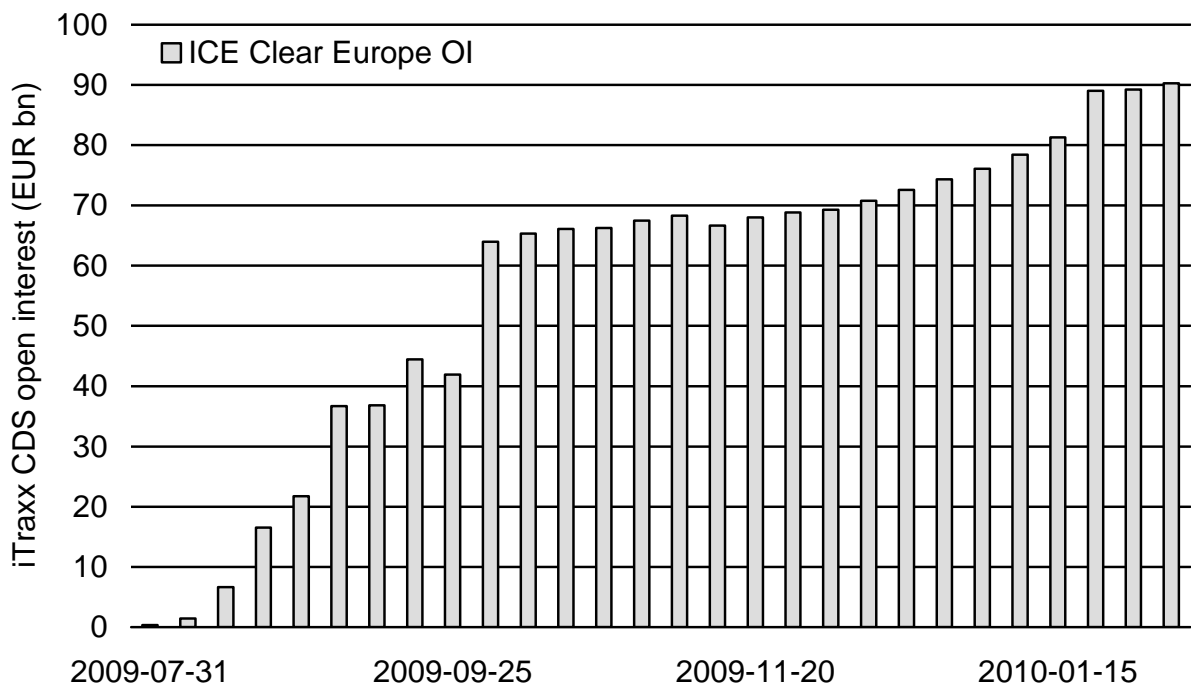
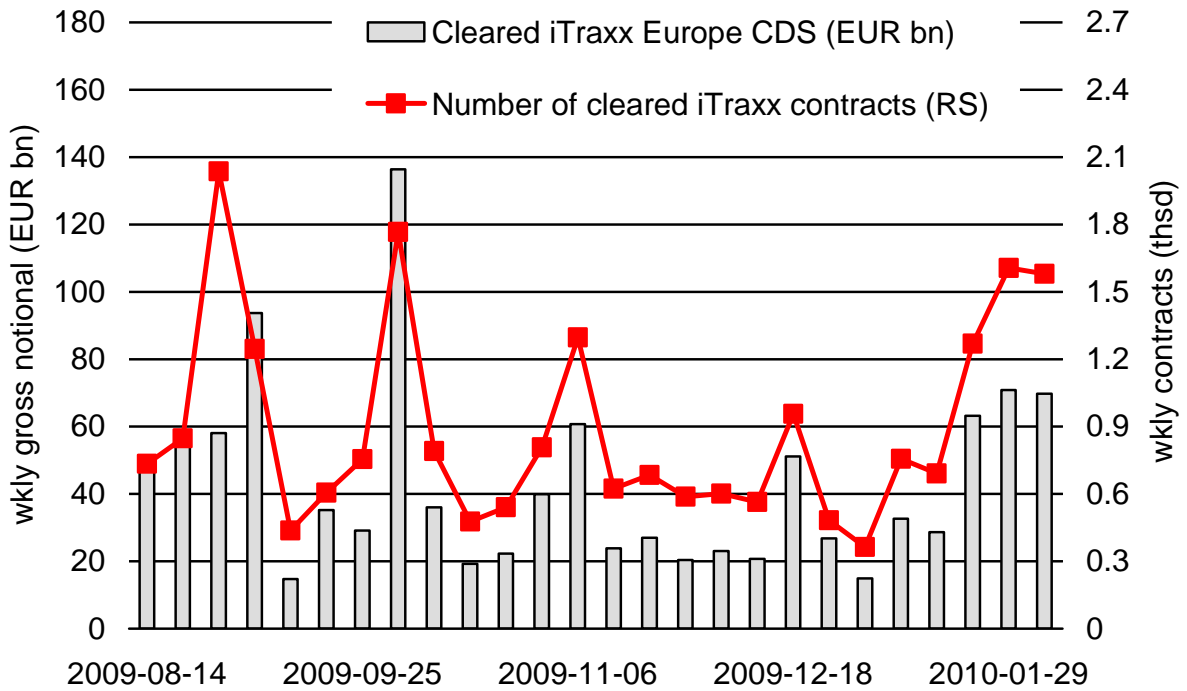
The regulatory environment is changing fast. With the commencement of deliberation of the Wall Street Reform and Consumer Protection Act 2009 on December 9th and parallel actions in Europe in less than a year the OTC Markets will be governed and overseen much different to what today is the standard. On both sides of the Atlantic new regulatory framework will require mandatory clearing of OTC standardized Derivatives including FX swaps and forwards, grants position setting powers to the regulators, and shall require pre- and post execution reporting from Banks and Central Counterparties (“CCP”). In light of the forthcoming framework there is no option other than to become a member for CDS Clearing with a CCP. Capital requirements will increase (CRD IV) and early signals from the EC indicate that the less competition is between Central Counterparties in Europe the more likely will be a capital charge for systemic risk. As of today it is not yet sorted out to what extent the buy-side (or end-users) will be affected by the new regime(s); in particular the definition of Major Swap Participant in the US is under discussion, as well as the proposal to collateralize also end-users OTC derivatives exposure with financial intermediaries.

