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memorandum

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To **Andrew Lamb**
CME Clearing Europe Limited

Memorandum on ring fencing arrangements

1 Executive summary

Background

- 1.1 CME Clearing Europe Limited (**CMECE**) is incorporated in England and has applied to the Financial Services Authority (**FSA**) for a recognition order designating it as a **recognised clearing house** for the purpose of the Financial Services and Markets Act 2000 (**FSMA**).
- 1.2 We understand that:
- (a) CMECE is submitting an application to the Commodity Futures Trading Commission (**CFTC**) for registration as a derivatives clearing organisation (**DCO**) pursuant to Section 5b of the Commodity Exchange Act (**CEA**) and Part 39 of the Regulations adopted under the CEA by the CFTC.
 - (b) the CFTC has requested a reasoned memorandum as to the effectiveness under English law of the arrangements to be put in place by CMECE to **ring fence** accounts maintained in relation to OTC derivatives contracts cleared by its US members on behalf of their clients (i.e. sequestered client accounts); and
 - (c) CMECE proposes to adopt a new version of its Clearing Rules and Clearing Procedures in substantially the form attached to this memorandum. That new version of the Clearing Rules

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and Clearing Procedures will have effect from the date on which CMECE is registered, and commences operation, as a DCO (and is referred to in this memorandum as the **Rules**).

- 1.3 Once CMECE is designated as a recognised clearing house and registered as a DCO, the relationship between CMECE and each of its clearing members will be governed by (once they have been adopted) the Rules, a Clearing Membership Agreement entered into by CMECE and the clearing member and individual Contracts entered into pursuant to the Rules (together, the **Clearing Arrangements**).
- 1.4 Words and expressions defined in the Rules shall have the same meaning when used in this memorandum, unless otherwise defined.

Analysis

- 1.5 The Rules are governed by English law. English law generally allows solvent parties to agree rights and obligations between them. However, on insolvency of one party, insolvency law may affect some of those rights and obligations.
- 1.6 On our understanding of the facts, the Cleared OTC Derivatives Clearing Members are required to be registered with the CFTC as "Futures Commission Merchants" under the CEA and are likely to be incorporated in and operating out of the USA. In that case, it seems likely that US federal and state insolvency law (rather than English law) will be the most important in determining whether the ring-fencing of Sequestered Client Accounts is effective on a Cleared OTC Derivatives Clearing Member's insolvency. There are however some cases in which the English courts may place non-English companies into an English insolvency proceeding.
- 1.7 This memorandum is therefore relevant in the more limited cases when either:
- (a) the English courts take insolvency jurisdiction over a US Cleared OTC Derivatives Clearing Member; or
 - (b) the Cleared OTC Derivatives Clearing Member is actually incorporated in and has its centre of main interests in England.
- 1.8 In those cases:
- (a) Part VII of the Companies Act 1989 (**Part VII**); and
 - (b) the Financial Collateral Arrangements (No 2) Regulations (the **Collateral Regs**),

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should protect CMECE and the Cleared OTC Derivatives Clearing Members from certain effects of English insolvency law so that, subject to the further discussion below, the ring-fencing of Sequestered Client Accounts is effective.

- 1.9 The rest of this memorandum discusses ring-fencing (Section 2) and the types of risks to its effectiveness under English insolvency law (Section 3); protections under Part VII (Section 4); the interaction of Part VII with other parts of English insolvency law (Section 5); and commentary on CMECE insolvency (Section 6).

2 Ring-fencing

- 2.1 This memorandum contemplates a default under the Clearing Arrangements, particularly an insolvency default of a Cleared OTC Derivatives Clearing Member. In that case, CMECE may take various steps under its Default Rules including:

- (a) seeking to discharge (e.g. by close out or settling) all of the Cleared OTC Derivatives Clearing Member's Contracts; and
- (b) applying Collateral credited to the Sequestered Client Account of a Cleared OTC Derivatives Clearing Member (**Sequestered Collateral**) against any resulting amount due from the Cleared OTC Derivatives Clearing Member to CMECE with respect to the Cleared OTC Derivatives Contracts of its Cleared OTC Derivatives Clients.

