

**13.3.2 OSC Notice and Request for Comment – CME Clearing Europe Limited – Application for Exemption from Recognition as a Clearing Agency**

**OSC NOTICE AND REQUEST FOR COMMENT**

**CME CLEARING EUROPE LIMITED**

**APPLICATION FOR EXEMPTION FROM RECOGNITION AS A CLEARING AGENCY**

**A. Background**

CMECE Clearing Europe Limited (CMECE) has applied (the Application) to the Commission for an order pursuant to section 147 of the *Securities Act* (Ontario) (OSA) to exempt CMECE from the requirement to be recognized as a clearing agency in subsection 21.2(0.1) of the OSA. Among other factors set out in the Application, the exemption is being sought on the basis that CMECE is subject to an appropriate regulatory and oversight regime in its home jurisdiction of the United Kingdom (U.K.) by the Financial Services Authority (FSA).

CMECE was established in the U.K. and commenced its clearing operations in May 2011. It currently clears over-the-counter (OTC) commodity derivatives trades.

In reviewing the Application, staff followed the process and assessed the Application against the criteria set out in OSC Staff Notice 24-702 *Regulatory Approach to Recognition and Exemption from Recognition of Clearing Agencies* (Staff Notice).

**B. Draft Order**

In the Application, CMECE describes how it addresses each of the criteria set forth in the Staff Notice. Subject to comments received, staff propose to recommend to the Commission that it grant CMECE an exemption order with terms and conditions in the form of the proposed draft order (Draft Order).

The Draft Order requires CMECE to comply with various terms and conditions, including relating to:

1. Regulation of CMECE
2. Filing requirements
3. Submission to jurisdiction and agent for service
4. Information sharing

**C. Comment Process**

The Commission is publishing for public comment the Application and Draft Order. We are seeking comment on all aspects of the Application and Draft Order.

You are asked to provide your comments in writing, via e-mail and delivered on or before **September 22, 2012** addressed to the attention of the Secretary of the Commission, Ontario Securities Commission, 20 Queen Street West, Toronto, Ontario, M5H 3S8, e-mail: [comments@osc.gov.on.ca](mailto:comments@osc.gov.on.ca).

The confidentiality of submissions cannot be maintained as comments received during the comment period will be published.

Questions may be referred to:

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August 3, 2012

Ontario Securities Commission  
20 Queen Street West  
Suite 1903, Box 55  
Toronto, ON M5H 3S8

Dear Sir/Madam:

**Re: CME Clearing Europe Limited – Application for Exemption from Recognition as a clearing agency in Ontario**

This application is filed with the Ontario Securities Commission (the OSC) by CME Clearing Europe Limited (the Applicant or CMECE), seeking the following relief:

An order, pursuant to section 147 of *The Securities Act* (Ontario) (the OSA), exempting CME Clearing Europe Limited from the requirement to be recognized by the OSC as a clearing agency pursuant to subsection 21.1(0.1) of the OSA.

The OSA, and all regulations, rules, policies and notices of the OSC made hereunder are collectively referred to as the Legislation.

**Approval Criteria**

OSC Staff has prescribed criteria that it will apply when considering applications for recognition or exemption from recognition by clearing agencies under subsection 21.1(0.1) of the OSA, which criteria is contained in OSC Staff Notice 24-702 *Regulatory Approach to Recognition and Exemption from Recognition of Clearing Agencies*. This application follows those criteria.

Part I: Background

- A. Legal and ownership structure
- B. Regulatory Status
- C. Participation of Canadian resident participants in clearing arrangements at CMECE
- D. Further Information on CMECE and its clearing activities
- E. Criteria for Recognition and Exemption from Recognition as a Clearing Agency
  - 1. Requirements imposed by the UK Financial Services Authority (FSA) on CMECE
  - 2. Description of how the oversight of CMECE by the foreign regulator FSA ensures ongoing compliance with the criteria

Part II: Application of Approval Criteria to the Clearing House

- 1. Governance
- 2. Fees
- 3. Access
- 4. Rules and Rulemaking
- 5. Due Process

6. Risk Management
7. Systems and Technology
8. Financial Viability and Reporting
9. Operational Reliability
10. Protection of Assets
11. Outsourcing
12. Information Sharing and Regulatory Cooperation

Part III Submissions

**Part I: Background**

**A. Legal and ownership structure**

CMECE is a private limited company incorporated and registered under the laws of England on June 3, 2009. It is headquartered at One New Change, London EC4M 9AF, England, and its primary place of business is the United Kingdom<sup>1</sup>.

The Articles of Association and Memorandum of Association of CMECE are publicly available.

CMECE's ultimate parent is CME Group Inc. (CME Group). CMECE's immediate parent (100% ownership) is Chicago Mercantile Exchange Luxembourg S.à r.l; it is in turn a wholly-owned subsidiary of Chicago Mercantile Exchange Luxembourg Holdings S.à r.l, which is wholly-owned subsidiary of CME Group Inc. As at February 8, 2012, Chicago Mercantile Exchange Luxembourg S.à r.l, holds 46,067,273 ordinary £1 shares of CMECE.

CME Group is the holding company for four futures exchanges: the Chicago Mercantile Exchange Inc. (CME), the Board of Trade of the City of Chicago Inc. (CBOT), the New York Mercantile Exchange Inc. (NYMEX) and the Commodity Exchange Inc. (COMEX). CME Group is a listed corporation whose shares are traded on the NASDAQ stock exchange. CME Clearing is a division of CME and offers central counterparty clearing and settlement services for all CME Group exchanges and over-the-counter (OTC) derivatives transactions.

**B. Regulatory Status**

CMECE received recognition as a clearing house (Recognised Clearing House – RCH) from the UK FSA, under Part XVIII of the Financial Services and Markets Act 2000 (FSMA), on December 14, 2010. CMECE's entry in the UK Financial Services Authority (FSA) Register as a Recognised Clearing House can be found at: <http://www.fsa.gov.uk/register/exchangeDetails.do?sid=256324>

The initial authorisation of clearing houses in the UK confers approval for them to clear the products that they have specified in their application to the FSA. Insofar as the product scope of the clearing of a RCH expands, it seeks approval for such expansion from the FSA. CMECE's initial authorisation is for the clearing of OTC commodity derivatives.

**C. Participation of Canadian resident participants in clearing arrangements at CMECE**

CMECE does not have any office or maintain other physical installations in Ontario or any other Canadian province or territory<sup>2</sup>. Nor does it have any plans to open such an office or to establish any such physical installations in Ontario or elsewhere in Canada.

However, CMECE does have a Clearing Member that is the London branch of a Canadian bank whose principal place of business is Ontario (accepted following the receipt, on May 3, 2011 of the interim exemption from the Commission). At the current time, we have a principal to principal arrangement with all Clearing Members (see the section on Membership below). At the current time, we do not have a relationship with the Clearing Members' clients and we do not ourselves promote services to Canadian resident participants.

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1 Please note that until August 14, 2011 CMECE was headquartered at its previously notified address of Watling House, 33 Cannon Street, London, England.

2 Please note that related organisations, owned by our ultimate parent company, have received exemptive relief in one Canadian province.

#### D. Further Information on CMECE and its clearing activities

CMECE has been established as part of the globalisation plans of CME Group. The associated business goal is to offer clearing services from the UK for a broad range of OTC derivatives, and prospectively for exchange-traded derivatives as well.

The first and as yet only definite provision of clearing services by CMECE centres on the clearing of OTC commodity derivatives. CMECE currently offers over 200 derivative contract types. CMECE was ready to commence clearing from May 6, 2011 and received its first trades for clearing on May 13, 2011.

CMECE plans to launch OTC Interest Rate Swaps (IRS) in the fourth calendar quarter of 2012, followed by Foreign Exchange and Credit Default Swap products in early 2013. As part of the IRS offering, CMECE plans to launch a Canadian Dollar IRS product (Vanilla Fixed vs. Float with a maximum maturity of 30 years). At the current time, we have no other specific plans in relation to the Canadian Dollar or in relation to Canadian government bonds (Federal or Provincial). CMECE strives to launch new products to satisfy demand and we will, of course, provide any information to the OSC that they request, should our offering expand to cover such products.

As outlined in Part 11 (Outsourcing), CMECE receives a number of services and support from CME in the US and from CME Operations Limited (CMEOL) in London.

Our website ([www.cmeclearingeuropa.com](http://www.cmeclearingeuropa.com)) provides further information on the clearing arrangements. In particular, the *OTC Commodity Derivatives Guide* (available on our website) provides details of our offering, including: risk management; banking and settlement operations, and trade capture and transaction services. The Commodities Contract Module,<sup>3</sup> which forms part of our Rules, contains full details of the current range of products offered.

#### E. Criteria for Recognition and Exemption from Recognition as a Clearing Agency

Responses made by a foreign clearing agency to the criteria in Appendix A to OSC Staff Notice 24-702 are required to: (1) describe the requirements, if any, that are imposed by the applicable regulator in the clearing agency's jurisdiction (the foreign regulator) in each area and (2) describe how the oversight of the foreign clearing agency by the foreign regulator ensures ongoing compliance with the criteria.

##### 1. Requirements imposed by the UK Financial Services Authority on CMECE

Please find below a list of the main legislation relevant to Recognised Clearing Houses in the UK<sup>4</sup>:

- The main primary legislation is the UK Financial Services and Markets Act 2000 (FSMA), Part XVIII. (Recognised Investment Exchanges and Clearing Houses), which can be found here: <http://www.legislation.gov.uk/ukpga/2000/8/contents>.
- This is supplemented by the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (SI 2001/995): <http://www.legislation.gov.uk/uksi/2001/995/contents/made>
- In addition, there is the Investment Exchanges and Clearing Houses Act 2006: <http://www.legislation.gov.uk/ukpga/2006/55/enacted> ;
- The main source of secondary legislation is the rules and guidance contained in the UK Financial Services Authority Handbook 'Recognised Investment Exchanges and Recognised Clearing Houses' (REC) which can be found here: <http://fsahandbook.info/FSA/html/handbook/REC>

Under proposals issued for consultation by the UK Treasury in February 2011, responsibility for the supervision of clearing houses will pass from the FSA to the Bank of England in 2013. Currently CMECE has a quarterly meeting with the Bank to discuss general clearing and payment related issues.

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3 <http://www.cmeclearingeuropa.com/membership/files/CMECE-Commodities-Contract-Module.pdf>

4 The following legislation also applies: Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (<http://www.opsi.gov.uk/si/si1999/19992979.htm>); Financial Markets and Insolvency (Settlement Finality) (Amendment) Regulations 2006 (<http://www.opsi.gov.uk/si/si2006/20060050.htm>); Financial Markets and Insolvency (Settlement Finality)(Amendment) Regulations 2007 ([http://www.opsi.gov.uk/si/si2007/uksi\\_20070832\\_en\\_1](http://www.opsi.gov.uk/si/si2007/uksi_20070832_en_1)), Companies act 1989 Pt VII ([http://www.opsi.gov.uk/acts/acts1989/ukpga\\_19890040\\_en\\_1](http://www.opsi.gov.uk/acts/acts1989/ukpga_19890040_en_1)).

The main requirements imposed by the FSA on CMECE are set out in REC.

Therefore, for each of the criteria set out in Part II below, we have noted the relevant reference in REC.

**2. Description of how the oversight of CMECE by the foreign regulator (FSA) ensures ongoing compliance with the criteria**

*'Close and continuous supervision'*

As a Recognised Clearing House (RCH), CMECE is expected to maintain an open, cooperative and constructive relationship with its dedicated FSA supervisors (a process known as "close and continuous supervision"), which reflects the important role played by market infrastructure providers. This enables the FSA to have a broad picture of the RCH's activities and ability to meet the recognition requirements (REC 2) (which include but are not limited to: the maintenance of sufficient financial resources to cover all aspects of risk, including Clearing Member default, fitness and propriety). RCH's must also respect 'notification requirements' (REC 3) (covering *inter alia*: financial information, changes to the Clearing Rules, complaints and disciplinary proceedings, major operational issues, default events).

The supervisory relationship consists of on-going communication (typically between the Regulatory Compliance Officer and the FSA Supervisor, on an almost daily basis), as well as a more structured series of meetings between the FSA and key individuals of the RCH. The frequency and nature of these meetings may vary in accordance with the risk profile of the RCH.

FSA recognises that an RCH is likely to develop and adapt their businesses in response to customer demand and new market opportunities. The FSA expects an RCH to take its own steps to assure itself that it will continue to satisfy the recognition requirements, and other obligations in or under FSMA when considering any changes to its business or operations. However, the FSA also expects the RCH to keep it informed of all significant developments and of progress with its plans and operational initiatives, and to provide it with appropriate assurance that the recognition requirements will continue to be satisfied.

*Risk based supervision*

FSA requires information to support their risk based approach to the supervision of all regulated entities. Risk based supervision is intended to ensure that the allocation of supervisory resources and the supervisory process are compatible with the regulatory objectives and the FSA's general duties under FSMA. The central element of the process of risk based supervision is an assessment by the FSA (a risk assessment) of the main risks to its supervisory objectives posed by each regulated entity. For each RCH, the FSA will conduct a periodic risk assessment. This assessment will take into account relevant considerations including the special position of recognised bodies under FSMA, the nature of the UK recognised body's members, the position of other users of its facilities and the business environment more generally.

The risk assessment will guide the FSA's supervisory focus. The FSA initially reviews its risk assessment with the staff of the RCH to ensure factual accuracy and a shared understanding of the key issues, and may discuss the results of the risk assessment with key individuals of the RCH. It then sends the assessment and an action plan relating to work that it considers appropriate for the RCH to undertake to the Board of the RCH for discussion and response.