As of today<sup>1</sup> there are 2 Central Counterparties (“CCPs”) in Europe offering clearing services for CDS transactions: the Eurex Clearing AG, owned by Deutsche Börse AG and Swiss Exchange (with a widespread shareholder structure) and ICE Clear Europe Ltd., owned by major global banks active in the OTC CDS market and Intercontinental Exchange Inc., founded by a group of international banks and energy traders and listed on the NYSE. While in theory the concepts of both are similar (replacing the original transaction by novating them into 2 CCP transactions; Margin requirements, Guarantee Funds, ) currently there are major differences in details i.e. Membership Criteria, Events of Default, Client and Customer Accounts treatment, indirect access of buy-side customers, Modification and Amendments of Rules & Procedures and Termination.. It goes for either of the CCPs that there is a lack in transparency as to where the eligible margin (whether initial or variation) will be booked with . There needs to be more transparency about the custodian and where the eligible margin (whether initial or variation) will be booked with – it appears that the choice of custodian(s) is at the full discretion of the CCP with no concentration caps hence re-introducing systemic risk.

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<sup>1</sup> Note that the CME has just announced its Dealer Founding Members for CDS Initiative available at <http://cmegroup.mediaroom.com/index.php?s=43&item=2968>

So far G15 banks<sup>2</sup> has not used Eurex and hence ICE Clear Europe via its presumably committed shareholders<sup>3</sup> and clearing members enjoys a quasi monopoly in CDS Clearing<sup>4</sup>.



<sup>2</sup> Group of fifteen financial institutions ("G15") expressed their (individual) commitment to submit a substantial amount of new as well as historical eligible trades for central clearing by October 2009. The group is comprised of all ICE clearing members (BoA, Barclays Capital, Citigroup Global Markets, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, J.P. Morgan, Morgan Stanley and UBS, two additional eurozone dealers (Commerzbank and Société Générale) and US bank Wachovia, UniCredit Research Strategy Flash 10<sup>th</sup> September 2009

<sup>3</sup> ICE Clear Europe does not publish a list of shareholders

<sup>4</sup> Source: UniCredit Research and UniCredit Research Strategy Flash September 2009

Regulators require a robust and sound legal framework. However Clearing Members come from the different jurisdictions, hence the applicable bankruptcy regimes are different, there are dissenting views on international securities law (*lex res sitae*), security perfection and client money protection rules. From that angle there is no need to think of client /customer transactions as a 3<sup>rd</sup> level to find it difficult to ascertain legal robustness. Despite so alleged by the CCPs.

## A. Scope & Issues

One need not to have a crystal ball to predict an imminent and fundamental change in OTC derivative markets most notably in relation to the regulatory and legal framework, the client- financial institutions relationship, risk management. It is worth to note that as of today the OTC notional volumes exceed the clearing volumes (exchanges, CCPs) by more than 10 times. That simple figure and the regulators goal to shift almost each and every OTC derivative transaction to a CCP demonstrate the magnitude ahead of the markets. It is therefore crucial to stay close to the administration action plans and the private initiatives.

This memo aims to provide a written, fairly comprehensive and up-date overview on the emerging regulatory environment (Annex.), the choices offered by the (European) CDS Clearing Solutions (C), open issues (D) and further considerations /assessment (E).

## B. The Changing Regulatory Environment *[tb up-dated before final release]*

### i. The US proposals<sup>5</sup>

#### 1. Process and Contents<sup>6</sup>

There have been a few proposals in early 2009 to regulate OTC Derivatives (in particular CDS) both on federal and state level. The true starting point was, however, the Obama proposal from August 11<sup>th</sup> 2009: The Over-the-Counter Derivatives Markets Act of 2009.

- The key tenets are: Swaps oversight by the CFTC, security-based swaps (SBS) by the SEC;
- Standardized swaps to be exchanged trade cleared and reported;
- Registration of market utilities known as alternative swap execution facilities;
- Registration and oversight of dealers in swaps and SBS and major swap participants by SEC/CFTC
- Position limit setting by SEC/CFTC and large pre- and post execution reporting obligations

Two versions of the financial reform bill were discussed since October 2009: The Frank Bill (SEC) and the Peterson Bill (CFTC).