- 2.2 The Rules require:

- (a) that the process described above shall be applied separately to Cleared OTC Derivatives Contracts and to the Cleared OTC Derivatives Clearing Member's other Contracts (please see Rule 8.4.1); and
- (b) that CMECE only applies Sequestered Collateral against the net sum certified by CMECE in relation to the Cleared OTC Derivatives Contracts of Cleared OTC Derivatives Clients (please see Rule 8.4.2(c)),

and in this memorandum, these provisions are referred to as **ring-fencing** (and **ring-fence** or **ring-fenced** should be construed accordingly).

3 English insolvency law

Overview

- 3.1 The main English insolvency statute is the Insolvency Act 1986 and upon the insolvency of a Cleared OTC Derivatives Clearing Member the most common insolvency proceedings are likely to be

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administration and liquidation. In 2009, England supplemented the insolvency regime to deal more specifically with banks. The primary legislation in this area is the Banking Act 2009 (the Banking Act) which applies to UK banks, UK holding companies of UK banks and certain other financial institutions. It introduces three regimes. The first is a special resolution regime intended for use when failure of a bank is imminent and other government powers are insufficient. The two other regimes - bank liquidation and bank administration - apply after the bank has become insolvent.

- 3.2 As mentioned above, this memorandum applies primarily when a Cleared OTC Derivatives Clearing Member is an English limited company or a bank (two common legal forms for clearing members). On the assumption that Cleared OTC Derivatives Clearing Members are US persons, it may be that this portion of the memorandum is less relevant. However, it is included for completeness. Please also note that the Banking Act does not regulate investment banks if they are not deposit-takers, although HM Treasury is currently consulting on a proposed special regime for them.¹
- 3.3 The rest of this section provides a little more detail on these insolvency regimes.

Liquidation

- 3.4 Liquidation² is an insolvency process leading to the end of the company's existence³. An insolvency official, the liquidator, is appointed over the company. Its principal role is to collect in and realise the assets, ascertain claims and distribute the net proceeds to creditors.

Administration

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

Special resolution regime

- 3.6 Part 1 of the Banking Act creates a special resolution regime for dealing with UK banks in financial difficulty. The regime is operated primarily by the Financial Services Authority, the Bank of England and HM Treasury and gives them three broad options in respect of a failing bank:

¹ *Establishing resolution arrangements for investment banks*, HM Treasury (16 September 2010)

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

³ In this memorandum, the terms liquidation and winding-up will be used interchangeably.

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- (a) to sell all or part of the business of the bank to a private sector purchaser;⁴
 - (b) to transfer all or part of the bank to a bridge bank (i.e. a bank wholly-owned by the Bank of England), normally with the intention of restructuring the bank and then to sell-on to the private sector;⁵ and
 - (c) to nationalise the bank, although only HM Treasury can exercise this power.⁶
- 3.7 The objectives for using this regime are broad, socio-economic measures, rather than strict, legal tests. By way of example, they include the protection and enhancement of the stability of the financial systems of the UK; to protect and enhance public confidence in the stability of the banking system of the UK; and to protect depositors.⁷
- 3.8 In operational terms, the Banking Act gives the authorities very strong powers to transfer ownership of failing banks and/or all or part of their assets to themselves or to the private sector. Broadly speaking, the powers operate regardless of any restrictions or limitations (e.g. prohibitions on transfer in underlying contracts). It is also possible to transfer part (as opposed to all) of the shares or assets/liabilities of a failing bank. Whilst this has been one of the most controversial issues to date in relation to the Banking Act, the position has been largely remedied in respect of the rights of clearing houses in these circumstances (please see paragraph 3.23 below).