Please see chapter 4 of REC for further details, in particular:

- 4.2 The supervisory relationship with UK recognised bodies
- 4.3 Risk assessments for UK recognised bodies
- 4.4 Complaints
- 4.5 FSA supervision of action by UK recognised bodies under their default rules
- 4.6 The section 296 power to give directions
- 4.7 The section 297 power to revoke recognition
- 4.8 The section 298 procedure

## Part II – Application of Approval Criteria to the Clearing Agency

### 1. GOVERNANCE

#### 1.1 The governance structure and governance arrangements of the clearing agency ensures:

##### (a) effective oversight of the clearing agency;

CMECE is a private limited company incorporated in England with registered number 06922932. The underlying principles of CMECE's constitution and corporate governance arrangements are set out in CMECE's Memorandum and Articles of Association, which are publicly available. The Articles of Association set out CMECE's formal corporate decision making powers and procedures. Under the Articles of Association and applicable company law, the directors of CMECE are responsible for the day to day running of the company.

The organisational structure of CMECE is such as to allow the senior executive and the Board of Directors (the Board) of CMECE to provide effective governance. Appropriate oversight and control of the functions of CMECE is key to ensuring effective governance by the directors. There are direct reporting lines from each of the relevant functions of CMECE to a particular member of the Board providing the Board with effective control and oversight of the operations of such relevant functions.

The organisation, balance and composition of the Board has been determined in accordance with good corporate governance practice and in accordance with the FSA's guidance on the suitability of individuals appointed as directors or employees of such bodies.

Article 9.1 of the CMECE Articles of Association requires that any decision of the Board is to be either a majority decision at a Board meeting or a unanimous decision taken in accordance with Article 10, i.e. by written resolution. In the event that the number of votes for and against a proposal is equal, the Chairman or other director chairing the meeting has a casting vote (see Article 15). In practical terms, in the event of a tied Board in relation to a decision, the preferred and more likely response would be for the issue to be re-debated and decided without the need for the Chairman to exercise his casting vote.

Article 13.2 of the CMECE Articles of Association specifies that the quorum for Board meetings is two; the directors are able to change the quorum through passing a resolution to that effect. Each director has one vote with the Chairman or other director who is chairing the meeting having the casting vote in the case of a tied vote (Article 15.1). In practice, it is highly unlikely that any meeting would take place with only the minimum of two required for a quorum.

Board members do not represent the interests of shareholders of CMECE. Under company law, the directors owe duties to the company as a whole. Three of the directors are non-executive directors, each of which is also a director of a CME Group company. When acting in their capacity as directors of the Board of CMECE, these directors are obliged to act in accordance with the general legal and fiduciary duties of directors under English company law and also in accordance with CMECE's internal constitutional and organisational rules, safeguards and procedures, as set out in the Articles of Association of CMECE.

The Companies Act 2006 (CA 2006)<sup>5</sup> contains the following duties applicable to executive and non-executive directors:

- Duty to act within powers (section 171 CA 2006)
- Duty to promote the success of the company (section 172 CA 2006)
- Duty to exercise independent judgment (section 173 CA 2006)
- Duty to exercise reasonable care, skill and diligence (section 174 CA 2006)
- Duty to avoid conflicts of interest (section 175 CA 2006)
- Duty not to accept benefits from third parties (section 176 CA 2006)
- Duty to declare interest in proposed transaction or arrangement with the company (section 177 CA 2006)

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<sup>5</sup> Please see: <http://www.legislation.gov.uk/ukpga/2006/46/contents>

**(b) the clearing agency's activities are in keeping with its public interest mandate;**

CMECE is committed to ensuring the integrity of the contracts it clears and the stability of the financial system, in which market infrastructure plays an important role. The rules, policies and activities of CMECE are designed and focused on ensuring that it maintains best practices and fulfils this public interest mandate. CMECE operates on a basis consistent with best practices of other derivatives clearing houses.

**(c) fair, meaningful and diverse representation on the governing body (Board) and any committees of the Board, including a reasonable proportion of independent directors;**

In the UK, corporate governance requirements are contained in the Companies Act 2006 (Part 10: A company's directors: in particular section 173 "Duty to exercise independent judgement") and the UK Corporate Governance Code (the Code)(please see <http://www.frc.org.uk/corporate/ukcgcode.cfm> for further details). The FSA reviewed our governance at the time of the RCH application and CMECE is required under REC 3.6 to notify FSA of any changes to our constitution or governance.

The Board's governance arrangements are set out in the Articles of Association, which are publicly available. CMECE's governance arrangements are transparent and fulfil public interest requirements.

The Board of CMECE currently consists of eight members: three independent non-executive directors, one of whom is the Chairman, three non-executive directors appointed by CME Group, and two executive directors (the CEO of CMECE and the COO of CMECE). The name and biographical information of each director is available to the public on the CMECE website ([www.cmececlearingeurope.com](http://www.cmececlearingeurope.com)). The Board generally meets on a monthly basis.

The Code sets out tests for independence of non-executive directors in Code Provision B.1.1. Ultimately, the Board is responsible for determining whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. This might include if the director:

- has been an employee of CMECE or the CME Group within the last five years;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the Board for more than nine years from the date of their first election.

CMECE has considered and applied the above independence criteria when appointing the independent non-executive directors. In accordance with the best practice reflected in the Code, the independent non-executive directors have recent and relevant experience in the fields of derivatives, financial markets more generally, clearing and settlement and corporate governance.

*Audit Committee*

The Audit Committee consists of the independent non-executive directors of CMECE. The Chairman is a qualified accountant who also has substantial experience as a finance director. The purpose of the Audit Committee is to assist the Board in ensuring the financial integrity of CMECE and the soundness of its internal risk controls and procedures. The Audit Committee is responsible for reviewing the effectiveness of CMECE's internal operational risk controls, as well as managing and overseeing CMECE's internal audit function, internal audit arrangements and the relationship with CMECE's external auditor. The Audit Committee is also responsible for monitoring CMECE's financial statements and procedures for whistle-blowing, detecting fraud, financial crime, and market abuse.

The terms of reference of the Audit Committee require it to meet at least three times a year at appropriate times in the reporting and auditing cycle and at such other times as the Chairman of the Audit Committee shall require. Since launch in 2011 the Committee has met more frequently than the minimum.

*Risk Committee*

The Risk Committee consists of: the Chairman, who is an independent non-executive director of CMECE; the CEO; at least three risk management specialists from Clearing Members (currently nine); at least one representative from other parties with a direct interest in the risk management of CMECE (currently two representatives of clients); and the Chairman of the CME Clearing House Risk Committee, *ex officio*. The Risk Committee currently has 15 members. The inclusion of risk management specialists from Clearing Members is a means by which CMECE is able to consider the views of its Clearing Members, who have a direct interest in the risk management of CMECE. Each Clearing Member is invited to nominate a representative to sit on the Risk Committee (although not all of them choose to nominate a representative). This is appropriate given the current number of Clearing Members, although as the number expands, CMECE will keep this under review and may at some point have to implement a 'turnaround' procedure whereby Clearing Members provide representatives on a rotating basis. The representatives that the Clearing Member chooses to nominate will generally be in the market risk or credit risk areas or a product specialist. CMECE will request a biography of the nominated representative and the Head of Risk and Membership will discuss the matter with the Chairman of the Risk Committee. To date, no nominated representatives have been rejected.

The Committee has commented on and validated the counterparty and market risk policies that are used for the clearing of OTC commodity derivatives.

The purpose of the Risk Committee is to provide, on behalf of the Board, oversight of the major risk management policies of CMECE relating to counterparty and market risk in relation to Clearing Members and to banking and custodial counterparties.

The work of the Risk Committee is complementary to that of the Audit Committee. The Risk Committee makes recommendations for endorsement by the Board. The Risk Committee is required to review annually the requirements of clearing membership, the policies and practices related to valuation and margining, including Eligible Collateral (see page 20) and haircuts from market value, security of CMECE and Clearing Member assets, and CMECE's other counterparty and market risk policies in relation to Clearing Members and banking and custodial counterparties, and to make recommendations for change, as appropriate, to the Board.

The Risk Committee is required to review, on at least a semi-annual basis, the continued adequacy of CMECE's default resources based on the stress test results presented to it by CMECE staff, and to make recommendations for change, as appropriate, to the Board.

The Risk Committee also is responsible for: (i) reviewing proposals for risk management of new markets or product types with novel risk characteristics and making recommendations to the Board; (ii) reviewing proposals for cross-margining and clearing linkages with other clearing houses; (iii) reviewing applications for clearing membership; and (iv) reviewing all risk-related material amendments to the CMECE Rules and making recommendations to the Board. The members of the Risk Committee are required to disclose the existence of any conflicts of interest and to abstain from any decisions in which they are conflicted.

The Risk Committee meets at least once every quarter and otherwise as required from time to time, keeps minutes of its proceedings and reports to the Board.

CMECE's overall risk management framework is made up of a number of internal risk management policies. These internal policies set out the responsibilities, accountabilities and tolerances/limits which must be adhered to. The default rules (chapter 8 of the Clearing Rules) addresses decision making in crises and emergencies and gives the CEO of CMECE the authority to declare a default and convene an Emergency Committee<sup>6</sup> if appropriate (Rule 8.1.3). The Head of Risk and Membership reports to the COO, and also has a reporting line to the Chairman of the Risk Committee. Following the approval by the Risk Committee, the Board will formally approve and 'sign off' the policies.

- (d) **a proper balance among the interests of the owners and the different entities seeking access (participants) to the clearing, settlement and depository services and facilities (settlement services) of the clearing agency;**

CMECE's Board ensures that the interests of all participants are addressed. The Board's focus is on operating a clearing house that conforms to best practices and ensuring that Clearing Members are treated fairly and consistently. In addition, the Risk Committee (a Committee of the Board) has a number of Clearing Member representatives (please see section 1.1(c) of this letter) – all Clearing Members are currently invited to nominate a representative to serve on the Risk Committee. This Clearing Member representation helps CMECE to ensure that the interests of Clearing Members are met.

It is in the interest of both the owner and participants that CMECE operates in a manner consistent with best practices of clearing houses to preserve the integrity of the contracts cleared. It is in both their interests to ensure stable, effective risk

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<sup>6</sup> The composition of the Emergency Committee shall be determined by the Clearing House from time to time.



management processes. Therefore, CMECE does not believe there is a conflict between the interests of the owners and the entities seeking to become Clearing Members.

**(e) the clearing agency has policies and procedures to appropriately identify and manage conflicts of interest;**

CMECE has in place a formal policy setting out structural arrangements and relevant allocation of responsibility to ensure that it can continue to take proper regulatory decisions notwithstanding any conflicts of interest that may arise in relation to its business. The Board of CMECE is responsible for ensuring that adequate systems and controls are in place to identify and manage conflicts of interest.

The Board of CMECE has been structured and appointed in accordance with corporate governance best practice. Its affairs are conducted so as to ensure that potential conflicts of interest are identified promptly, managed and recorded. The number and type of directors on the Board are such as to ensure that in the event of a number of directors being conflicted and unable to vote on certain matters (for example, where the CME Group non-executive directors are unable to vote due to a conflict with the interests of CME Group), the Board of CMECE will still be quorate and have sufficient competence and expertise to discharge its decision making functions. The Board of CMECE will allocate responsibility for decisions so that it can continue to take proper decisions notwithstanding any conflicts of interest.

The Articles of Association of CMECE set out restrictions and procedures for dealing with conflicts of interest at Board level, in particular outlining circumstances in which a director will not be eligible to vote on a matter in relation to which he has an interest that may conflict with that of CMECE. The directors of CMECE have certain duties under CA 2006 to ensure that their interests do not conflict with their duties as a director to CMECE. These provisions apply equally to all types of directors, regardless of whether they are executive or non-executive directors.

The non-executive directors of CMECE will have roles and responsibilities outside CMECE, in particular with other CME Group entities (with the exception of the independent non-executive directors whose independent status would be compromised by holding a position in the CME Group). This is a potential source of conflicts of interest, where, for example, the CMECE Board is required to make a decision in which the interests of CMECE may conflict with the interests of CME. As noted above, when acting in their capacity as directors of CMECE, the non-executive directors will be obliged to act in accordance with (i) the Articles of Association of CMECE, (ii) the provisions of CA 2006 and (iii) internal policies.

Non-executive directors' letters of appointment include a clause which prevents them from being employed by, hold any directorship in, or holding shares in, any company which is similar to CMECE (or CME Group) because of the confidential information and trade secrets that they have access to. The clause also states that non-executive directors must disclose any potential conflicts to the Board. Where the non-executive directors are conflicted, they may not be eligible to vote on the relevant matter in accordance with the CMECE Articles of Association.

The minutes of all meetings (of the Board and committees) must document the procedures followed to show compliance with the requirements.

The UK requirements relating to conflicts can be found in REC 2.4.3(11) and REC 2.5.13 which deal with identification and management of conflicts of interest. Article 16 of the CMECE Articles of Association sets out restrictions and procedures for dealing with conflicts of interest at Board level; in particular, outlining circumstances in which a director will need to disclose his interest in a matter that may conflict with that of CMECE. In addition, Part 10 of CA 2006 contains provisions imposing general duties on directors. Section 175 CA 2006 requires directors to avoid conflicts of interest and section 177 CA 2006 requires directors to declare any interest in a proposed transaction or arrangement.

**(f) each director or officer of the clearing agency, and each person or company that owns or controls, directly or indirectly, more than 10 per cent of the clearing agency is a fit and proper person; and**

The directors and officers of CMECE were all interviewed by FSA prior to the granting of RCH status in December 2010<sup>7</sup>. Any new officers or directors will have to be interviewed by FSA and approved by them prior to appointment.

There is currently no Nomination Committee. Members of the Board appointed to executive positions are nominated and appointed on the basis of their particular knowledge and experience, with a view to ensuring that the Board as a whole has the competencies and qualifications required to carry out its responsibilities as the governing body of an RCH.

The CMECE Articles of Association (section 19 and 20) set out the details for appointment of directors. In accordance with UK company law (specifically section 12 of the Companies Act 2006), when the first directors are appointed, they must be appointed in writing by completion of the statement of proposed officers (this will form part of the registration that must be delivered to the

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<sup>7</sup> With the exception of James E. Oliff, who replaced Robert Ray on the Board of CMECE in early 2011 and was interviewed by FSA in 2011.

registrar of companies<sup>8</sup>, who will in turn issue a certificate of incorporation). The statement contains details of the names of those directors and their consent to act in the relevant capacity.