Early December 2009 on the two competing versions of the bill (Frank Bill - House Financial Services Committee – overseeing the SEC - and Peterson Bill - House Agriculture Committee - oversight of the CFTC) an agreement was reached on many of the differences between the two versions of the OTC bill passed out of their Committees in October 2009.

The determination of which transactions must be cleared will be made by the SEC and the CFTC. Earlier versions of the bill would have left the initial determination up to clearinghouses with subsequent approval by the regulators. However, since Committee action, Chairman Frank expressed concern about conflicts of interest if clearinghouses could decide which transactions would be deemed clearable and which would not.

Foreign exchange swaps and forwards will no longer be excluded from the requirements of the bill, as initially proposed and as supported by Treasury<sup>7</sup>. Rather, it is expected that the CFTC and Treasury will be given additional authority over these products.

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<sup>5</sup> Excerpt from ISDA Global Regulatory Up-Date December 2<sup>nd</sup>, 2009

<sup>6</sup> Further detailed information is available on the House Financial Services Committee website [http://financialservices.house.gov/Key\\_Issues/Financial\\_Regulatory\\_Reform/Financial\\_Regulatory\\_Reform.html](http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/Financial_Regulatory_Reform.html)

<sup>7</sup> See critical statement by ISDA December 2009: Impact of Treasury's OTC Derivatives Legislation on the Foreign Exchange Market [www.isda.org](http://www.isda.org)

The issues of whether to require end-users to meet margin requirements for non-cleared trades and whether to restrict the ownership of clearinghouses, exchanges, and alternative swap execution facilities have not been resolved.

The Committee is developing comprehensive legislation. No specific timetable has been announced as to when the Committee will release its bill.

The National Conference of Insurance Legislators (NCOIL) adopted Credit Default Insurance Model Legislation at its annual meeting last month. The model bill defines “authorized” credit default insurance (CDI) and establishes a state insurance regulatory regime to oversee the CDI market. Under the model legislation, “unauthorized” CDI would be prohibited. In addition, the model bill bans so-called “naked” credit default swaps.

Following NCOIL adoption of the model bill, state legislators from New York, Virginia and North Dakota are indicating they intend to introduce legislation based on the model bill in their respective state legislatures. Supporters of the NCOIL legislation continue to say that Congress has been slow to act on comprehensive legislation to regulate OTC derivatives and that absent federal legislation, the states need to act.

## 2. Timing

- a) The House started consideration on December 9<sup>th</sup>, 2009<sup>8</sup>.
- b) Compliance is expected either 180, 270, 365 days after enactment (depends which bill will be eventually adopted after consultation)
- c) It is up to the SEC/CFTC to create rules for implementation

## ii. The European Perspective [tb up-dated]

- a) The European Commission has published its action plan on October 20<sup>th</sup> 2009<sup>9</sup> which aims for the purpose of sound, efficient and safe markets to shift derivatives markets from predominately bilateral OTC to more centralized clearing and trading. The action plan is focusing mainly on 3 areas: (1) Counterparty Credit Risk (including central clearing and mandatory collateralization, capital charges, central clearing), (2) Operational Risk and (3) Transparency.

On February 11, the European Parliament (EP) published a pre-legislative draft report on OTC derivative market reforms in the EU. The document was prepared by Member of the European Parliament (MEP) Werner Langen (Germany, Christian Democrats, EPP) in German (<http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPART+PE-438.493+01+DOC+PDF+V0//DE&language=EN>).

- b) Timing: EC sent legislative proposal to parliament end of the year with having an EC internal document due on December 16th, 2009 a public consultation for two months in Spring 2010, proposal on clearinghouses **and** trade repositories for mid-2010 and proposals on MiFID and CRD for end-2010<sup>10</sup>. The EC has set-up a "Derivatives and Market Structures Member States Working Group" preparing for future legislation.
- c) The implementation phase into national legislation will then probably happen 2011.

## iii. The Asian Perspective

- a) [ tbd]

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<sup>8</sup> Wall Street Reform and Consumer Protection Act 2009 - text available <http://www.opencongress.org/bill/111-h4173/text>

<sup>9</sup> COM (2009) 563/4 Communication From The Commission “Ensuring efficient, safe and sound derivatives markets: Future policy actions”

<sup>10</sup> Source ISDA Global Regulatory Update November 18th 2009

iv. The International Perspective<sup>11</sup>

The Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) have launched a comprehensive review of their existing standards for financial market infrastructures such as payment systems, securities settlement systems and central counterparties. The review will be led by representatives of the central banks that are members of the CPSS and those of the securities regulators that are members of the IOSCO Technical Committee. The International Monetary Fund and the World Bank are also participating in the review. The review is part of the Financial Stability Board's work to reduce the risks that arise from interconnectedness in the financial system.

The committees will coordinate with other relevant authorities and communicate with the industry, as appropriate, as the work progresses. They aim to issue a draft of all the revised standards for public consultation by early 2011.