Bank liquidation

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

⁴ Banking Act 2009, s11

⁵ Banking Act 2009, s12

⁶ Banking Act 2009, s13

⁷ Banking Act 2009, s4

their deposits to another financial institution or arranging compensation for the depositor from the Financial Services Compensation Scheme.

Bank administration

3.10 Part 3 of the Banking Act establishes the new, bank administration regime. As with bank liquidation, it is largely based on the existing administration regime under the Insolvency Act 1986. The main features of the bank administration regime are:⁸

- (a) bank administration is used specifically when part of a bank is sold to a commercial purchaser (please see paragraph 3.6(a) above) or transferred to a bridge bank (please see paragraph 3.6(b) above); and
- (b) in that case, the bank administrator is able and required to ensure that the remaining part of the bank (**the residual bank**) provides the services or facilities required to enable the commercial purchaser or bridge bank to be operated effectively.

Non English companies

3.11 Against this overview of English insolvency, our understanding is that the Cleared OTC Derivatives Clearing Members are likely to be US entities. This section therefore summarises the jurisdiction of the English courts to wind-up a foreign company or to put it into administration.

3.12 The jurisdiction of the English courts to wind up foreign companies is contained in sections 220 to 228 of the Insolvency Act 1986, which deal with the winding-up of unregistered companies. The expression **unregistered company** includes any association and any company other than companies incorporated under the companies legislation of the United Kingdom.

3.13 Section 221(1) provides:

Subject to the provisions of this Part, any unregistered company may be wound up under [the Insolvency Act 1986]; and all the provisions of this Act about winding up apply to an unregistered company with the exceptions and additions mentioned in the following subsections.

3.14 Whilst this is a rather broad starting point, the power of the English courts to wind up foreign companies is discretionary and the courts tend to exercise this discretion more restrictively than with English companies. The tests for exercising discretion are drawn from case law and have changed

⁸ Banking Act s136

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over time. However a reasonably good characterisation is found in *Stocznia Gdanska v Latreefers (No 2)*.⁹ Morritt LJ, giving the judgment of the court, described the requirements as follows:

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

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

3.16 As mentioned earlier in this memorandum, it may therefore be that the English courts would not take jurisdiction to wind-up a US Cleared OTC Derivatives Clearing Member without assets or a material connection with the United Kingdom; and they are unlikely to put a Cleared OTC Derivatives Clearing Member which is incorporated and managed in the US into administration.

Example risks to ring-fencing

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

3.18 **Automatic set-off** - if a company goes into liquidation all sums due from it to each counterparty are set off automatically against all sums due from each counterparty to the insolvent company. This provision cannot be contracted out of or varied. This means for example that debts from the Cleared OTC Derivatives Clearing Member to CMECE under Contracts relating to its House Account would be set-off automatically against debts from CMECE under Cleared OTC Derivatives Contracts so that ring-fencing would not be effective.¹⁰

⁹ [2001] 2 BCLC 116 at 120

¹⁰ Insolvency Rules 1986 (r4.90). A similar provision exists in the administration regime but the automatic set-off only occurs when the administrator proposes to make a distribution (r2.85).

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- 3.19 **Void dispositions of property** - if the company is subject to a winding up by the court, any disposition of its property made after the commencement of the winding up is, unless the court orders otherwise, void.¹¹
- 3.20 **Moratorium** - as mentioned above, if a company is in administration, no security may be enforced and no legal process (including legal proceedings, execution and distress) may be instituted or continued against the company without the consent of the court or the administrator.¹²
- 3.21 **Preferences and transactions at undervalue** - in certain cases, payments or deliveries (e.g. in relation to Cleared OTC Derivatives Contracts) may be set aside if they improve the position of one creditor ahead of others¹³ or if they are made in circumstances in which the Cleared OTC Derivatives Clearing Member receives significantly less than the value of the payment or delivery that it makes.¹⁴
- 3.22 **Failure to register security** - this is an important requirement of English law. In summary, many types of security created by an English company should be registered at UK Companies House within 21 days of creation or they will be void against a liquidator, administrator or creditor of that Company.¹⁵ However, at the date of this memorandum, the form of Clearing Membership Agreement contemplates that CMECE will take Collateral on a so-called title transfer basis which does not require registration.