After the initial registration, the Board may appoint any persons whom it sees fit and who are willing to act as directors, either to fill a vacancy or as an addition to the Board, provided that the Board is satisfied that the appointment of such persons would not prejudice CMECE's status as a Recognised Clearing House or any other recognition or status granted to CMECE. As mentioned above, any such appointments would be subject to approval by FSA and will also be notified to the registrar of companies.

- (g) there are appropriate qualifications, limitation of liability and indemnity provisions for directors and officers of the clearing agency.**

Members of the Board appointed to executive positions are nominated and appointed on the basis of their particular knowledge and experience, with a view to ensuring that the Board as a whole has the competencies and qualifications required to carry out its responsibilities as the governing body of an RCH.

The Articles of Association contain clauses relating to director's indemnity (Article 72) and insurance (Article 73).

Article 72.1 sets out that a relevant officer of the Company or an associated company may be indemnified out of the Company's assets against:

- any liability incurred by that officer in connection with any negligence, default, breach of duty or breach of trust in relation to the Company or an associated company;
- any other liability incurred by that officer as an officer of the Company or an associated company.

However, Article 72.1 does not authorise any indemnity which would be prohibited or rendered void by any provision of the Companies Acts or by any other provision of law.

Article 73.1 states that the directors may decide to purchase and maintain insurance, at the expense of the Company, for the benefit of any relevant officer in respect of any relevant loss. CMECE has in place Directors' & Officers' Liability Insurance. This provides insurance for liability arising from acts, errors or omissions occurring in the capacity as a director, officer or employee. Coverage also applies for securities claims against CMECE. The policy will reimburse CMECE for its indemnification obligations and will pay the loss of any individual director or officer for non-indemnifiable claims.

## **2. FEES**

### **2.1 All fees imposed by the clearing agency are equitably allocated. The fees do not have the effect of creating unreasonable barriers to access.**

CMECE's clearing fee structure is the same for all Clearing Members.

For the first year of operation, CMECE waived fees on most contracts for all Clearing Members joining CMECE at the outset. Before the launch of clearing operations, CMECE held meetings with a wide range of firms to explain its proposals to offer certain incentives to those becoming 'founder' members. In the event, not all of those approached felt that they had an internal business case to join from "Day One". During the first year of operation, all Clearing Members of CMECE were founder members and enjoyed the fee waiver, which was inclusive of: (i) cash settlement fees and other processing fees (give-ups, transfers, etc.) and (ii) facilitation desk fees. The fee waiver was discontinued after one year and the clearing fees applicable to founder Clearing Members are identical to those applicable to any new Clearing Members.

In addition, in order to build liquidity and activity and to demonstrate CMECE's long-term commitment to its relationship with brokers, under the broker incentive scheme CMECE incentivises brokers who agree to provide market prices for the purposes of establishing settlement data. Under the broker incentive scheme, an order entered into CME Inc. ClearPort Clearing Systems by an "Eligible Participant" (a broker who meets CMECE's criteria) on behalf of its client (i.e. not on its own account or a proprietary account) which has been accepted for clearing by CMECE and novated in accordance with chapter 5 of the Clearing Rules will be an "Eligible Transaction". As at the date of this letter, CMECE pays an Eligible Participant 25% of net transaction fees charged to, and received from, a Clearing Member in regard to each Eligible Transaction submitted by the Eligible Participant.

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<sup>8</sup> The Registrar of Companies for England and Wales, and Chief Executive of Companies House is Tim Moss. His office is based at Companies House. The main functions of Companies House are to incorporate and dissolve limited companies; examine and store company information delivered under the Companies Act and related legislation; and make this information available to the public. Company registration matters are dealt with in law, by the Companies Act 2006.

These schemes are in line with current market practice and are (or were) available on a consistent and transparent basis to all participants that met the criteria. The schemes were notified to our regulators (the FSA), who did not raise concerns. For these reasons, we do not believe that they distort behaviour or incentivise one group of participants to the detriment of others.

The fees do not create unreasonable barriers to access. On the contrary, we have sought to introduce fees (and incentive schemes) that are conducive to allowing participation in our services.

Fees and incentive schemes are covered by REC 3.9. FSA was provided with a copy of the fee schedule prior to CMECE's launch. As required by Bottom of Form REC 3.9.2, the FSA will be kept informed of (1) any proposal to change the fees or charges levied on our members (or any group or class of them), at the same time as the proposal is communicated to those members; and (2) any such change, no later than the date when it is published or notified to those members.

Access to facilities is governed by REC 2.7 and this is described in more detail in 3.1 below.

## **2.2 The process for setting fees is fair and appropriate, and the fee model is transparent.**

Fees and charges for clearing transactions are determined by CMECE's management team and approved by the Board. Fees and charges are set out in a Fees and Charges Notice, which is published on the website. Fees and Charges are payable in the currencies set out in the Fees and Charges Notice.

## **3. ACCESS**

### **3.1 The clearing agency has appropriate written standards for access to its services.**

The membership requirements of CMECE for OTC commodity derivatives clearing are objective, publicly disclosed and permit fair and open access. Chapter 3 of the CMECE Rules and the CMECE Membership Procedures, set out the admission and eligibility standards that an applicant for clearing membership must satisfy to become a clearing member of CMECE (Clearing Member). Among other requirements, these standards require that an applicant to be a Clearing Member must:

- a) have all necessary licenses to become a Clearing Member;
- b) meet minimum capital requirements of £10 million;
- c) have made a contribution to the Guarantee Fund (currently a minimum of US\$2.5 million)(see below);
- d) satisfy CMECE as to its fitness and propriety, financial, operational, technical, and risk management capacity and competence; and
- e) satisfy CMECE that it has written anti-money laundering, risk management, disaster recovery, and business continuity policies.

All of CMECE's clearing membership requirements are designed to permit fair and open access while protecting CMECE and its Clearing Members. CMECE does not intend to deny an applicant membership in CMECE if it satisfies all of the clearing membership requirements.

As noted above in paragraph (c), Clearing Members must normally make a contribution to the Guarantee Fund unless CMECE has decided to waive this requirement. At the current time, CMECE does not require a Clearing Member to make a contribution to the Guarantee Fund, except in certain circumstances<sup>9</sup> as our Guarantee Fund is still viewed as being in a 'Transitional Period' while the clearing business develops and expands.

#### *Membership application process*

To apply for clearing membership, an applicant must complete an application form and submit it with the required documentation to CMECE. The Risk and Membership Department of CMECE will initially review the submitted application and request additional information from the applicant, if necessary. After the Risk and Membership Department determines that the application is complete, it will submit the application for review and consideration by the Risk Committee, which will make a determination for CMECE.

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<sup>9</sup> If CMECE determines, following the advice of the Risk Committee, that the Guarantee Fund should be increased to an amount greater than US\$60 million, or if CMECE issues a declaration of default in respect of a Clearing Member and, in exercising its powers and responsibilities under the Default Rules (chapter 8 of the Clearing Rules), CMECE is required to apply part or all of the Guarantee Fund to discharge the defaulting Clearing Member's liabilities.

CMECE anticipates that the Risk Committee review will take place within six weeks of receipt of the completed application. The Risk Committee will notify the applicant in writing of its decision.

Any applicant whose request to become a Clearing Member is denied will be provided with a written explanation and reasons for the decision. However, according to CMECE's internal procedures, an applicant whose application is denied may appeal to the Board.

Any appeal by an applicant will follow a two-stage process: the Company Secretary will first refer the appeal to the Board, who will be tasked with carrying out an objective and thorough consideration of the appeal. The Board can determine its own procedure for considering the appeal referred to it and may, without limitation, (i) seek further or other information from the Risk Committee and/or the applicant or (ii) make any further or reasonable inquiries as it deems fit in order to properly and fully consider the appeal. The Board may approve the appeal and approve the applicant as a Clearing Member by a majority vote only if it is satisfied that the Risk Committee's decision was arbitrary, capricious or an abuse of the Risk Committee's discretion. The Board must deliver its decision and the reasons for its decision to the applicant within 30 Business Days from the date on which the appeal was referred to it and the costs of the appeal will be met entirely by CMECE.

CMECE maintains records of its Clearing Member application reviews and any resulting hearings or appeals. Complete records are maintained for each Clearing Member. Once approved as a Clearing Member, an applicant must enter into a legal agreement with CMECE.

REC 2.7 Access to Facilities includes 2.7.2A (taken from the Schedule to the Recognition Requirements Regulations, Paragraph 21A) which states that:

- (1) The [UK RCH] must make transparent and non-discriminatory rules, based on objective criteria, governing access to central counterparty, clearing or settlement *facilities* provided by it.
- (2) The rules under sub-paragraph (1) must enable an *investment firm* or a *credit institution* authorised by the *competent authority* of another *EEA State* (including a *branch* established in the *United Kingdom* of such a firm or institution) to have access to those *facilities* on the same terms as a *UK firm* for the purposes of finalising or arranging the finalisation of transactions in *financial instruments*.
- (3) The [UK RCH] may refuse access to those *facilities* on legitimate commercial grounds.

**3.2 The access standards and the process for obtaining, limiting and denying access are fair and transparent. A clearing agency keeps records of**

- (a) each grant of access including, for each participant, the reasons for granting such access, and**

The Risk Committee is responsible for reviewing and recommending whether the Board should approve or reject applications for clearing membership and all Clearing Member mergers, changes and withdrawals. The Board will then consider and approve or reject all applications.

The papers submitted to the Risk Committee and the Board will document the reasons why the Risk and Membership team believe the applicant meets the membership requirement criteria. The documentation provided to the meetings, as well as the minutes documenting the discussion held (at both the Board and Risk Committee meetings) will be retained in accordance with internal policy.

- (b) each denial or limitation of access, including the reasons for denying or limiting access to an applicant.**

As stated under 3.2(a), all applications for access (membership) will be considered by the Risk Committee and (if approved by the Risk Committee) the Board. The papers and minutes relating to these meetings will document the reasons for denying or limiting access to an applicant<sup>10</sup> and will be retained in accordance with CMECE's internal policy. FSA receives all papers and minutes for Risk Committee and Board meetings as part of its supervisory role.

The FSA regulates the access standards of CMECE under REC 2.7 (Access to Facilities) and 3.18 (Membership).

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<sup>10</sup> To date, no applicants have been denied access or granted only limited access.

#### 4. RULES AND RULEMAKING

**4.1 The clearing agency's rules are designed to govern all aspects of the settlement services offered by the clearing agency, and (a) are not inconsistent with securities legislation, (b) do not permit unreasonable discrimination among participants, and (c) do not impose any burden on competition that is not necessary or appropriate.**

CMECE maintains a set of written rules, procedures and Contract Modules (together 'the Rules') which are all available on an unrestricted basis to the public, on the website ([www.cmececlearingeuropa.com](http://www.cmececlearingeuropa.com)).

The Rules were reviewed by the FSA at the time of application for Recognised Clearing House status. Each change to the Rules has to be notified to the FSA as part of the ongoing Recognition Requirements (see REC 3.26 'Proposals to make regulatory provision'. The definition of regulatory provision in this context means any "rule, guidance, arrangements, policy or practice") and any change to the default rules must be pre-notified to the FSA, who will then have 14 days in which to approve them (UK Companies Act 1989<sup>11</sup> s157).

The Rules are not inconsistent with applicable derivatives legislation. CMECE Rules apply equally to all Clearing Members (CMECE currently only has one category of Clearing Member). The Rules do not unreasonably discriminate against any category of Clearing Member and do not impose unnecessary or inappropriate burdens on competition.

**4.2 The clearing agency's rules and the process for adopting new rules or amending existing rules should be transparent to participants and the general public.**

If CMECE determines<sup>12</sup> that it is necessary or beneficial to adopt new Rules or amend existing Rules then these are first drafted by legal counsel (who will ensure all proposed amendments are consistent with relevant legislation), and reviewed and approved by CMECE staff<sup>13</sup> and management (the CEO or COO).

CMECE's Rules are transparent and are available to participants and the general public on our website. Chapter 2 of the Rules (specifically 2.2) states how the Rules may be adopted or amended. CMECE will generally amend the Rules by issuing a Notice setting out the text of the proposed changes and a brief explanation. There will then follow a consultation period, during which time Clearing Members are invited to submit comments in writing within a specified deadline (the consultation period will normally be four weeks, although CMECE may specify a longer or shorter period, depending on the nature and complexity of the proposed changes). However, CMECE will not be required to consult on any amendments which are minor changes of an administrative or commercial character, are considered to be necessary to ensure compliance with the Applicable Laws or a requirement of a Regulatory Authority, are considered to be necessary as a result of an event of default or force majeure event, or are otherwise considered to be necessary for the purpose of mitigating a significant risk to the CMECE.

Under Article 2.2.3, CMECE may consult on a proposed amendment to the Rules with only a limited number of Clearing Members if it considers it appropriate to do so – including where a proposed amendment will affect a limited number of Clearing Members or is a limited technical amendment.

After the consultation period, legal counsel will review the comments received from Clearing Members and, as far as possible, reflect them in the re-drafting. If necessary (depending on the extensiveness of the comments received and the extent to which the comments are aligned), a further round of consultation may take place, or there may be bilateral discussions with those who have provided comments to the consultation. Rule amendments will again be reviewed and approved by CMECE staff and management. Recommendations for amendments then go to the Board for approval (and the Risk Committee, if the change concerns risk management). The final Rule changes will then be confirmed by publication of a Confirmation Notice, which will set out the finalised Rules and the implementation date.

As noted in 4.1, the FSA must be notified of all changes to the Rules. In addition, REC 2.14 covers Rules and Consultation. In particular, REC 2.14.2 states that:

- (1) The [UK RCH] must ensure that appropriate procedures are adopted for it to make rules, for keeping its rules under review and for amending them.
- (2) The procedures must include procedures for consulting users of the [UK RCH's] facilities in appropriate cases.

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11 <http://www.legislation.gov.uk/ukpga/1989/40/part/VII>

12 This may be on CMECE's own initiative, or based on feedback from Clearing Member(s) or other stakeholders.

13 Depending on the nature of the change, this may be any of the following: the Regulatory Compliance Officer, the Head of Risk and Membership, the Head of Operations, IT and Client Support and/or the Head of Banking and Settlement.