**C. Open issues**

Though according to market sources there is a current trend to harmonize ICE Clear and Eurex rules at this point in time there are a number of open issues still pending.

i. Concentration risk

1. CCPs

a. Ownership

At present there are apparently only 2 European CCP present in the market to offer clearing services for CDS transactions. While ICE Clear Europe is privately owned by the main players in the OTC market and ICE, Eurex Clearing shareholders via Deutsche Börse AG and Swiss Exchange are wide-spread. There are also some arguments in the US<sup>12</sup> criticizing the policy to allow the biggest derivatives dealers to own the very clearinghouses that review and police "these extremely lucrative derivative deals". That might foster concentration. In that respect it is quite unclear to what extent owners/CM can benefit from the pricing of the very CCP they own<sup>13</sup>.

b. Clearing Rules

While there is constant up-date in regulation it appears that the admission criteria are much higher with ICE Clear compared to EUREX. While both CCPs view and obligations vis-à-vis the Clearing Members only Eurex expressly stipulates the CM obligation to provide access to clients and 3rd parties if the requirements are met.

c. It goes without saying that a single CCP would create a super-concentration risk which might cause the European Regulators to require a systemic risk charge.

d. Due to high entry bars to ICE, an apparent lack of market acceptance for Eurex' clearing solution and no interoperability between the clearers, even significant market players might be forced to indirectly participate as an NCM at ICE only. As a consequence, some NCMs would concentrate their trades on one or a limited number of CMs, which might present a problem with regards to supervisory laws (i.e in Germany MaRisk or GroMiKV) [...], nor is it complaint with the EU's expressed goal to mitigate market risks associated with OTC derivatives.

e. Further, it is unclear whether those NCM trades qualify for zero risk weighting (it seems to be more likely that one have to apply the individual risk weighting in accordance with the applicable regime). Together with the requirement to post collateral some transactions may not appear economically reasonable so that NCMs might be pushed out of the market. Consequentially, certain types of transactions would only be offered by a limited number of CMs, which in turn leads to more undesired market concentration.

<sup>11</sup> Press release 2 February 2010 Standards for payment, clearing and settlement systems: review by CPSS-IOSCO 2 February 2010 - <http://www.bis.org/press/p100202.htm>

<sup>12</sup> Bloomberg November 20th 2009 - Lynch says Bank Opposition to Clearing Limits is "Hilarious" - Amendment to H.R.4173 OFFERED by Mr. Lynch adopted December 10<sup>th</sup>, 2009 – Conflicts of Interest in Clearing Organizations -

<sup>13</sup> According to market sources ICE Clear Europe is offering a 50% sharing in profits for Clearing Members from 2010 on; Eurex Clear is rumored to offer up to 90% of its shares and a 30% participation in revenues

- f. Lack of harmonization in the clearing rules amongst the CCPs does not provide a level playing field and can create a potential for arbitrage. A Directive or Regulation at the EU level will help in this respect.

## 2. Approved Financial Institutions

There is silence apparently on the issue where the CCP maintains its security and cash accounts. It should be reviewed whether there is a need to set upper limits as it evidently does not make sense to create a new systemic risk by letting the CCP concentrate all cash flows only with those institutions acting as CM. CCPs and Central Banks should reconsider whether it would not be a wise idea to maintain such accounts with a central bank.

## 3. Indirect Risk via Customers vs. open market access

As the bar is pretty high to become a CM, market access and probably also market participation in products where mandatory clearing is required, it is inevitable to access to a CCP via a CM. By the same token CM assuming - as give-ups or broker model - NCM positions must maintain a prudent and stable margin system/Contractual framework since otherwise again the CM themselves would introduce instability into the system. If there were only a few CMs offering such services such concentration may re-install systemic risk. It is open at this point in time if and to what extent regulators would require such "2nd level" protective measures from CM and CCPs.

## 4. Reporting, Position Limits and Transparency

Note that regulations will most likely require CCP to provide figures and transaction reporting in relation to CM which may provide the regulators to impose position limits, and post-trade information.

### ii. Interoperability

As of now interoperability is not even being discussed in much more than in general terms. Major dealers voice their concern that interoperability would be detrimental to risk and cost efficiency. It goes without saying that interoperability is a must have if there were to be more than one single CCP.

### iii. Robustness of Netting & Margin

For CDS Clearing the legal regime is far from being clear. Whether the Settlements Finality Directive applies to a broad extent (i.e. all cash flows and transfers of a CCP) – as some in the market believe – or is just works in the narrow sense is debatable.

1. CCP Level – In respect of the CCP netting opinions are available to confirm the enforceability of the close-out provisions embedded in the respective clearing rules. Whether in respect of segregated account and in particular margin accounts for clients such robustness can be confirmed also is not yet proven<sup>14</sup>. Moreover, CCPs appear to fully rely on the representations made by CM/NCMs (through the CCP's Terms & Conditions) as to the question whether they are (legally) capable to enter into certain types of transactions (such as e.g. CDS). This might insert undesired legal risks into the CCP system in the event e.g. local supervisory authorities change their view on the legality or an administrator challenges the validity of those transactions. As a consequence, the CCP might lose funds or collateral retroactively for which in turn other CMs/NCM would be liable.
2. CM level – Portability of margin and collateral appears to be an issue if there is a failing CM – legal review and opinions are missing or at least not made public. To the same extent there is a lack in transparency if and under which conditions CCP review and obtain legal opinions in respect of their CM.