Banking Act 2009

- 3.23 The Banking Act itself is not a traditional “insolvency risk” under English law. There has however been some concern with the speed of its implementation and it is expected that it will not be widely used unless or until there is a future banking crisis. This suggests that there will be little case law or commentary to guide when the regime is next used. The market has already required modification of certain unclear provisions in the original form of the Banking Act. For example:
- (a) **Bank liquidator and bank administrator** - the Banking Act broadly says that, where ordinary insolvency law (i.e. the Insolvency Act 1986 mainly) refers to **liquidator** and **administrator**, those terms should include **bank liquidator** and **bank administrator**. However, the Banking Act overlooked the fact that over 20 other UK Acts and a further 20+ pieces of secondary legislation also use the term **liquidator** and **administrator**. Most importantly for this memorandum, that list includes the safe harbour under Part VII of the Companies Act 1989. It was therefore not clear that Part VII protection did apply against the actions of bank liquidators or bank administrators appointed over clearing members. This has now been rectified by The

¹¹ Insolvency Act 1986, s127

¹² Insolvency Act 1986, Schedule B1, paragraph 43

¹³ Insolvency Act 1986, s239

¹⁴ Insolvency Act 1986, s238

¹⁵ Companies Act 2006, s874. This requirement for registration also applies to non-English companies but only if both the relevant collateral is situated in England at the time of the security and if the company has an establishment registered in England.

Banking Act 2009 (Parts 2 and 3 Consequential Amendments) Order 2009 which confirms that references to liquidator and administrator in the Companies Act 1989, also include references to bank liquidator and bank administrator: and

- (b) **Property and securities transfers** - as mentioned above (please see paragraph 3.6), one of the powers of the UK authorities under the special resolution regime is to sell/transfer the assets of or securities issued by a relevant bank. In this respect, there has been discussion about partial transfers - where the UK authorities transfer some, but not all, of the business of a failing bank to a third party; and whether they could, for example, transfer assets to the third party but leave liabilities (e.g. obligations to CMECE) in the residual bank. There is still some discussion on this topic but the situation has been substantially remedied by The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009. Regulation 7(1) of that Order provides:

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

- (a) *a market contract;*
- (b) *the default rules of a recognised clearing house; or*
- (b) *the rules of a recognised clearing house as to the settlement of market contracts not dealt with under its default rules.¹⁶*

4 Part VII

- 4.1 Against this background of the normal corporate insolvency law, CMECE is given protection by Part VII, which is comprised of sections 154 to 191 of the Companies Act 1989. Please also see Section 6 in respect of the insolvency of CMECE itself.
- 4.2 The regime and accompanying secondary legislation¹⁷ is designed to safeguard the operation of financial markets. It does this by modifying English insolvency law to protect the actions of recognised clearing houses and recognised investment exchanges in the event that one of their members defaults on the obligations he has entered into in the course of buying or selling financial instruments. The

¹⁶ The terms **market contract**, **default rules** and **recognised clearing house** are all important and discussed in section 4 of this memorandum.

¹⁷ This is mainly the Financial Markets and Insolvency Regulations 1991 and the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (the **Recognition Requirements**)

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intention of the regime is to "enable [a recognised clearing house] to take action to close out a defaulter's unsettled market contracts in accordance with [its] default rules."¹⁸

- 4.3 The remainder of this part of the memorandum will summarise the key provision (section 159) and the main supporting sections in Part VII.