- (3) The [UK RCH] must consult users of its facilities on any arrangements it proposes to make for dealing with penalty income in accordance with paragraph 22(3) ... (or on any changes it proposes to make to those arrangements).

#### **4.3 The clearing agency monitors participant activities to ensure compliance with the rules.**

The detection and assessment of any non-compliance with the relevant CMECE Rules by Clearing Members is the responsibility of CMECE's personnel in Risk and Membership, Operations, IT and Client Support, and Banking and Settlement, supplemented in certain cases by the CME Market Regulation Department and the CME Audit and Membership Department. All cases of non-compliance will be reported to the COO, the CEO, and to the Regulatory Compliance Officer. CMECE will decide whether to conduct a formal investigation or disciplinary proceeding on the basis of the factual record and the gravity of the non-compliance.

The CMECE Risk and Membership Department is responsible for verifying, on an ongoing basis, the compliance of Clearing Members with the CMECE admission and eligibility standards and monitoring compliance with the CMECE Rules. Clearing Members are required to submit audited financial statements, which must demonstrate compliance with CMECE's minimum capital requirements.

In addition, Clearing Rule 3.4.2 allows CMECE to at any time request information to which it is entitled under the Rules from a Regulatory Authority and to disclose it to any of its Affiliates, Settlement Bank or Custodian to the extent necessary for them to provide their services to CMECE. To the extent such information is confidential, CMECE shall use its reasonable endeavours to ensure that any person receiving such information will keep that information confidential.

The Membership Procedures (contained within the Clearing Procedures) section 7 and 8 states the following:

- Section 7.1 states that Clearing Members authorised and supervised by a Regulatory Authority for financial services must submit any and all financial reports that are required to be filed with such Regulatory Authority to CMECE, unless CMECE is able to obtain them directly from such Regulatory Authority.
- Section 7.2 states that Clearing Members not regulated by a Regulatory Authority for financial services must submit monthly unaudited financial reports in a form acceptable to the Clearing House.
- Section 7.3 states that the financial reports must demonstrate compliance with the Clearing House's minimum capital requirements, demonstrate a Total Risk-Based Capital Ratio of 10% (if applicable) and be stated in the currency in which the Clearing Member is legally required to produce its audited financial reports.

Clearing Members are also required to submit audited financial statements as of their financial year-end, unless CMECE is able to obtain them directly from their Regulatory Authority.

The audited financial statements of Clearing Members must include at a minimum the following (or the equivalent in any jurisdiction to the extent applicable):

- external auditor's opinion letter;
- statement of financial condition;
- statement of income (loss);
- statement of cash flows;
- statement of changes in ownership equity; and
- appropriate footnote disclosures.

The Risk and Membership Department will review these financial statements for such compliance.

The CMECE Rules permit CMECE to conduct audits on each Clearing Member's compliance with the CMECE Rules. Clearing Members are required to provide such information, books and records as CMECE may request and to cooperate with CMECE in its audit.

In addition to the financial statements, section 3.5 of the Clearing Rules (Notification Requirements) states that each Clearing Member shall notify CMECE in writing immediately in the event of any of the following:

- a) it ceases to be able to satisfy any of the Membership Criteria or reasonably believes it may cease to be able to do so;
- b) any material changes are made to the information previously provided to the Clearing House including that relating to its Nominee and Transaction Manager;
- c) the Clearing Member is notified that a Regulatory Authority shall investigate any of its affairs or those of any of its Parent Undertakings or Guarantors which is material in terms of the overall size of its group or take disciplinary or other formal action against it or a Parent Undertaking or Guarantor or the Clearing Member has reason to believe that a Regulatory Authority is considering the same; or
- d) of anything relating to the Clearing Member of which the Clearing House would reasonably expect notice.

Further, each Clearing Member is required (under 3.5.2) to give CMECE prompt prior written notice of any material change in its form or organisation, ownership structure, or business operations, including (but not limited to) a merger or the sale of a significant part of the business.

Clearing Rule 3.5.3 states that the Clearing House shall be entitled to require each Clearing Member to provide it with a report on its large positions, as and when requested.

Clearing Rule 3.5.5 states that each Clearing Member shall furnish to the Clearing House such documents in a timely manner with respect to any of the foregoing events as the Clearing House may from time to time require.

Under Clearing Rule 3.8.1, in order to protect the integrity of its clearing arrangements or to avoid the introduction of uncertainty, volatility or risk into the financial markets, CMECE may take certain actions, including (but not limited to) requiring a Clearing Member to increase its capital, deposit additional collateral, decrease the size or volume of its contracts or to not enter into any new contracts.

If a Clearing Member is not compliant with the Rules, then CMECE may suspend a Clearing Member or terminate their membership.

As stated above, the CMECE Risk and Membership Department is responsible for verifying, on an ongoing basis, the compliance of Clearing Members with the CMECE admission and eligibility standards and monitoring compliance with the CMECE Rules. In some instances, non-compliance with the Clearing Rules may be identified as the result of a complaint received by CMECE. The details of CMECE's complaints process is set out in Chapter 9 of the Clearing Rules (Complaints).

All complaints must be made and dealt with in accordance with the Complaints Procedures (which form part of the Clearing Procedures). If a Clearing Member complaint alleges a breach of the Rules, CMECE will commence an investigation and may commence disciplinary proceedings in accordance with the Rules. CMECE will notify a Clearing Member that makes a complaint of the steps it has taken to review such complaint and the outcome. CMECE may provide details to a Regulatory Authority about any complaint which it considers requires investigation (and about any outcome of an investigation or disciplinary proceeding).

The Rules set out the process that CMECE will follow in order to investigate breaches of the Rules and provide that a Clearing Member shall cooperate fully with any investigation irrespective of whether they are the subject of or otherwise involved in the investigation. The Rules require each Clearing Member to provide any information requested within set timescales, allow CMECE to access their business premises, attend meetings with CMECE, produce or give CMECE reasonable access to documents, records, files, tapes and computer systems and to print information from such systems.

If CMECE considers that a complaint, matter or concern requires investigation, it will issue an Investigation Notice to the Clearing Member concerned, which will set out a brief description of the matter under investigation. Once CMECE has carried out the investigation it shall send a preliminary letter to the relevant Clearing Member that describes its preliminary factual conclusions and the action it proposes to take in the light of such breach. CMECE will also invite the Clearing Member to either attend a meeting or to send written comments, to correct any factual error that it reasonably considers has been made in the preliminary letter. CMECE will then finalise its initial findings and present them in writing to the Clearing Member. CMECE may then exercise one or more of the following powers: decide that no further action should be taken, issue a private written warning to the Clearing Member(s), instigate disciplinary proceedings (see section 4.4 below), carry out further enquiries, or refer all or a portion of the investigation to a Regulatory Authority. The Clearing House shall notify the Clearing Member(s) in writing of the power to be exercised.

#### **4.4 The rules set out appropriate sanctions in the event of non-compliance by participants.**

CMECE has adequate arrangements to monitor and enforce compliance with the CMECE Rules, and to resolve disputes among Clearing Members, and will have the authority and ability to discipline, limit, and suspend a Clearing Member for violations of the CMECE Rules.

The Clearing Rules Chapter 9 (Complaints and Enforcement) set out the detail of the sanctions available to CMECE in the event of non-compliance by participants. The disciplinary procedures have two stages – investigations (set out in section 4.3 of this letter) and disciplinary proceedings (set out below) – and the powers available to CMECE in respect of each reflect the magnitude of the breach of the CMECE Rules. If CMECE believes a breach to be particularly serious, CMECE need not undertake an investigation before launching Disciplinary Proceedings (for example, if we have incontrovertible evidence of a criminal offence, we would wish to have the ability to institute disciplinary proceedings before further investigation).

The Clearing House will commence the disciplinary proceedings set out in Rule 9.4 only when it is reasonably satisfied that the Clearing Member has breached the Rules, whether as a result of an investigation or otherwise. CMECE may decide at any time to terminate the disciplinary proceedings or to reach a settlement.

Article 9.4.3 of the Rules states that, for the purposes of each disciplinary proceeding, the Board will nominate members to form a disciplinary panel. Each Disciplinary Panel shall consist of a chairman sitting with two other persons (who may be market practitioners, experts, lawyers or other suitable persons). The Rule prevents any person from sitting on the panel if they are conflicted (such as employees or directors of CMECE or the Clearing Member subject to disciplinary proceedings). The Clearing Member alleged to have committed the breach has the opportunity to object to any particular appointment to the disciplinary panel.

Article 9.4.7 of the Rules states that, to commence the Disciplinary Proceedings the Clearing House shall send to the Clearing Member concerned a written notice (the Disciplinary Notice), which contains details of the alleged breach of the Rules and sufficient information to enable the Clearing Member to understand and respond to such allegations. The Clearing Member then has 20 Business Days if they wish to provide a statement of defence, which should outline the plea that they intend to make and any admissions of fact.

Article 9.4.14 of the Rules states that the Disciplinary Panel shall apply the civil standard of proof on the balance of probabilities, with the cogency of evidence required being commensurate with the seriousness of the alleged breach.

Article 9.4.16 of the Rules states that the Disciplinary Panel shall communicate in writing its findings and particulars of any sanction determined to the Clearing House and to the Clearing Member concerned. Such findings and sanctions shall be deemed conclusive and binding upon expiry of the time permitted for appeal or receipt by the Clearing House of any earlier written notice from the Clearing Member that such right of appeal will not be exercised. Subject to Rule 9.4.17(b), such findings and sanctions shall not be made public.

Article 9.4.17 of the Rules states that the Disciplinary Panel may impose one or more of the following sanctions:

- a) issue a private written warning to the Clearing Member;
- b) issue of a public notice of censure;
- c) impose a fine of any amount;
- d) require the disgorgement of any gain made by the Clearing Member or its Representatives in connection with the breach of the Rules;
- e) recommend to the Clearing House to suspend or terminate the membership of the Clearing Member with immediate effect; or
- f) issue an order requiring the Clearing Member to take such steps including making an order for compensation, as the Disciplinary Panel may direct, to remedy the situation caused by the breach of the Rules.

Article 9.4.18 of the Rules states that the Disciplinary Panel has discretion as to the appropriate sanction in each case and such differentiation may take into account factors including whether the breach was deliberate or negligent, the seriousness of the consequences and whether the Clearing Member has since taken action to remedy the breach or prevent a recurrence.

Section 9.5 of the Rules set out CMECE's Appeals Process. For further detail please see section 5.5 of this application letter (below).

The FSA requires RCH's to have appropriate sanctions in REC 2.15 – most notably 2.15.2 which states:

- (1) The [UK RCH] must have effective arrangements for monitoring and enforcing compliance with its rules.
- (2) The arrangements must include procedures for -



- (a) investigating complaints made to the [UK RCH] about the conduct of persons in the course of using the [UK RCH's] facilities; and
  - (b) the fair, independent and impartial resolution of appeals against decisions of the [UK RCH].
- (3) Where the arrangements include provision for requiring the payment of financial penalties, they must include arrangements for ensuring that any amount so paid is applied only in one or more of the following ways -
- (a) towards meeting expenses incurred by the [UK RCH ] in the course of the investigation of the breach in respect of which the penalty is paid, or in the course of any appeal against the decision of the [ UK RCH] in relation to that breach;
  - (b) for the benefit of users of the [UK RCH's] facilities;
  - (c) for charitable purposes.

REC 3.20 (Disciplinary action relating to members') requires that where a RCH has taken any disciplinary action against any member or any employee of a member, in respect of a breach of a rule, it must immediately notify the FSA of that event, and give: the name of the person concerned; details of the disciplinary action taken by the UK recognised body; and the RCH's reasons for taking that disciplinary action. Where an appeal is lodged against any disciplinary action, the RCH must immediately give the FSA notice of that event, and the name of the appellant, the grounds on which the appeal is based and the outcome of the appeal (when known).

## 5. DUE PROCESS

**5.1 For any decision made by the clearing agency that affects an applicant or a participant, including a decision in relation to access, the clearing agency ensures that:**

- (a) **an applicant or a participant is given an opportunity to be heard or make representations; and**
- (b) **the clearing agency keeps a record of, gives reasons for, and provides for appeals or reviews of, its decisions.**

*Applicants* – As described in section 3.1, the Risk Committee will decide whether to recommend that the Board accepts the applicant as a Clearing Member and communicate this to the Board. This will then be confirmed by the Board and CMECE will report this to the new Clearing Member and CME Audit & Membership Department as necessary.

An applicant that is not accepted shall have 10 Business Days from notification of such result to file an appeal to the Board of CMECE. The Board may have to re-examine the Risk Committee's recommendation and its own decision if it is satisfied that either were arbitrary, capricious or an abuse of discretion. Clearing Members do not have an explicit right to appeal to a regulatory authority. Such a right would be inappropriate as it should ultimately be up to the Clearing House to determine whether an applicant fulfils its criteria. The FSA would be able to take action if it felt that CMECE's overall membership criteria or rules were unfair or discriminatory. It should be noted that it would be counter to CMECE's interests to reject a Clearing Member's application on spurious grounds.

*Participants* – the Clearing Rules (section 9.5) set out the Appeals process, whereby Clearing Members can appeal a decision made by CMECE in respect of a breach of the Rules by the Clearing Member. Specifically, Clearing Rule 9.5.1 states that within 10 Business Days of receiving notice in writing of a decision of a Disciplinary Panel, or a notice of sanction (whichever is the later), a Clearing Member (whether current or former in the case of expulsion) or the Clearing House, or both, may appeal to the appeals body (the Appeals Body) by lodging with the Clearing House a notice of appeal in writing and by delivering a copy thereof to any other party to the Disciplinary Proceedings. The Clearing House shall refer the appeal to the Appeals Body within 10 Business Days of receipt of the appeal.