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<sup>14</sup> But see ICE Clear Europe Response Questionnaire for CDS CCPs on Protection of Customer Initial Margin with no specific response yet at [http://www.managedfunds.org/members/downloads/ICE\\_Clear\\_Europe%20questionnaire-public%20legend.pdf](http://www.managedfunds.org/members/downloads/ICE_Clear_Europe%20questionnaire-public%20legend.pdf)

3. 3rd Party – Customer Level – As there is a buy-side access necessary via CM it remains a direct risk of each CM which provides such service. However, as being a member of the CCP clearing service it is in the strong interest of the CCP that each CM applies strict risk management processes also in its bi-lateral relation to the customer. It is not evident that all CCPs are requiring such robust (also legal) review process of their CM vis-à-vis CM clients.
  
- iv. Basis Risk – some argue there is a basis risk if and to the extent different sets of documentation are used both in wording, terms, language, applicable law etc. As there is in general freedom of choice and contracts is well accepted standard in known jurisdictions the difference in governing law (i.e. English vs. NY law) appears not to create a huge amount of basis risk. In respect of CDS – whether single name or indices - the trend is adopt by incorporation the ISDA regime into the clearing rules and procedures. Again basis risk is limited if thoroughly drafted. The basis risk appears to be high, however, if the terms differ – which is case of not standardized documentation on the hand (i.e. with end-user for instance) and CCP cleared “standard” on the other.
  
- v. Arguably, it might be prudent that a CCP should maintain a direct liquidity link (at least as a fallback) to the respective local central banks/the ECB to guarantee sufficient liquidity in the event the CCP's Guarantee Fund is unable to cover losses from the insolvency of one or more CM/NCMs. In such case, the respective CCP might not be in a position to determine the individual (remaining CM/NCM's) liability to cover those losses in a timely manner to that the whole clearing system might be jeopardized.
  
- vi. Transparency and Fairness  
CCPs should provide on their website a full disclosure at minimum of :
  - their org chart and the regulators who supervise either the global structure or parts thereof;
  - how their insolvency will be played out internationally;
  - if they are privately held, their shareholders and their holding levels, their liability/guarantee, their seats and voting rights on the board of the CCP;
  - identity of their custodians: if it is an internationally active custodian, where the assets will be booked and if the assets can be moved around and the safeguards for local assets and if European assets would be ringfenced

#### **D. Further Considerations and Assessment**

##### **i. Clearing Member and its Corporate Customers**

Assuming that all risk, operational and IT related issues have been settled to achieve a straight through process (including the collateral and margin management) with other market participants the buy-side access and its practical impact on business deserves to be carefully considered. While the contractual, operational and risk management inter-connection between the CCP and the DCM is pretty clear the same aspects are unclear when it comes to the relation between the DCM and the end-user. This holds true in particular in light of co-operate clients: given the necessity to clear standard OTC transaction via a CCP and a DCM the DCM will envisage to impose on its co-operate clients the same terms which apply to itself vis-à-vis the CCP. As the CCP looks only at the risk with the DCM the DCM will have post initial and variation margin not only on its own account transactions but also for those of its buy-side clients either (i) with the DCM (ii) another DCM or (iii) buy-side clients of a the other DCM. This means in particular that the terms and conditions including the margining will migrate from a bilateral (ISDA, DRV, CSA = e.g. Siemens – Bank) to a CCP driven regulation (ICE Europe – Bank – Siemens). While the traditional bilateral portfolio will shrink, the CCP pool will in general grow (depending on the number of NCMs). While the bi-lateral T&C provide tailor-made conditions (e.g. interest rate, eligible collateral, less independent amounts – if any ) the CCP terms are less generous (lower interest rate, higher initial margining, limited eligible collateral, higher hair-cuts). As a consequence thereof the Bank's needs to decide whether it is prepared to subsidize the end-users hedging if the clients are either not willing or capable to mirror the CCP/DCM terms, hence to accept the terms imposed by the CCP on the DCM for the bi-lateral relation. If a Bank is not accepting this mismatch it is likely to lose its position as hedging counterparty for the corporate client with the negative impact on cross-selling in particular and the relationship in general.



ii. CCPs in comparison

1. At this point in time a comprehensive and final assessment of the CCPs is not possible as there are (i) no legal opinions being made available or commissioned (ii) a constant change/update in rules and procedures are going on and (iii) the external regulatory environment is changing. However, in a nutshell and subject to further realignment Eurex appears to provide more flexibility on 3<sup>rd</sup> party access, is more balanced in rights and obligations vis-à-vis its CM, provided a clearer segregation on own account and client account transactions. ICE Clear in contrast is currently not offering 3<sup>rd</sup> party access and retains the full flexibility (it can kick out a CM virtually at its discretion) and lesser obligations, is much more restrictive in its admission criteria (i.e. ISDA Member, € 6 billion Tier 1)

## Annex - The CCPs

*[up-date to the most recent available Rules and presumably in table format]*

The following is a non-exclusive summary of the relevant and publicly available framework of both, Eurex Clearing AG and ICE Clear Europe (as of December 2009) [Note: If there are further service providers report to be extended]. The subsequent overview focuses on those parts of such rules and procedures which appear of major significance for Clearing Members (CM) and in particular in respect of the clearing and settlement of CDS Contracts. Note that the Terms and Conditions of the CCP are under constant review and may change from time to time at short notice.

i. ICE Clear Europe – Clearing Rules – as of November 30th 2009

The Clearing Rules provide the CCP with a large degree of discretion (good faith), unlimited power and limited responsibilities at almost no liability (best endeavors).