Section 159

- 4.4 Sub-sections (1) and (2) provide the fundamental insolvency protection under Part VII. They read as follows:¹⁹

(1) *None of the following shall be regarded as to any extent invalid at law on the ground of inconsistency with the law relating to the distribution of assets of a person on bankruptcy, winding up or sequestration or in the administration of a company or other body or in the administration of an insolvent estate -*

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

(2) *The powers of a relevant office-holder in his capacity as such, and the powers of the court under the Insolvency Act 1986 shall not be exercised in such a way as to prevent or interfere with -*

- (a) *the settlement in accordance with the rules of a recognised clearing house of a **market contract** not dealt with under **its default rules**; or*
- (b) *any action taken under the **default rules** of such clearing house.*

- 4.5 Subject to the further discussion below on market contracts, the CMECE ring-fencing provisions should receive section 159 protection. Whilst section 159 gives broad protection, it is possible for an insolvency official or court to afterwards challenge a step taken. However, broadly speaking, such a challenge will not be successful if the step is taken under the default rules of CMECE.

- 4.6 As a result, this means for example that an insolvency official appointed over a Cleared OTC Derivatives Clearing Member could not bring an action to set aside settlement of a Cleared OTC

¹⁸ Modernising the insolvency protections for the operation of financial markets – proposals to reform Part 7 of the 1989 Companies Act (HM Treasury, July 2008)

¹⁹ This extract reflects the current text of Part VII which was updated in 2009 by the Financial Markets and Insolvency Regulations 2009.

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Derivatives Contract because it constitutes a preference or transaction at an undervalue (please see paragraph 3.21 above).

Market contracts

4.7 When looking to obtain Part VII protection, the central concept is the **market contract**. It is the existence and settlement of a market contract that is given direct protection in sub-sections 159(1)(a) and (c) and (2)(a) above. And a market contract is the basis of the defined term **default rules**²⁰ as used in sub-sections 159(1)(b) and (c) and (2)(b). A DCO Contract must therefore qualify as a market contract to receive Part VII protection.

4.8 **Market contract** is defined in s155(3) of the Companies Act 1989 and was broadened in 2009 following consultation by HM Treasury²¹ on potential inconsistencies between the previous definition and secondary legislation. The current definition is:

(3) *In relation to a recognised clearing house this Part applies to -*

(a) *contracts entered into by the clearing house, in its capacity as such, with a member of the clearing house for the purpose of enabling the rights and liabilities of that member under a **transaction** to be settled; and*

(b) *contracts entered into by the clearing house with a member of the clearing house for the purpose of providing central counterparty clearing services to that member...*

4.9 The word **transaction** is not defined in Part VII but it is clear that this is meant to be a broad term.²² We understand that CMECE will start by Clearing OTC energy derivatives. Whilst we are not advising on the individual contracts, our view is that this class of contract cleared by CMECE will qualify as market contracts.

²⁰ **Default rules** means rules of a recognised investment exchange or recognised clearing house which provide for the taking of action in the event of a person (including another recognised investment exchange or investment house) appearing to be unable, or likely to become unable, to meet his obligations in respect of one or more **market contracts** connected with the exchange or clearing house (Companies Act 1989, s188)

²¹ Please see footnote 18

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

Supplemental provisions

- 4.10 In addition to section 159, Part VII provides a number of specific protections and some of the central ones are summarised below. However, the over-riding rule is contained in section 159 and the remainder of Part VII should not be construed to limit the generality of section 159.²³

No set-off

- 4.11 As mentioned in paragraph 3.18 above, the normal position would be that CMECE could claim against an insolvent Cleared OTC Derivatives Clearing Member for a debt under a market contract (e.g. in respect of a house position) but that such a debt would be set-off automatically against debts outstanding the other way from CMECE to the Cleared OTC Derivatives Clearing Member (e.g. in respect of a Cleared OTC Derivatives Contract). This is a risk to effective ring-fencing.
- 4.12 However, section 159(4) of Part VII provides that a debt or other liability arising out of a market contract may not be proved in the winding up, bankruptcy or administration of the Cleared OTC Derivatives Clearing Member. That section also provides that such a debt shall not be taken into account for the purpose of any set-off until the completion of the default-proceedings. Therefore a liability under a Contract which relates to a Cleared OTC Derivative Clearing Member's House Account should not be set-off (other than in accordance with the Clearing Arrangements) until the completion of default proceedings relating to the Cleared OTC Derivatives Clearing Member.