According to 9.5.2 of the Clearing Rules, a notice of appeal shall set out the grounds of the appeal and shall contain a brief statement of all matters relied on by the appellant. The grounds of the appeal may be any one or more of the following:

- a) the Disciplinary Panel's decision was: (i) arbitrary, capricious, or an abuse of its discretion; or (ii) based on a clearly erroneous application or interpretation of the Rules; or
- b) the sanction imposed by the Disciplinary Panel was excessive or, in the case of an appeal by the Clearing House, was insufficient or inappropriate.

Clearing Rule 9.5.3 states that in the case of appeal against a sanction, the Appeals Body may affirm, vary or revoke the sanction. The Appeals Body may make such order or give such direction as it considers fit including a direction for a rehearing of the case by another newly constituted Disciplinary Panel.

Clearing Rule 9.5.4 specifies that the Appeals Body shall consist of one or more than one persons who shall be nominated for the purposes of this Rule 9.5.4 by the Centre for Effective Dispute Resolution<sup>14</sup> in London. Such person shall:

- a) be independent of the Clearing House, meaning for the purposes of these Rules, that such person is not and has not ever been an officer, director or employee of the Clearing House or an Affiliate;
- b) have appropriate experience of the clearing market and normal clearing operations; and,
- c) have appropriate knowledge of the Clearing House, the Rules and relevant Applicable Law.

Clearing Rule 9.5.5 states that an Appeals Body may adopt such procedure as it thinks fit and just, including, without limitation, the procedures described in Rule 9.4.13 and shall notify the Clearing Member accordingly. The Appeals Body shall be bound by Rule 9.4.14. The appellant and the respondent shall be entitled to appear, make representations and (subject to any restriction on adducing new evidence), call witnesses, who may be examined and cross-examined at any hearing, which will not be held in public.

Clearing Rule 9.5.6 states that the decision of an Appeals Body shall be final and binding and there shall be no further appeal. The decision shall be supported with reasons and shall be notified to the appellant and respondent in writing without undue delay. The decision of an Appeals Body shall not be made public unless otherwise agreed between the appellant and the respondent.

Clearing Rule 9.6.1 states that the proceeds of any fine imposed by the Clearing House shall be used for the following purposes only:

- a) to meet expenses incurred by the Clearing House in the course of the Investigation, Disciplinary Proceeding or appeal from a Disciplinary Proceeding in respect of which it has been imposed;
- b) for the benefit of the Clearing Members generally; or,
- c) for charitable purposes.

In addition to the formal process described above, Clearing Members will have access to the executive of CMECE to discuss any issues. The Regulatory Compliance Officer will maintain correspondence with Clearing Members (including any requests for information, disciplinary actions etc.) in its original hard copy format on-site for a minimum of one year. The CME Audit and Membership Department will also maintain an electronic database of all disciplinary actions and Clearing Member correspondence.

## **6. RISK MANAGEMENT**

### **6.1 The clearing agency's settlement services are designed to minimize systemic risk.**

Through the collection of Margin under its Risk Management Procedures (which form one chapter of CMECE's Clearing Procedures) and the maintenance of the Guarantee Fund (including CMECE's commitment to the Guarantee Fund), CMECE will possess financial resources that, at a minimum, exceed the total amount that would enable CMECE to meet its financial obligations to its Clearing Members, notwithstanding a default by the Clearing Member creating the largest financial exposure for CMECE in extreme but plausible market conditions. The adequacy of CMECE's default resources are stress tested on a daily basis.

Further information can be found in the OTC Commodity Derivatives Guide available on our website.

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<sup>14</sup> The Centre for Effective Dispute Resolution (CEDR) is an independent, non-profit organisation with a mission to cut the cost of conflict and create choice and capability in dispute prevention and resolution. The CEDR set the standard for dispute resolution and conflict management with their mediation, consultancy and training services. CEDR Solve is the largest independent alternative dispute resolution body in Europe, has access to over 5000 mediators and neutrals worldwide.

*Margin and Variation Requirements*

CMECE manages its counterparty and market risk by margining each Clearing Member's contracts on a daily and intra-day basis according to the Risk Management Procedures. Risk is further mitigated through CMECE's payment to and collection from Clearing Members of profits and losses determined through the variation settlement process.

The CME SPAN model is used to calculate a Clearing Member's "Margin Requirement" for OTC commodity derivatives. The CME SPAN model simulates the effects of changing market conditions and uses tailored options pricing models to determine a portfolio's overall risk. CME SPAN constructs scenarios of price and volatility changes to estimate the potential loss arising if an entire portfolio must be closed out over a one-day time horizon. The resulting Margin Requirement is designed to cover this potential loss at a 99% confidence level.

The Margin Requirement forms part of the collateral required by CMECE in respect of each contract. It is calculated in a different way (net or gross basis) in respect of each type of account (House Account, Non-Segregated Client Account or Segregated Client Account).

CMECE calculates the "Variation Requirement" for contracts at least twice daily. The Variation Requirement consists of a mark-to-market revaluation of contracts based on current market prices. CMECE uses the Margin Requirement and the Variation Requirement to calculate the "Net Settlement Amount" for the settlement cycle.

*Guarantee Fund*

CMECE maintains a Guarantee Fund, which is an important element of the financial safeguards for the protection of CMECE and the Clearing Members. CMECE will maintain the Guarantee Fund in accordance with the Guarantee Fund Procedures (which form a chapter in the Clearing procedures).

After the initial phase<sup>15</sup> of CMECE's clearing operations, the Guarantee Fund for OTC commodity derivatives will comprise Guarantee Fund contributions from Clearing Members and a contribution by CMECE of at least US\$20 million. Each Clearing Member will be required to contribute the higher of US\$2.5 million or its pro rata portion of the total Guarantee Fund, based on its proportion of the average daily margin requirement for all Clearing Members in the previous quarter, weighted to a factor of 85% and its proportion of gross volume in the previous quarter, weighted to a factor of 15%.

However, during the initial phase, CMECE's contribution to the Guarantee Fund is US\$60 million, and during this phase CMECE will not require Clearing Members to make a contribution to the Guarantee Fund, except in certain circumstances (see section 3.1 above).

In the event that the Guarantee Fund is depleted in the course of handling a Clearing Member default, CMECE currently has an assessment power against non-defaulting Clearing Members for 275% of the original Guarantee Fund contribution of the Clearing Members with respect to the Guarantee Fund. In the course of the depletion of some of the Guarantee Fund during default management, CMECE would require Clearing Members to replenish their contributions (Rule 8.5.2).

However, please note that CMECE has recently proposed changes in order to address concerns that there is currently no aggregate maximum for cascading defaults over a short period of time.

The proposed changes (which are – at the date of this letter – still subject to FSA approval and consultation with Clearing Members and therefore subject to change) state that following a Declaration of Default, the Clearing House shall re-assess the Guarantee Fund and each non-defaulting Clearing Member's Contribution. If the Clearing House applies all or part of the Contributions of the non-defaulting Clearing Members, each non-defaulting Clearing Member shall provide such replenishment amount to the Clearing House as notified and requested by the Clearing House to ensure that such non-defaulting Clearing Member's Contribution deposited with the Clearing House is maintained at the same level as required prior to the issue of the first Declaration of Default in the relevant Cooling Off Period, save that during a Cooling Off Period, the replenished Contribution provided by each non-defaulting Clearing Member to the Clearing House shall not exceed a total of 550% of its Contribution to the Guarantee Fund as at the date on which the first Declaration of Default in the relevant Cooling Off Period was issued. Subject to the 550% maximum, a non-defaulting Clearing Member may be required to deposit further amounts more than once during a Cooling Off Period. The Clearing House shall use such amounts in accordance with the rule set out below (Proposed new Rule 8.6.1).

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<sup>15</sup> The initial phase was originally intended to be the first year following CMECE's launch. However, this has now been extended until further notice.

If there remains an unsatisfied obligation after the Clearing House has used in full the contributions set out in Rules 8.5.1(a) and 8.5.1(b)<sup>16</sup>, the Clearing House shall have a right to use the replenished Contribution received from each non-defaulting Clearing Member pursuant to Rule 8.6.1 provided that:

- a) if there is only one Declaration of Default during the relevant Cooling Off Period, the Clearing House may use a total of 275% of each non-defaulted Clearing Member's Contribution to the Guarantee Fund as determined at the date on which such Declaration of Default in the relevant Cooling Off Period was issued; and
- b) if there is more than one Declaration of Default during the relevant Cooling Off Period, the Clearing House may use a total of 550% of each non-defaulting Clearing Member's Contribution to the Guarantee Fund as determined at the date on which the first Declaration of Default in the relevant Cooling Off Period was issued (proposed new Rule 8.6.2).

Each non-defaulting Clearing Member is required to provide the amount as required pursuant to (proposed new) Rule 8.6.1 to the Clearing House within one (1) hour of notification of such amount if notification is received during the hours when CHAPS is open and otherwise, within one hour of the time at which the CHAPS first opens after such notification. The Clearing Member agrees that the Clearing House may debit such amount from its Bank Account. With respect to assessments pursuant to (proposed new) Rule 8.6.1, the Clearing House shall use its reasonable endeavours to notify non-defaulting Clearing Members and provide estimates of the amounts required in advance of any formal notifications.

After the Cooling Off Period, each non-defaulting Clearing Member's Contribution will be assessed pursuant to the Clearing House's assessment methodology. The Clearing House shall notify each Clearing Member of the new amount of Contribution.

#### *Eligible Collateral*

Clearing Members are required to make their Guarantee Fund contributions and Margin deposits in Eligible Collateral, which comprises Eligible Securities<sup>17</sup> and Eligible Cash<sup>18</sup> (please note that we are currently consulting on changes to the Clearing Rules which will – subject to regulatory approval by FSA – enable us to also accept gold as collateral, which would be deemed Eligible Commodities). The list of Eligible Collateral is made available to Clearing Members on our website.

From time to time, CMECE will wish to add securities as Eligible Collateral (this would generally be on the initiative of the Head of Banking and Settlement or the Head of Risk and Membership and may be the result of requests from Clearing Members). Proposals to accept new securities as Eligible Collateral will need to be approved by the Risk Committee and Board. If the proposal is for a completely new type of Eligible Collateral (i.e. a new asset class, such as precious metal), then CMECE will also require approval from the FSA. We plan to accept Canadian government bonds and Canadian dollars as Eligible Collateral in future, although there are currently no fixed timescale or fixed plans to introduce them.

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<sup>16</sup> Clearing Rule 8.5.1 referred to above states that "to the extent that the assets referred to in Rule 8.3.3 (below) are insufficient, the following assets shall be used to satisfy any outstanding amount in the order set out below:

- a) the Clearing House's contribution to the Guarantee Fund;
- b) the Contributions of the non-defaulting Clearing Members to the Guarantee Fund; and
- c) amounts received by the Clearing House pursuant to Rule 8.5.2 (below).

Clearing Rule 8.5.2 referred to above states that "in the event that there remains an unsatisfied obligation, the Clearing House shall have a right to assess each non-defaulting Clearing Member for an amount not exceeding 275% of its Contribution to the Guarantee Fund as at the date on which the Event of Default occurred. Each non-defaulting Clearing Member is required to provide the amount assessed to the Clearing House within one (1) hour of notification of such amount if notification is received during the hours when Clearing House Automated Payment System (CHAPS) is open and otherwise, within one hour of the time at which CHAPS first opens after such notification. The Clearing House shall use its reasonable endeavours to notify Clearing Members and provide an estimate of the amount required in advance of the formal notification".

Clearing Rule 8.3.3 referred to above states that "the sum produced pursuant to Rule 8.3.1 (below) will, if due from the Defaulting Clearing Member, be set off against the following assets in the following order or, if due to the Defaulting Clearing Member, be aggregated with the following assets:

- a) the Defaulting Clearing Member's Collateral; and
- b) the Defaulting Clearing Member's Contribution to the Guarantee Fund."

Clearing Rule 8.3.1 referred to above states that "upon the Clearing House issuing a Declaration of Default, the Clearing House shall seek to discharge all of the Defaulting Clearing Member's rights and liabilities under all of the Affected Contracts, aggregate any obligations for the payment of money, whether present or future, actual or contingent by the Defaulting Clearing Member under such Contracts and the Rules (including any amounts owing to the Clearing House including any costs and expenses arising from the implementation of the Default Rules), aggregate any such obligations to the Defaulting Clearing Member under each Affected Contract and the Rules, and set-off the two aggregated amounts against one another so as to produce a single net sum for the purpose of Rule 8.3.3.(above)".

17 Eligible Securities currently includes: French and German Government Bills, Notes, and Bonds; UK Government Bills and Gilts; and US Treasury Bills, Bonds, and Notes.

18 Eligible Cash currently includes: EUR, GBP, and USD

Haircuts are applied to eligible cash and collateral to ensure that upon liquidation in a time of market stress, cash received would at least equal the value of the collateral.

Appropriate haircuts will be applied to cash only when it is utilised to meet CMECE requirements in other currencies. Appropriate haircuts will be applied to all securities and physical collateral utilised to meet CMECE requirements. FX rates will be taken into account when setting haircuts for securities, to account for the fact that securities may be lodged in currencies other than the currency of the liability. Haircuts will be based on a minimum of the 99% confidence level over 12 months of 1-day moves.

This historical percentile analysis is considered alongside the following other quantitative measures: Extreme Value Theory (EVT), Exponentially Weighted Moving Average (EWMA) and Normal Mixtures.

In addition to using quantitative data from these methodologies, qualitative information is also incorporated into the analysis. An example of qualitative information is a change in market fundamentals pertaining to the collateral that may not yet be reflected in the quantitative information. Additionally, further investigation into the cause of a period of increased volatility may indicate that the indicated level of haircut is not warranted and therefore the haircut may be set at a lower level, but at all times ensuring the 99% confidence level is maintained.

### *Stress Testing*

CMECE runs a comprehensive suite of risk-based stress testing analysis on a daily basis to inform decisions on margin and Guarantee Fund adequacy, determine the need for additional margin requirements, and for general Clearing Member monitoring. CMECE employs three separate stress-testing models to assess potential Clearing Member exposures across all markets, each of which is currently used by CME:

- Largest Net Debtor Stress Testing
- Concentration Margin Stress Testing
- Trend Analysis Stress Testing

### *Default Rules*

CMECE's default rules can be found in chapter 8 of the Clearing Rules and are described in the OTC Commodity Derivatives Guide.