1. English Law governed, recognized as an UK Recognized Clearing House

2. Clearing membership (CM) & obligations

a. Membership Criteria (among others)

- I. Application fees
- II. Sufficient Capital
- III. Controller Guarantee (Major Shareholder of CM)
- IV. Controller maintain sufficient capital
- V. CCP in its discretion determines proper quality of CM in terms of staff, systems and processes
- VI. Guaranty Fund Contribution
- VII. Eligible commercial entity or eligible contract participant (US )
- VIII. No entitlement to shareholder meetings whatsoever
- IX. Extensive Regular Financial Reporting (including parent company) (“...a copy of all financial returns, reports, statements and notices provided to the relevant Regulatory Authority and if such material is other than a routine periodic financial return, statement or report ...a written statement setting out ..The reasons why such CM or Controller is filling it”).
- X. Additional Criteria for CDS CM as set out in the CDS Procedures (as of December 4<sup>th</sup> 2009) - excerpt
  1. \$ 5 billion Tier one capital
  2. Minimum Rating S&P “A” /Moody’s “A2” or equivalent
  3. Member of industry organizations related to CDS as designated by the CCP (ISDA and Deriv/Serv)
  4. 2002 ISDA Master Agreement executed
  5. Access to physical settlement system CDS related

b. Invoice Back

- I. The CCP has at all times the right to reverse the positions of buy and selling CM and , at its discretion, may also determine different prices or premium and other terms of the contract. Hence it may over-ride the price or other terms of any CDS Contract.

3. Customer and Customer Account

- a. Clearing Member is liable and responsible for all of its Proprietary and the Customer Accounts
- b. Customer Accounts serve only for an administrative purpose. No obligation of the CCP vis-à-vis any Customer of the CM
- c. Customer Transactions will be documented pursuant to a separate ISDA Master Agreement between the Customer and Clearing Member dealing only with ICE Clear Europe cleared

contracts (and not with any other derivatives). In order for a Customer Transaction to be eligible for clearing, the relevant Customer-Member Transaction will be required to include a standard annex in the form approved by the clearing house under the Rules (the “Standard Annex”)<sup>15</sup>.

4. Suspension and Termination of CM

- a. CM may be suspended upon any breach of the Rules by CM or the CCP at its discretion considers suspension necessary
- b. In case of suspension CM remains liable and obligated to any fees, cost expenses whatsoever
- c. Disciplinary proceeding against the CM commenced by the CCP and failing to continue to meet the membership criteria (and in addition if a CDS CM those as set out in the Procedure, which may be changed by the CCP upon its discretion) may lead to a termination of the CM whilst CM remains liable and obliged to pay fees, margin, etc..

5. Financial Requirements and Payment

- a. Liability to pay fees and charges electronically debited from an account of the CM with an Approved Financial Institution.
- b. CCP advises CM of amounts due the following Business Day and instructs the CM s Approved Financial Institution to transfer funds (net) accordingly to the CCP account.

6. Clearing Mechanism

- a. In general two Contracts shall arise automatically one between Selling CM and the CCP and the other one between CCP and the Buying CM subject to an acceptance notice to be sent to both by the CCP in case of a CDS Contract(s).
- b. Right to create a Contract in case of CM default (see below)
- c. Confirmation to be sent by CM to CCP in a form and content as requested by CCP and designating each Contract as related to one of the CM Proprietary or Customer Accounts
- d. CCP has the right to avoid CDS Contracts it considers void or voidable or unenforceable

7. Margin

- a. All cash transfers to be made by a CM must be effected through an Approved Financial Institution permitted by the CCP
- b. In the first place Permitted Cover (cash and assets) shall be transferred as required; if not sufficient transfer of cash in Eligible Currency (USD, EUR, GBP) - for CDS Contracts: Mark-to-Market and Variation Margin payment in the denomination of the CDS Contract
- c. Right of the CCP to impose, withdraw or amend Margin requirements at any time at its discretion
- d. Daily calculation and at the discretion of the CCP also intra-day calls with debit CM account with the Approved Financial Institution.
- e. Amount of Variation Margin calculated separately for Proprietary and Customer Account
- f. CDS Contracts: Regular calls following COB. Note that there are different sets of calls to be dealt with in a separate manner as such Portfolio Risk Margin , Physical Settlement Margin and Mark-to-Market Margin
- g. All collateral transferred shall be free of any rights of any 3rd party and the arrangements made in the Rules and Procedures shall qualify as Financial Collateral Arrangements within the meaning of the Financial Collateral Directive.

8. Position Limits

- a. The CCP may impose Position Limits. Non-compliance may result in a suspension of the CM.
- b. CCP will determine at its discretion and may take into account CM financial and operational capacity.