Transaction avoidance

- 4.13 The ability of the courts or an insolvency official to set-aside transactions on the grounds of preference or undervalue²⁴ (amongst others) are also limited by Part VII. For example, by virtue of section 165, no order shall be made under the provisions relating to preferences or transactions at undervalue in relation to a market contract, a disposition of property in pursuance of such market contract, the provision of margin in relation to a market contract, any contract effected by the clearing house in question to realise property provided as margin or any disposition of such property in accordance with the rules of the clearing house.

5 Interaction of Part VII with other parts of English insolvency law

- 5.1 Whilst Part VII was updated in 2009, the majority of that law has been in force since 1989 and does not clearly fit with all subsequent legislation. The following paragraphs comment in particular on the Recognition Requirements.

²³ Companies Act 1989, s159(3)

²⁴ Please see paragraph 3.21

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- 5.2 Both Part VII and the Recognition Requirements contemplate that a central counterparty will apply its default procedures separately to calculate and settle Contracts/Collateral relating to a clearing member's House Account from those relating to its Segregated Client Account.²⁵ However, neither the Recognition Requirements nor Part VII deal expressly with rights and obligations in relation to Sequestered Client Accounts.
- 5.3 The question therefore is how to reconcile a US law based concept of Sequestered Accounts with Part VII and the Recognition Requirements. We believe that there are two alternative views.
- 5.4 The first is that Part VII (section 187) contemplates expressly that a person could enter into a market contract in more than one capacity. In that case, section 187 provides that:
- (1) *the provisions of this Part [VII] apply as if the contracts entered into in each different capacity were entered into by different persons.*
- 5.5 This means that where positions are closed and collateral applied, those steps should be taken separately for each **capacity** and Part VII would treat them as such. This indeed entirely supports the ring-fencing of Accounts. The question here is whether, as a matter of English law, a Cleared OTC Derivatives Clearing Member enters into Cleared OTC Derivatives Contracts on behalf of its Cleared OTC Derivatives Clients in a different **capacity** from that in which it enters into a Contract relating to its House Account.
- 5.6 One negative factor is that, in respect of House Account and Segregated Client Accounts, regulations have been passed to confirm specifically that they are held in a different capacity. To date, there is no equivalent clarification in respect of Sequestered Client Accounts. It is also the case that English law recognises 3 main capacities - principal, agent and trustee. It is not entirely clear how a Cleared OTC Derivatives Clearing Member fits with that classification.
- 5.7 More positively, on the assumption that the CEA regime in relation to Sequestered Client Accounts has a client protection (rather than a proprietary position) focus, it is certainly plausible to argue that the capacity of the Cleared OTC Derivatives Clearing Member is different and therefore section 187 applies. In this case, the concept of Sequestered Client Accounts reconciles well with Part VII and the Recognition Requirements.
- 5.8 The other analysis is that Sequestered Client Accounts do not reconcile clearly with section 187. The basis for this view is simply that there is no express statement or guidance in English law or regulation for the proposition in paragraph 5.7.

²⁵ This relates to FSA Client Money Rules, rather than to CFTC requirements.

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5.9 However, if that is true, it is fair to say that English law then only expressly recognises House Accounts and Segregated Client Accounts. In that case, a Sequestered Account should be treated as one of those types of account for Part VII purposes. This does not mean that amounts are commingled with or set-off across the Sequestered Account and the other relevant account (please see Rule 8.4 in this respect). It is more in the nature of understanding whether the Part VII regime is flexible enough to also apply to Sequestered Accounts.