CMECE's default rules, supported by the provisions of English law under amendments to Part VII of the UK Companies Act 1989, permit CMECE to apply any surplus assets (a net sum under terms used in the legislation and in the default rules) available after it has finalised the default management of a defaulter's house account positions to meet any shortfall in relation to the defaulting Clearing Member's Client account positions. CMECE is not permitted to apply a net sum related to the CMECE Segregated Client Account of a defaulting Clearing Member to cover a shortfall in the defaulting Clearing Member's house account. In that context, Client accounts have a priority over house accounts.

CMECE is able to use the Guarantee Fund (including the contribution from CME Group and contributions of non-defaulting Clearing Members) to cover shortfalls in relation to a defaulting Clearing Member's Client accounts, house account, or both.

## **6.2 The clearing agency has appropriate risk management policies and procedures and internal controls in place.**

CMECE has set up a number of processes and internal management practices to ensure the proper operation of the clearing house. The risk department has a number of internal policies in place which are all considered and approved by the Risk Committee.

In addition, CMECE's Clearing Procedures contain procedures relating to membership, risk management and the Guarantee Fund. These are available on the CMECE website.

The Risk and Membership department reports directly to the COO, who is a member of the Board. In addition, the Head of Risk and Membership reports in to the Chairman of the Risk Committee. Ongoing monitoring of the Risk and Membership department's policies and procedures is undertaken by the Regulatory Compliance Officer (as part of the Compliance Monitoring Programme) and the internal auditor.

The staff working in the risk and membership team are required to have sufficient qualifications, skills and experience to perform their roles: the amount of which will obviously depend on the level of the role and the responsibilities undertaken. The specific requirements will be stated in job descriptions and verification of the skills necessary will form part of the interview and selection process. There is no formal written requirement regarding the skills or experience of members of the Risk Committee, although

it is to Clearing Members advantage to nominate a representative with sufficient ability, qualifications and aptitude. The biographies of nominated representatives to the Risk Committee are supplied to CMECE and reviewed by the Chairman of the Risk Committee and the Head of Risk and Membership prior to appointment to the Risk Committee.

**6.3 Without limiting the generality of the foregoing, the clearing agency's services or functions are designed to achieve the following objectives:**

**1. Where the clearing agency acts as a central counterparty, it rigorously controls the risks it assumes.**

CMECE acts as a central counterparty (CCP) and it rigorously controls the risk it assumes: this is achieved by having an experienced, dedicated risk management team in the UK, which is able to also draw on the resources of the CME Risk Management department. The policies and procedures are put in place to ensure consistency and transparency: these are approved by the Risk Committee, the Board and filed with (and subject to review and comment by) the FSA.

As described above, CMECE has in place financial safeguards to ensure the integrity of the marketplace and the contracts it clears. The activities of CMECE are designed and focused on ensuring that it maintains best practices and fulfils its public interest mandate.

**2. The clearing agency minimizes principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.**

CMECE minimises principal risk by waiting for confirmation of the movement of cash (or securities) from Clearing Members before we release the corresponding securities (or cash).

**3. Final settlement occurs no later than the end of the settlement day. Intraday or real-time finality is provided where necessary to reduce risks.**

As stated in the Risk Management Procedures (which form a chapter of the Clearing procedures), CMECE operates two settlement cycles each day and may require the Clearing Member to transfer Collateral to it or make payment to the Clearing Member at the end of each settlement cycle in satisfaction of a Net Settlement Amount. However, for certain Transactions, the clearing house may, in practice, only require the Clearing Member to transfer Collateral or make payment to the Clearing Member at the end of one settlement cycle each day. Collection from Clearing Members must be made prior to 9:00am for the previous end of day settlement cycle or within two hours of the intraday settlement cycle (if required).

The Variation Requirement consists of a periodic mark-to-market or revaluation of contracts and the determination of any final settlement amounts. The Variation Requirement also takes account of other amounts payable under the contracts relating to an Account such as premiums. Under volatile market conditions, the clearing house will conduct additional Variation Requirement calculations.

To calculate the intra-day Variation Requirement, the Clearing House uses current market prices and applies them to the position data submitted by Clearing Members prior to the relevant time set out on the Website on that Business Day. For the end-of-day Variation Requirement, the Clearing House uses final settlement prices and applies them to the position data submitted by Clearing Members prior to the relevant time set out on the Website.

The Clearing House uses the Margin Requirement and the Variation Requirement to calculate the Net Settlement Amount for the settlement cycle. The Net Settlement Amount for each Clearing Member is reported to the Clearing Member at the end of each settlement cycle.

**4. Where the clearing agency extends intraday credit to participants, including a clearing agency that operates net settlement systems, it institutes risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle.**

In order to ensure we have adequate liquidity each day for required payments and settlements, CMECE invests in rolling overnight repos, which provides us with a daily pool of liquidity from which to manage outgoing payments. This policy means that we only re-invest any cash which is not required to manage liquidity.

**5. Assets used to settle the ultimate payment obligations arising from securities transactions carry little or no credit or liquidity risk. If central bank money is not used, steps are to be taken to protect participants in settlement services from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.**

Where the Net Settlement Amount is payable to the clearing house, it shall be provided in the form of Eligible Cash. The Clearing Member may subsequently substitute part or all of such Collateral with an amount of Eligible Securities which is of an equivalent value as at the date of the substitution.

All of our acceptable collateral is of very high quality and is very liquid. However, in order to account for potential credit or liquidity risk, haircuts from current market value are applied when recognising the value of Eligible Collateral. According to internal CMECE policy, haircuts will be based on a minimum of the 99% confidence level over 12 months of 1-day moves. The haircuts are established and reviewed based on volatility using several VaR methodologies and historical observations for varying periods of time and confidence intervals. In addition to using the quantitative data from these methodologies, qualitative information is also incorporated into the analysis.

**6. If the clearing agency establishes links to settle cross-border trades, it designs and operates such links to reduce effectively the risks associated with cross-border settlements.**

CMECE does not have any such links. Were it to establish one or more in the future, it would focus on ensuring that the legal structure and general risk management of the linkage or linkages was such as to reduce residual risks to a minimum.

**6.4 The clearing agency engaging in activities not related to settlement services carries on such activities in a manner that prevents the spillover of risk to the clearing agency that might affect its financial viability or negatively impact any of the participants in the settlement service.**

CMECE does not at the current time engage in any activities other than that of a clearing house for OTC commodity derivatives.

**7. SYSTEMS AND TECHNOLOGY**

**7.1 For its settlement services systems, the clearing agency:**

- (a) develops and maintains,**
  - (i) reasonable business continuity and disaster recovery plans,**
  - (ii) an adequate system of internal control,**
  - (iii) adequate information technology general controls, including controls relating to information systems operations, information security, change management, problem management, network support, and system software support;**

CMECE uses information technology (IT) systems provided and supported by CME at all levels of its operations, including those key to the daily processing and risk assessment of a clearing house. The core systems standards and procedures that underpin performance and resilience are those established and reviewed by CME. CMECE's separate internal audit function, which will draw on IT audit experts from an external auditor, will rely on CME Group Internal Audit work<sup>19</sup> or undertake complementary work, as appropriate.

The CME Clearing IT Department includes a dedicated Quality Assurance Team responsible for manual and automated testing of all clearing systems. The team provides test coverage for each of the systems described above. It has developed a large suite of regression test cases that cover all existing functionality and continues to add new test cases to cover new functionality added to the various systems. It executes various types of tests, including testing individual systems in isolation as well as end-to-end integration tests that exercise the functions of the clearing systems.

In addition, the CME Clearing IT Department includes a dedicated performance and reliability testing team responsible for executing tests that stress the clearing systems with large numbers of transactions to ensure that the systems are sized to support at least twice the last known transaction volume peak. Additional hardware will be added as necessary to meet increasing transaction volumes. The Quality Assurance Team also executes tests that simulate various types of system failure and ensures that these scenarios are handled predictably and can be recovered with no impact on data integrity.

CMECE has defined business-critical IT systems with appropriate redundancy, including immediate recovery time objectives for core components and up to four hours recovery for certain ancillary systems. In practice, the business could withstand a system outage of up to eight hours.

The CMECE Operations, IT and Client Support Team are responsible for overall monitoring of the operation of the CMECE IT systems and the provision of IT services by CME. Monitoring will include system performance, availability, and integrity of the relevant systems. The Operations, IT and Client Support Team will in turn report to the CEO and the Board pursuant to the

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<sup>19</sup> The CME Internal Audit Department performs systems reviews on an annual basis as part of the CME Group Sarbanes-Oxley (SOX) program and also as part of the Internal Audit risk based audit plan. The CMECE IT systems will be reviewed by CME Internal Audit at the same time that it carries out its review of the CME systems, with a separate report for the CMECE systems provided and reported to the relevant departments / the Board of CMECE.

CMECE internal reporting line structure. Monitoring of IT system performance also takes place within CME with reporting lines to the CMECE Operations, IT and Client Support Team.

CME and CMECE have both implemented disaster recovery plans in the event of a failure of their systems. While these plans are designed to ensure that business operations can continue in the event of a wide range of disaster situations, IT failure is at their core. Since most of the IT systems are operated by CME on CMECE's behalf, the CME disaster recovery plan is key to CMECE. However, CMECE also has its own disaster recovery plan to set out back-up arrangements for CMECE staff and their connections with the services being provided on an outsourced basis by CME. The CMECE disaster recovery plan is parallel to CME's disaster recovery plan and extensive work has been carried out by CMECE and CME to ensure that the two plans are coordinated and operate effectively together.

To retain its recognition as an RCH, CMECE must comply with REC 2.5 (systems and controls) which requires an RCH to ensure that the systems and controls used in the performance of its relevant functions are adequate and appropriate for the scale and nature of its business. The relevant REC guidance on information technology systems set out in REC chapter 2.5, specifically 2.5.18 and 2.5.19:

**REC 2.5.18**

Information technology is likely to be a major component of the systems and controls used by any UK recognised body. In assessing the adequacy of the information technology used by a UK recognised body to perform or support its relevant functions, the FSA may have regard to:

- (1) the organisation, management and resources of the information technology department within the UK recognised body;
- (2) the arrangements for controlling and documenting the design, development, implementation and use of information technology systems; and
- (3) the performance, capacity and reliability of information technology systems.

**REC 2.5.19**

The FSA may also have regard to the arrangements for maintaining, recording and enforcing technical and operational standards and specifications for information technology systems, including:

- (1) the procedures for the evaluation and selection of information technology systems;
  - (2) the arrangements for testing information technology systems before live operations;
  - (3) the procedures for problem management and system change;
  - (4) the arrangements to monitor and report system performance, availability and integrity;
  - (5) the arrangements (including spare capacity and access to back-up facilities) made to ensure information technology systems are resilient and not prone to failure;
  - (6) the arrangements made to ensure business continuity in the event that an information technology system does fail;
  - (7) the arrangements made to protect information technology systems from damage, tampering, misuse or unauthorised access; and
  - (8) the arrangements made to ensure the integrity of data forming part of, or being processed through, information technology systems.
- (b) on a reasonably frequent basis, and in any event, at least annually, and in a manner that is consistent with prudent business practice,**
- (i) makes reasonable current and future capacity estimates,**

All automated systems employed by CMECE meet the International Organization of Securities Commissions (IOSCO) Principles for the Oversight of Screen-Based Trading Systems issued in 1990, as supplemented in October 2000, including those involving physical security, environmental controls, network management, capacity, and systems testing.



The CMECE clearing system, a dedicated, separate instance of CME's clearing system, has been configured initially to handle a level of transactions per day that provides significant headroom above the level currently handled by CMECE. The type of product cleared has no impact on system capacity. CMECE believes this is a suitable and prudent capacity for initial activity, with considerable excess capacity, and will be kept under periodic review.

- (ii) **conducts capacity stress tests to determine the ability of those systems to process transactions in an accurate, timely and efficient manner,**

As stated under (i), CMECE will keep capacity under periodic review and will at least annually conduct capacity stress tests to ensure systems are able to process transactions in an accurate, timely and efficient manner.

- (iii) **tests its business continuity and disaster recovery plans; and**

CME Group tests the full capabilities of its Disaster Recovery Clearing systems at least twice a year. CMECE is included in disaster recovery planning and testing.

In the first part of the year it does not test with Clearing Members. For the second test of the year, CME Group carries out a full test of its Disaster Recovery systems with its Clearing Members (the FIA industry test).

In addition, CME Group tests the Business Continuity Planning business plans with participation from all CME Group business units. These tests do not currently include Clearing Members.

CMECE participated in the FSA's market wide exercise in November 2011. The key objective of the MWE programme is to improve UK financial sector preparedness by providing opportunities to test, review and update plans to deal with a range of major operational disruptions; both as individual organisations and as part of the sector, including the Tripartite Authorities (FSA, the Bank of England and HM Treasury).

- (c) **promptly notifies the regulator of any material systems failures.**

It is the duty of the Regulatory Compliance Officer to notify the FSA of any material systems failures. Under REC 3.15, the RCH is required to notify FSA of any suspension of services or inability to operate facilities. In addition, REC 3.16 requires that:

3.16.2 Where a UK recognised body changes any of its plans for action in the event of a failure of any of its information technology systems resulting in disruption to the operation of its facilities, it must immediately give the FSA notice of that event, and a copy of the new plan.

3.16.3 Where any reserve information technology system of a UK recognised body fails in such a way that, if the main information technology system of that body were also to fail, it would be unable to operate any of its facilities during its normal hours of operation, that body must immediately give the FSA notice of that event, and inform the FSA: (1) what action that UK recognised body is taking to restore the operation of the reserve information technology system; and (2) when it is expected that the operation of that system will be restored.

**7.2 The clearing agency annually engages a qualified party to conduct an independent systems review and prepare a report in accordance with established audit standards regarding its compliance with section 7.1(a).**

*Internal Audit Department*

CMECE Internal Audit and CME Group Internal Audit have established independent assurance functions that report functionally to the Audit Committees of their respective boards. The functions are established with reporting lines that are independent of management and governed by terms of reference duly approved by their Audit Committees and staffed with qualified and credentialed audit personnel.