9. Clearing Members Events of Default (EoD)

- a. If so declared by the CCP and

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<sup>15</sup> Taken from ICE Clear Response July 2009 -ICE Clear Europe Response Questionnaire for CDS CCPs on Protection of Customer Initial Margin [http://www.managedfunds.org/members/downloads/ICE\\_Clear\\_Europe%20questionnaire-public%20legend.pdf](http://www.managedfunds.org/members/downloads/ICE_Clear_Europe%20questionnaire-public%20legend.pdf) – not sure whether this still applies – no response from Legal ICE Clear yet

- I. CM is likely to be unable to meet its obligations under the Rules
  - II. Any Financial Indebtedness of that CM or any of its Affiliates is or becomes to be declared due or a Creditor is entitled to declare due – always before its specified maturity as a result of an event of default. Note that there is no threshold being set and the definition of Financial Indebtedness is fairly broad as also Affiliate is. This is not only a cross acceleration but very harsh cross default clause.
  - III. Any material action being taken against the CM by a Governmental, Regulatory or even a Clearing Organization.
  - IV. Breach of any law relevant to the business as a CM
  - V. Export of EoD by integration via cross reference to the Rules into the bi-lateral ISDA Master Agreement with the effect of providing the CCP with the power to designate an EoD and automatically terminate the Master Agreement and the CM at any time.
  - b. Consequences of an EoD are
    - I. Liquidation of all contracts
    - II. Applying a close-out method. Note that the CCP has a full set of discretion as to what kind of actions it considers appropriate and necessary. It may require the entry into New Contracts between the CCP and the non-defaulting CM to replace the Defaulters CDS at a price determined by the CCP.
    - III. Net sum payable calculation.
10. Liability of CCP and Termination of Membership
- a. All obligations of the CCP under the rules are solely to CM and not to clients or customers of the CM. Where an obligation of the CCP must be performed immediately promptly or by notice prior to a specified time or date the CCP shall not be in breach having used all reasonable endeavors to perform such obligation. Liability is excluded save for fraud, bad faith, willful misconduct, personal injury or death, obligations under the contracts or if not liability cannot lawfully excluded.
  - b. CM shall indemnify CCP against all losses, delays, liabilities, damages, injuries, cost, expenses etc. in connection with conduct, breach of obligation, breach of Contract or any applicable law.
  - c. CM may terminate membership (i) with 3 months notice (ii) upon insolvency of the CCP or (iii) Event of Default (defined in Rule 903 as an Event in respect of a CM - which makes no sense)
  - d. Virtually only very limited EoD which apply to the CCP – restricted to a Cross Default to other CDS Master Agreements, non-payment and a modified ISDA Master Agreement definition of Bankruptcy (= “Insolvency” under the Rules).
11. Complaints & Disciplinary Procedures
- a. All written complaints shall be considered by the CCP with a subsequent Notice of Investigation being sent to the CM concerned. CM must co-operate fully.
  - b. Disciplinary proceeding only if the CCP is satisfied that there is prima facie evidence of breach of Rules by the CM concerned.
12. Guaranty Funds
- a. There are two separate funds: (i) CDS Guaranty Fund (in EUR) and (ii) the Energy Guaranty Fund (in USD).
  - b. CM is required to make contributions to the relevant fund they are active in.
  - c. New CM are required to make the minimum contribution plus any other amount the CCP considers necessary based on projected clearing activity.
  - d. Any shortfall in case of a default of a CDS CM (after liquidations, collateral, and funds ) must be covered by the remaining, non-defaulting CDS CM (for further details reference is made to the sophisticated procedures as set out in Rule 1106 – Powers of Assessment)
13. CDS Rules & Procedures
- a. The CDS Rules follow the ISDA governance. Note that initial payments or any other payments stemming from a bilateral CDS Transaction submitted for clearing remain the direct obligation of the CM as CDS Buyer or CDS Seller.
  - b. No CM is entitled to serve a Credit Event Notice to the CCP unless the relevant ISDA Determination Committee has decided that it is a Credit Event.
14. Alteration of Rules etc. may take place without prior consultation of CM (among other things)
- a. CCP may change fees if consultation is reasonably considered as not appropriate

- b. Margin or Guaranty Fund
  - c. Rules affecting change in contract terms removal of Contract Terms  
Note: A Rule change, Procedure amendment, or the contents of any Circular shall be valid even if not published or omission by the CCP required.
15. Procedures which are specifically designed for CDS as set out in the CDS Procedures
- a. CDS Default Committee
  - b. Regional CDS Committees and Dispute Resolution
  - c. Credit Events and Physical Settlement
  - d. CDS Products eligible: iTraxx series
16. CDS Operational Procedures dealing with
- a. Clearing Cycle,
  - b. Products,
  - c. Mark-to-Market Margin Process
  - d. Banking & Collateral Management
  - e. Processing and Settlement
- ii. Eurex Clearing AG (as per Clearing Terms of December 4th 2009)
1. Clearing Terms are recognized as a “Maser Agreement” privileged as such in the meaning of the German insolvency code
  2. German law governed in general - Eurex Clearing is a company incorporated in Germany and licensed as a credit institution under supervision of the BaFin. The FSA has granted Eurex Clearing status as a Recognized Overseas Clearing House (ROCH) in the United Kingdom.
  3. Force Majeure and limited Liability
    - a. Also for negligence in case of technical problems but
    - b. limited in value
  4. Clearing Member EoD (excerpt) and Suspension
    - a. Nonpayment or delivery of margin or other failure to pay any amounts when due
    - b. Failure to comply with any other obligation under the Terms
    - c. Possible consequence : Penalty and consequential loss
    - d. Suspension from right to clear or open positions
    - e. Waiver in case of a Technical Default at the discretion of the CCP
  5. Termination and Settlement
    - a. Right of the CCP to close-out all open contracts and positions of a CM including any margin
    - b. Calculation of a Net-amount
  6. Close-out Netting and Termination applicable in case of CCP in case of
    - a. Insolvency
    - b. Non-payment of amounts due and payable
    - c. Termination by notice (non-payment) or automatic (Insolvency)
  7. Clearing Mechanism
    - a. A General CM (“GCM”) may clear on (i) its own behalf, (ii) clients and (iii) Non CM (“NCM”). A Direct Clearing Member (“DCM”) may clear (i) own account and (ii) for DCM group members – affiliates -.
    - b. In general a contract is generated between CCP and CM(s)
    - c. If a NCM provides a transaction for clearing to the CCP two contracts will be generated: one between the NCM and the CM and a second between the CCP and the CM.
    - d. Booking of such NCM Transaction takes place in a special NCM account of such CM.
    - e. For OTC transactions a recognized Servicer must transmit the dataset of either the CM or a registered client. CCP becomes by novation counterparty as buyer and seller to the original transaction
    - f. Registered Clients must have entered into a standard Clearing Agreement with a CM.
    - g. Weekly Clearing Cycle
    - h. Novation takes place on regular Fridays for replaced transactions
    - i. Special Rules for the Clearing of CDS contracts