5.10 In this respect nothing in Part VII or the Recognition Requirements prohibits the analysis (particularly for the operation of the default proceedings) that the Sequestered Account could be treated as part of the House Account. To repeat, this does not mean that assets and liabilities are therefore commingled or set-off across those accounts. It is a reasonable interpretation of how Sequestered Accounts fit in the Part VII regime.

5.11 That said, our view is that the analysis in one of paragraphs 5.7 or 5.10 is correct. Whilst it is not clear to us which is the better view, the conclusion is that it is possible to reconcile the concept of Sequestered Accounts into English law either one way or the other.

6 CMECE insolvency

6.1 The Rules include specific provisions on CMECE insolvency (please see Rule 8.5) and section 158 Companies Act 1989 provides that Part VII also applies to clearing house insolvency. Subsections (1) and (2) of that section state that:

(1) *The general law of insolvency has effect in relation to market contracts.... subject to the provisions of sections [of the remainder of Part VII].*

(2) *So far as those provisions relate to insolvency proceedings in respect of a person other than a defaulter, they apply in relation to -*

(a)

(aa) ***proceedings in respect of a recognised clearing house or a member of a recognised clearing house;***

7 Assumptions

7.1 This memorandum has been based on the following assumptions:

(a) the Clearing Arrangements will be entered into in substantially the form attached and will create legal, valid, binding and enforceable obligations and the parties will comply with their terms;

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- (b) CMECE will open a Sequestered Client Account in relation to each Cleared OTC Derivatives Clearing Member and will record in that account all Cleared OTC Derivatives Contracts and all Sequestered Collateral;
- (c) each Cleared OTC Derivatives Clearing Member will establish a Sequestered Client Account with respect to all transactions and assets required to be segregated pursuant to the CEA and CFTC requirements and will advise CMECE correctly of all contracts and collateral which are to be recorded in relation to the Sequestered Client Account;
- (d) any non-cash Collateral is in the form of **financial instruments**,²⁶
- (e) CMECE is a recognised clearing house; and
- (f) Sequestered Collateral is not subject to the FSA client money or asset rules.

8 Scope and interpretation

- 8.1 This memorandum and any non-contractual obligations connected with it are governed by English law and are subject to the exclusive jurisdiction of the English courts.
- 8.2 This memorandum is given only in relation to English law as it is understood at the date of this opinion. We have no duty to keep you informed of subsequent developments which might affect this opinion. There is almost no case law in relation to Part VII.
- 8.3 If a question arises in relation to a cross-border transaction or any agreement or arrangement not governed by English law, it may not be the English courts which decide that question and English law may not be used to settle it.
- 8.4 We express no opinion on, and have taken no account of, the laws of any jurisdiction other than England and Wales.
- 8.5 We express no opinion on matters of fact.
- 8.6 The contents of this memorandum are not to be extended by implication. In particular, we express no opinion on the accuracy of the assumptions contained in Part 7.
- 8.7 This memorandum is given solely for the benefit of CMECE. It may not be relied on by any other person. It may not be disclosed to any other person apart from the CFTC and the FSA on the basis

²⁶ This is a broad concept which is defined in the Financial Collateral Arrangements (No 2) Regulations 2003 as "(a) shares in companies and other securities equivalent to shares in companies; (b) bonds and other forms of instruments giving rise to or acknowledging indebtedness if these are tradeable on the capital market; and (c) any other securities which are normally dealt in and which give the right to acquire any such shares, bonds, instruments or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment)" (Regulation 3)

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that those persons will make no further disclosure except that the CFTC may post a complete copy of this memorandum on its website in connection with the application referred to in paragraph 1.2(a). A person, who accesses the memorandum in this way, agrees that it does not rely on the memorandum and will take its own professional advice in connection with the matters contained herein.

Norton Rose LLP

24 November 2010