*Clearing, Technology and Related Processes*

CMECE has implemented formal business processes with a system of internal controls to operate, manage and control CMECE.

*Independent Systems Review*

CMECE Internal Audit performs periodic risk assessments of CMECE business processes and system of internal controls. The scope of this risk assessment includes processes managed and operated internally by CMECE as well as processes performed by CME Group. This risk assessment is used to prepare a schedule of internal audits that are approved by, monitored and reported to CMECE's Audit Committee (comprised of independent non-executive directors). This schedule of internal audits includes coverage of Clearing and Technology services. CME Group Internal Audit conducts independent audits of CME Group

Clearing and Technology processes and prepares reports in accordance with established audit standards and provides these reports to CMECE Internal Audit and CMECE Management. CMECE Internal Audit relies on these audits performed by CME Group Internal Audit to provide adequate risk coverage. CMECE Internal Audit and CMECE Management use these reports to draw independent conclusions about the relevance of results to CMECE.

The audits performed by CMECE Internal Audit and CME Group Internal Audit provide reasonable assurance that processes included in the system of internal controls are designed and operating effectively. Among other areas, these audits examine the integrity, completeness and timeliness of processing as well as the design and operating effectiveness of technology processes. Technology processes audited include among others: Access Controls, Business Continuity Management, Change Management, Database Management, Disaster Recovery Planning, Information Security, Network Management, Systems Configuration, Systems Development, Technology Operations and Quality Assurance.

## **8. FINANCIAL VIABILITY AND REPORTING**

### **8.1 The clearing agency has sufficient financial resources for the proper performance of its functions and to meet its responsibilities and allocates sufficient financial and staff resources to carry out its functions as a clearing agency in a manner that is consistent with any regulatory requirements.**

CMECE has adequate financial and staff resources to carry on its activities in full compliance with its regulatory requirements and with best practices of clearing houses.

#### *Financial resources*

REC 2.3 sets out the recognition requirement regarding financial resources (known as the financial resources requirement (FRR)). In particular, 2.3.2 requires that the RCH must have financial resources sufficient for the proper performance of its relevant functions as a UK RCH. REC 2.3.7 states that the FSA considers that a RCH should have at any time: (1) liquid financial assets (LFA) amounting to at least six months' operating costs; and (2) net capital of at least this amount.

CMECE maintains LFA to meet the FRR: Net Capital Cover (base plus buffer) and LFA ratio over the minimum requirement of 150% – effectively 9 months of wind-down costs.

CMECE's Audit Committee is responsible for ensuring compliance with the financial requirements. CMECE files regular financial information with the FSA (as set out in REC 3.8), including monthly management accounts.

#### *Staff resources*

CMECE participates in a group wide performance management programme on an annual basis to assess the calibre of its talent base and skill set. This performance planning tool aims to capture data and feedback related to individual performance, objectives of the role within CMECE and to identify any additional training/learning that may be required to ensure the job holder can develop and fully perform their role with the capabilities required. All CMECE employees participate in this programme.

CMECE also participates in a headcount planning and approval workflow to allow the business to make business justification for additional headcount to support recruitment. A committee meets regularly to discuss headcount needs based on business commitments. In addition, CMECE participates in an annual budget planning process whereby additional resources are requested and approved. This is driven by the CEO of CMECE.

## **9. OPERATIONAL RELIABILITY**

### **9.1 The clearing agency has procedures and processes to ensure the provision of accurate and reliable settlement services to participants.**

The processes and procedures utilised by CMECE are designed to ensure that it fulfils its necessary reporting and operational requirements. CMECE has rules, procedures, schedules and deadlines for all processes related to settlement services.

The CMECE Banking and Settlement team's role is to manage the cash and collateral that is central to the operations and integrity of the clearing house. Apart from its responsibilities for the accounts in which the cash and collateral is held, the team oversees the daily settlements of margin between CMECE and the settlement banks acting on behalf of Clearing Members.

The Banking and Settlement team works closely with the Operations, IT and Client Support and Risk teams. The Risk team will review Clearing Members' positions before settlement instructions are approved for release by the Banking and Settlement team. Any large exposure may be communicated to Clearing Members' staff and settlement banks prior to release of payment instructions.

Payment instructions will be released to settlement banks daily, after Regular Trading Hours (RTH) settlement cycle calculations are completed, at around 2:00 AM GMT. All margin/variation calls resulting from the RTH cycle will be processed by the settlement banks by 9:00 AM GMT with payments confirmed to CMECE. Any delays will be immediately escalated to senior management. CMECE will also run a routine Intra-Day (ITD) settlement cycle every day at 12:00 PM GMT.

CMECE uses the Combined Cash Flow settlement method. This means that any cash initial margin excess will be utilised to cover a Clearing Member's cash variation margin requirement; and any cash variation margin payments due from CMECE will be deposited into the Clearing Member's cash initial margin accounts. Instructions to deposit or release any margin (whether cash or eligible financial instruments) will be accepted via the Clearing 21 system on the CME Clearing Europe portal.

CMECE uses the settlement prices established for the US-cleared (NYMEX) contracts, reserving the right in exceptional circumstances and on risk management grounds to depart from those values. The OTC Commodities Contract Module (available on our website) contains the product specifications and the settlement methodologies applicable to the contracts.

As an RCH, CMECE is required by REC 2.8 (Settlement and Clearing Services) to ensure that its clearing services involve satisfactory arrangements for securing the timely discharge (whether by performance, compromise or otherwise) of the rights and liabilities of the parties to transactions in respect of which it provides such services, (being rights and liabilities in relation to those transactions).

## **10. PROTECTION OF ASSETS**

### **10.1 The clearing agency has established accounting practices, internal controls, and safekeeping and segregation procedures to protect the assets that are held by the clearing agency.**

#### *Accounting practices*

With respect to accounting practices, all financial reporting is outsourced to CME Operations Limited accounting personnel (see Part 11: Outsourcing). All clearing deposits are included in the overall financial reporting of the Clearing House and are reviewed by management and the independent Board members on a monthly basis.

All financial information of CME Group Inc., including all of its subsidiary companies is also consolidated and reported in the 10Q and 10K filings submitted to the US S.E.C.

#### *Internal controls*

The Audit Committee has responsibility for oversight of the operational risk framework of CMECE. The Audit Committee is responsible for monitoring and reviewing the effectiveness of the internal audit function in the context of CMECE's overall risk management system. It will also review and approve the statement to be included in CMECE's annual report concerning internal controls and risk management. The Audit Committee provides general oversight of the transaction recording process.

The internal audit function consists of one dedicated person (the Head of Internal Audit) (outsourced), who as mentioned in section 7 is supported by other specialists from their firm on various aspects of the audit work, supported by the CME Group Internal Audit department. The Head of Internal Audit is ACA<sup>20</sup> qualified. The Head of Internal Audit of CMECE reports to the Audit Committee of the Board functionally and to the CEO of the Clearing House administratively.

The role of Internal Audit is to understand the key risks of the organisation and to examine and evaluate the adequacy and effectiveness of the system of risk identification and management and internal control as operated by the organisation. CMECE Internal Audit, therefore, shall have unrestricted access to all activities undertaken in the organisation (including, where relevant, CME Group-wide activities), in order to review, appraise and report on: systems and controls, risk management, finance and controls, regulatory and governance issues.

#### *Safekeeping and segregation*

Whilst CMECE holds both legal and beneficial title to all assets transferred to it, we keep separate records and accounts to distinguish:

- the assets and positions of a Clearing Member from the assets and positions held for another Clearing Member and from our own assets;

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20 ACA stands for Associate Chartered Accountant and is a qualification gained through the Institute of Chartered Accountants in England and Wales.

- the assets and positions of a Clearing Member from the assets and positions held for its clients (omnibus client segregation);
- the assets and positions of a client from the assets and positions held for other clients (individual client segregation).

We will be consulting on new safekeeping and segregation procedures and rules shortly. Our proposed segregation and safekeeping structure will be compliant with the proposed EMIR<sup>21</sup> requirements in Europe. Our proposed account structure will enable us to identify positions of a Clearing Member's clients and to segregate related collateral. We will maintain client positions and collateral in omnibus client accounts or individual client accounts. This account structure will be supported by our Clearing Rules, Clearing Procedures and legal agreements to be entered into by a Clearing Member, a client and CMECE. We are in the process of obtaining legal opinions from the relevant jurisdictions to verify and support the enforceability of the segregated account structure.

We are able to facilitate portability of client positions and collateral to another Clearing Member in the event of a Clearing Member default because:

- we offer omnibus client accounts where collateral is held on a gross basis;
- we offer individually segregated client accounts (i.e. both legally segregated accounts and legally and operationally segregated accounts);
- we have a legal agreement under which a Clearing Member assigns to its client its rights to any collateral and the account balance remaining (after the close-out of the Clearing Member's client transactions) as a result of the Clearing Member's default (known as 'Portable Net Sum'). Such security will be perfected by registration;
- we ask clients to nominate in advance new Adopting Clearing Members in the event that their Clearing Member defaults; and
- proposed EMIR legislation in Europe will legally recognise the concept of porting.

## **11. OUTSOURCING**

**11.1 Where the clearing agency has outsourced any of its key functions, it has appropriate and formal arrangements and processes in place that permit it to meet its obligations and that are in accordance with industry best practices. The outsourcing arrangement provides regulatory authorities with access to all data, information, and systems maintained by the third party service provider required for the purposes of regulatory oversight of the agency.**

As mentioned in Part I (section D) of this letter, CMECE receives a number of services and support from CME in the US and from CME Operations Limited (CMEOL) in London. The outsourcing arrangement is governed by legal agreements entered into by CMECE with CME and with CMEOL. Under the agreements, the regulators have access to all data and information maintained by CME.

CMECE receives legal and company secretarial, financial accounting, human resources, IT support services and office administrative support from CMEOL staff working in London. U.S. based staff of CME provide support to CMECE in these and other areas.

CME and CMEOL are required to provide the services in a manner which is consistent with that in which CME provides equivalent services, including quality and timing, and with due skill, care, and diligence. The Board has ultimate oversight of the services provided by CME through regular reports from management. On a day-to-day basis, satisfactory performance of the outsourcing arrangements is overseen by the relevant CMECE staff, who are in frequent contact with their counterparts at CME and receive regular notices and reports on the provision of the services to supplement their direct observations of the performance of the services provided by CME. The oversight procedure put in place by CMECE comprises CMECE operational staff, for example, those in the risk management department, reporting all breaches of service standards to the Regulatory Compliance Officer, the CEO, and the COO. Corrective action in respect of persistent problems will be escalated to CME at a senior level and the internal CMECE reports and escalation actions and agreed consequential changes will form the basis of management reports from the Regulatory Compliance Officer to the Board of CMECE.

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<sup>21</sup> The European Union European Market Infrastructure Regulation, which is due to be formally adopted in the next few months.

CMECE is bound by REC 2.2.1(3) which requires that:

“Where a UK recognised body or applicant makes arrangements of the kind mentioned in paragraph (2), the arrangements do not affect the responsibility imposed by [FSMA] on the UK recognised body or applicant to satisfy recognition requirements applying to it under these Recognition Requirements Regulations, but it is in addition a recognition requirement applying to the UK recognised body or applicant that the person who performs (or is to perform) the functions is a fit and proper person who is able and willing to perform them.”

## **12. INFORMATION SHARING AND REGULATORY COOPERATION**

**12.1 For regulatory purposes, the clearing agency cooperates by sharing information or otherwise with the Commission and its staff, self-regulatory organizations, exchanges, quotation and trade reporting systems, alternative trading systems, other clearing agencies, investor protection funds, and other appropriate regulatory bodies.**

CMECE is required by REC 2.13.2 (2) to be “able and willing to cooperate, by the sharing of information or otherwise, with the FSA, with any other authority, body or person having responsibility in the United Kingdom for the supervision or regulation of any regulated activity or other financial service, or with an overseas regulator within the meaning of section 195 of [FSMA]”.

In order to comply with 2.13.2(2), each Clearing Member is required to enter into a Clearing Membership Agreement with CMECE, which will bind the Clearing Member to the Clearing Rules. The Clearing Membership Agreement requires the Clearing Member to agree that CMECE shall be permitted to disclose information it receives from the Clearing Member and which it learns about the Clearing Member in the course of its business as a clearing house to the FSA and any other regulator which has jurisdiction over CMECE in relation to the Clearing Member. Clearing Rule 2.4 also makes it clear that CMECE is entitled to disclose confidential information relating to Clearing Members in this way.

CMECE intends to be open with the FSA and any other appropriate regulatory bodies in relation to the running of the clearing house. CMECE will investigate and pursue enquiries from the FSA and other appropriate bodies diligently. This is the responsibility of the Regulatory Compliance Officer and the CEO.

CMECE will, as appropriate, enter into and abide by the terms of information sharing agreements and use relevant information obtained from such agreements in carrying out its risk management program.

CMECE is not currently party to any formal, UK, or international information-sharing agreements and arrangements. CMECE is not aware of any such arrangement between clearing houses in the UK but may initiate discussion with other UK clearing houses.

CMECE is a member of the European Association of Clearing Houses (EACH). Membership in EACH, which is open to all regulated CCP houses in Europe, does not involve formal information-sharing agreements. It does, however, provide close contacts for the informal sharing of information about risk concerns and risk perceptions (not covering the precise information that may be needed for regulatory investigations) that is in practice the way in which clearing house risk managers can and do best co-operate and offer mutual support.

CMECE will join the international exchange and clearing house information sharing agreement administered by CME, which provides for information sharing on an international basis. CMECE will notify the Commission of its entry into information-sharing arrangements with other clearing organisations or other groups or associations, on a timely basis.

### **Part III Submissions**

CMECE submits that it meets the criteria set out for recognition as a clearing agency, all as outlined in Appendix A to Staff Notice 24-702. CMECE further submits that it would be appropriate and would not be contrary to the public interest for the Commission to exempt CMECE from recognition due to the fact that it is already subject to appropriate regulatory oversight by the Financial Services Authority of the United Kingdom (FSA).