- I. Eligible Products determined by CCP after consultation with the owners of the Credit Distribution and Service Company GmbH (“CDS Company”).
  - II. Set-up of CDS Committees (“Risk”, “Clearing Conditions”, “Operations”) out of Eligible CM having a CDS license (see below).
  - III. Incorporation of ISDA documentation with a bridge as to English law concerning the interpretation of terms
  - IV. Remaining Maturity min 1 Business Day
  - V. Rules on the establishment / treatment of Credit Events, Restructuring
8. Clearing membership
- a. Financial Institution (i) having its registered office within the European Union or Switzerland licensed and oversight by respective supervisors (ii) US Institutes for OTC Clearing with specific requirements established by the SEC or (iii) pass ported branches. CCP may accept exemptions. Head Office must guarantee branch clearing obligations
  - b. The minimum number of Tier 1 capital is set by the CCP (currently set at € 1 billion)
  - c. Extra rules for US Clearing Members and US customers and clients
    - I. US CM must require segregation of cash and securities of US persons from own account, even though legally allowed to commingle
    - II. Warning obligations regarding SIPA
  - d. OTC Clearing License required for certain OTC Products
  - e. Credit Derivatives License requiring (i) extra contribution to CDS Clearing Funds (ii) usage of a central payment service or indirect access via recognized servicer and (iii) an account with CLS Bank for cash payments in connection with Fixed Payments and Credit Events
9. Relation between CM, NCM, the CCP, Linked CCPs and their interconnected rights and obligations
- a. A NCM may have only one CM – change possible
  - b. A CM is obliged to enter into a NCM-CM Clearing Agreement if the NCM fulfills the conditions for admission in a specific market (e.g. Repos, OTC etc). In respect of Derivatives Transactions cleared by the CCP between the CM and the NCM the Close-out Netting provisions of the German Rahmenvertrag for Financial Transactions apply.
  - c. NCM may be excluded by the CCP if it does not honor its obligations vis-à-vis the CM
  - d. No right of a CM to close out transactions or positions of its NCM but may ask the CCP to do so
  - e. Right to agree on Pre-Trade Limits and Stop-Bottom
10. Clearing Funds for OTC Credit Derivatives
- a. Any CM is obliged to provide additional funds to the Clearing Funds becoming due with the granting of a license and reviewed quarterly
  - b. Eligible: Cash , securities or a bank guarantee
  - c. Waterfall concept and segregation of proceeds if fund is executed per Clearing license caused by financial shortfall
  - d. joint severability following a waterfall concept with prior execution of margin/collateral
11. Margin
- a. Cash and Securities to cover CM obligations as the sum of (i) own account and client account transactions and (ii) NCM own and client transactions.
  - b. Additional Margin to cover market price movements
  - c. CM are obliged to request from NCM at least the same margin amount to be calculated in accordance with CCP methodology.
  - d. CCP has the right to request higher or additional collateral promptly available to the CCP at an RTGS account.
  - e. Eligible currency for margin as determined by the CCP
  - f. CCP has the right to use such cash collateral at its own discretion to secure the ordinary course of business and for investment purposes
  - g. Securities as collateral shall be pledged to the benefit of the CCP with Clearstream Banking or SEGAInterSettle. Right of CM to request release on any Business Day.
  - h. CCP has the right of re-use of pledged securities (“Aneignungsrecht”)
12. CM accounts

- a. Different accounts for (i) CM own account transactions and (ii) transactions stemming from NCM original transactions
  - b. Sub segregation for transactions having the CM or the NCM acting as principal or as agent (client transactions)
  - c. CCP Collateral account in the name of each CM
13. Fees are due
- a. for granted licenses
  - b. transaction based
14. Clearing Procedure for OTC Credit Derivatives
- a. Eligibility Criteria (OTC-Trade-Entry Conditions) must be met
  - b. Index Credit Default Swaps
  - c. Single Name CDS
15. Amendment and changes of Clearing Terms
- a. Any time by CCP with a 10 business days grace period before becoming effective after electronic publication
  - b. Right of CMs to object to a change