Yours sincerely,

“Lee Betsill”

Lee Betsill

Chief Operating Officer

[DRAFT ONLY]

**IN THE MATTER OF  
THE SECURITIES ACT,  
R.S.O. 1990, CHAPTER S.5, AS AMENDED  
(the Act)**

**AND**

**IN THE MATTER OF  
CME CLEARING EUROPE LIMITED**

**ORDER  
(Section 147 of the Act)**

**WHEREAS** CME Clearing Europe Limited (CMECE) filed an application dated August 3, 2012 (the Application) with the Ontario Securities Commission (the Commission or OSC) requesting an Order pursuant to section 147 of the Act exempting CMECE from the requirement to be recognized by the OSC as a clearing agency pursuant to subsection 21.2(0.1) of the Act;

**AND WHEREAS** CMECE has represented to the Commission that:

1. CMECE is a private limited company incorporated under the laws of England and Wales;
2. CMECE's ultimate parent is CME Group Inc. (CME Group). CMECE's immediate parent (100% ownership) is Chicago Mercantile Exchange Luxembourg S.à r.l.; it is in turn a wholly-owned subsidiary of Chicago Mercantile Exchange Luxembourg Holdings S.à r.l, which is a wholly-owned subsidiary of CME Group;
3. CME Group is the holding company for four futures exchanges: the Chicago Mercantile Exchange Inc. (CME), the Board of Trade of the City of Chicago Inc. (CBOT), the New York Mercantile Exchange Inc. (NYMEX) and the Commodity Exchange Inc. (COMEX). In addition to being an exchange, CME offers through a division, "CME Clearing", central counterparty clearing and settlement services to all CME Group exchanges and for certain over-the-counter (OTC) derivatives transactions. CME Group is a listed corporation whose shares are traded on the NASDAQ stock exchange;
4. CMECE has been established as part of a globalization strategy by CME Group. The associated business goal is to offer clearing services from the United Kingdom (UK) for a broad range of OTC derivatives;
5. CMECE is a Recognised Clearing House (RCH) in the UK under the Financial Services and Markets Act 2000 (FSMA);
6. The Financial Services Authority of the UK (FSA) is CMECE's primary regulator. As part of its regulatory oversight of CMECE, the FSA reviews, assesses and enforces the on-going compliance by CMECE with the requirements set out in the FSMA including financial resources; suitability; systems and controls (including the assessment and management of risks to the performance of the clearing house's functions); safeguards for investors (including access to facilities); promotion and maintenance of standards; rule-making (including default rules in respect of market contracts); and arrangements regarding discipline and complaints;
7. CMECE is required to provide to the FSA, on request, access to all records and to cooperate with other regulatory authorities, including making arrangements for information-sharing;
8. CMECE's financial safeguards model includes clear and certain rules and procedures (and other aspects of its legal framework) governing CMECE's role as central counterparty, as well as appropriate membership criteria that are risk-based. CMECE operates a robust pricing and margining/collateral methodology. CMECE also has in place appropriate banking and custody arrangements, default resources and management processes. These components are linked by daily monitoring and oversight, undertaken by an experienced risk management team, with appropriate oversight by the Board of Directors;
9. The membership requirements of CMECE for OTC derivative clearing are publicly disclosed and are designed to permit fair and open access, while protecting CMECE and its clearing members (Clearing Members). The clearing membership requirements include fitness criteria, financial standards, operational standards and appropriate registration qualifications with applicable statutory regulatory authorities. CMECE applies a due diligence process to ensure that all applicants meet the required criteria and conducts on-going monitoring of Clearing Members;

10. CMECE currently offers clearing services for over 200 OTC commodity derivative contract types. CMECE also has plans to launch clearing services for OTC interest rate swaps in the last quarter of 2012, followed by foreign exchange and credit default swap products in the first half of 2013. Any such launch of new products requires the approval of the FSA;
11. CMECE does not have any office or maintain other physical installations in Ontario or any other Canadian province or territory. CMECE does not have any plans to open such an office or to establish any such physical installations in Ontario or elsewhere in Canada. However, CMECE offers or proposes to offer direct clearing access in Ontario for clearing OTC derivatives products to entities that have a head office or principal place of business in Ontario (Ontario Clearing Members);
12. Section 21.2 of the Act prohibits clearing agencies from carrying on business in Ontario unless they are recognized by the Commission as a clearing agency or exempted from such recognition under s.147;

**AND WHEREAS** based on the Application and the representations that CMECE has made to the OSC, the Commission has determined that (i) CMECE satisfies the applicable criteria set out in Schedule "A"; and (ii) it would not be prejudicial to the public interest to grant the Order requested;

**AND WHEREAS** the Commission will monitor developments in international and domestic capital markets and CMECE's activities on an ongoing basis to determine whether it is appropriate that CMECE continue to be exempted from the requirement to be recognized as a clearing agency and, if so, whether it is appropriate that it continue to be exempted subject to the terms and conditions in this order;

**IT IS ORDERED** by the Commission that, pursuant to section 147 of the Act, CMECE is exempt from the requirement to be recognized as a clearing agency under subsection 21.2(0.1) of the Act;

**PROVIDED THAT** CMECE complies with the terms and conditions attached hereto as Schedule "B".

**DATED** at Toronto this \_\_\_\_\_ day of \_\_\_\_\_

## SCHEDULE "A"

### Criteria for Exemption from Recognition by the OSC as a clearing agency pursuant to section 21.2(0.1) of the OSA

#### PART 1 GOVERNANCE

- 1.1 The governance structure and governance arrangements of the clearing agency ensures:
- (a) effective oversight of the clearing agency;
  - (b) the clearing agency's activities are in keeping with its public interest mandate;
  - (c) fair, meaningful and diverse representation on the governing body (Board) and any committees of the Board, including a reasonable proportion of independent directors;
  - (d) a proper balance among the interests of the owners and the different entities seeking access (participants) to the clearing, settlement and depository services and facilities (settlement services) of the clearing agency;
  - (e) the clearing agency has policies and procedures to appropriately identify and manage conflicts of interest;
  - (f) each director or officer of the clearing agency, and each person or company that owns or controls, directly or indirectly, more than 10 percent of the clearing agency is a fit and proper person; and
  - (g) there are appropriate qualifications, limitation of liability and indemnity provisions for directors and officers of the clearing agency.

#### PART 2 FEES

- 2.1 All fees imposed by the clearing agency are equitably allocated. The fees do not have the effect of creating unreasonable barriers to access.
- 2.2 The process for setting fees is fair and appropriate, and the fee model is transparent.

#### PART 3 ACCESS

- 3.1 The clearing agency has appropriate written standards for access to its services.
- 3.2 The access standards and the process for obtaining, limiting and denying access are fair and transparent. A clearing agency keeps records of
- (a) each grant of access including, for each participant, the reasons for granting such access, and
  - (b) each denial or limitation of access, including the reasons for denying or limiting access to an applicant.

#### PART 4 RULES AND RULEMAKING

- 4.1 The clearing agency's rules are designed to govern all aspects of the settlement services offered by the clearing agency, and
- (a) are not inconsistent with securities legislation,
  - (b) do not permit unreasonable discrimination among participants, and
  - (c) do not impose any burden on competition that is not necessary or appropriate.
- 4.2 The clearing agency's rules and the process for adopting new rules or amending existing rules should be transparent to participants and the general public.
- 4.3 The clearing agency monitors participant activities to ensure compliance with the rules.
- 4.4 The rules set out appropriate sanctions in the event of non-compliance by participants.



## **PART 5 DUE PROCESS**

- 5.1 For any decision made by the clearing agency that affects an applicant or a participant, including a decision in relation to access, the clearing agency ensures that:
- (a) an applicant or a participant is given an opportunity to be heard or make representations; and
  - (b) the clearing agency keeps a record of, gives reasons for, and provides for appeals or reviews of, its decisions.

## **PART 6 RISK MANAGEMENT**

- 6.1 The clearing agency's settlement services are designed to minimize systemic risk.
- 6.2 The clearing agency has appropriate risk management policies and procedures and internal controls in place.
- 6.3 Without limiting the generality of the foregoing, the clearing agency's services or functions are designed to achieve the following objectives:
- 1. Where the clearing agency acts as a central counterparty, it rigorously controls the risks it assumes.
  - 2. The clearing agency minimizes principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.
  - 3. Final settlement occurs no later than the end of the settlement day. Intraday or real-time finality is provided where necessary to reduce risks.
  - 4. Where the clearing agency extends intraday credit to participants, including a clearing agency that operates net settlement systems, it institutes risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle.
  - 5. Assets used to settle the ultimate payment obligations arising from securities transactions carry little or no credit or liquidity risk. If central bank money is not used, steps are to be taken to protect participants in settlement services from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.
  - 6. If the clearing agency establishes links to settle cross-border trades, it designs and operates such links to reduce effectively the risks associated with cross-border settlements.
- 6.4 The clearing agency engaging in activities not related to settlement services carries on such activities in a manner that prevents the spillover of risk to the clearing agency that might affect its financial viability or negatively impact any of the participants in the settlement service.

## **PART 7 SYSTEMS AND TECHNOLOGY**

- 7.1 For its settlement services systems, the clearing agency:
- (a) develops and maintains,
    - (i) reasonable business continuity and disaster recovery plans,
    - (ii) an adequate system of internal control,
    - (iii) adequate information technology general controls, including controls relating to information systems operations, information security, change management, problem management, network support, and system software support;
  - (b) on a reasonably frequent basis, and in any event, at least annually, and in a manner that is consistent with prudent business practice,
    - (i) makes reasonable current and future capacity estimates,
    - (ii) conducts capacity stress tests to determine the ability of those systems to process transactions in an accurate, timely and efficient manner,

(iii) tests its business continuity and disaster recovery plans; and

(c) promptly notifies the regulator of any material systems failures.

7.2 The clearing agency annually engages a qualified party to conduct an independent systems review and prepare a report in accordance with established audit standards regarding its compliance with section 7.1(a).

**PART 8 FINANCIAL VIABILITY AND REPORTING**

8.1 The clearing agency has sufficient financial resources for the proper performance of its functions and to meet its responsibilities and allocates sufficient financial and staff resources to carry out its functions as a clearing agency in a manner that is consistent with any regulatory requirements.

**PART 9 OPERATIONAL RELIABILITY**

9.1 The clearing agency has procedures and processes to ensure the provision of accurate and reliable settlement services to participants.

**PART 10 PROTECTION OF ASSETS**

10.1 The clearing agency has established accounting practices, internal controls, and safekeeping and segregation procedures to protect the assets that are held by the clearing agency.

**PART 11 OUTSOURCING**

11.1 Where the clearing agency has outsourced any of its key functions, it has appropriate and formal arrangements and processes in place that permit it to meet its obligations and that are in accordance with industry best practices. The outsourcing arrangement provides regulatory authorities with access to all data, information, and systems maintained by the third party service provider required for the purposes of regulatory oversight of the agency.

**PART 12 INFORMATION SHARING AND REGULATORY COOPERATION**

12.1 For regulatory purposes, the clearing agency cooperates by sharing information or otherwise with the Commission and its staff, self-regulatory organizations, exchanges, quotation and trade reporting systems, alternative trading systems, other clearing agencies, investor protection funds, and other appropriate regulatory bodies.

## SCHEDULE "B"

### Terms and Conditions

#### REGULATION OF CMECE

1. CMECE will maintain its status as a RCH with the UK Financial Services Authority (FSA) or its successor to the FSA and will continue to be subject to the regulatory oversight of the FSA or its successor.
2. CMECE will continue to meet the criteria set out in Schedule "A".

#### FILING REQUIREMENTS

##### FSA Filings

3. CMECE will provide staff of the Commission, concurrently, the following information that it is required to provide to or file with the FSA or its successor:
  - (a) the annual audited financial statements of CMECE;
  - (b) the institution of any legal proceeding against it;
  - (c) the presentation of a petition for winding up, the appointment of a receiver or the making of any voluntary arrangement with creditors;
  - (d) changes and proposed changes to its bylaws, rules, operations manual, participant agreements and other similar instruments or documents of CMECE which contain any contractual terms setting out the respective rights and obligations between CMECE and Clearing Members or among Clearing Members;
  - (e) new types of products to be offered for clearing to Clearing Members or products that will no longer be available for clearing to Clearing Members;
  - (f) the CME Clearing Europe Risk Committee Quarterly Report or other materials that provide equivalent risk management information.

##### Prompt Notice

4. CMECE will promptly notify staff of the Commission of any of the following:
  - (a) any material change to its business or operations or the information as provided in the Application;
  - (b) any material problem with the clearance and settlement of transactions that could materially affect the financial safety and soundness of CMECE;
  - (c) an event of default by a Clearing Member;
  - (d) any material change or proposed material change in CMECE's RCH status or the regulatory oversight by the FSA or its successor;
  - (e) any new services or clearing of new products that are proposed to be offered to Ontario Clearing Members.

##### Quarterly Reporting

5. CMECE will maintain the following updated information and submit such information to the Commission in a manner and form acceptable to the Commission on at least a quarterly basis, and at any time promptly upon the request of staff of the Commission:
  - (a) a current list of all Ontario Clearing Members;
  - (b) a list of all Ontario Clearing Members against whom disciplinary action has been taken in the last quarter by CMECE or the FSA or its successor with respect to activities at CMECE;
  - (c) a list of all investigations by CMECE relating to Ontario Clearing Members;

- (d) a list of all Ontario applicants who have been denied Clearing Member status by CMECE;
- (e) the average daily volume and value of trades cleared by asset class during the previous quarter, for each Ontario Clearing Member;
- (f) the portion of total volume and value of trades cleared by asset class during the previous quarter for all Clearing Members that represents the total volume and value of trades cleared during the previous quarter for each Ontario Clearing Member; and
- (g) any other information in relation to an OTC derivative cleared by CMECE as may be required by the Commission from time to time to carry out the Commission's mandate.

**INFORMATION SHARING**

- 6. CMECE will provide such other information as may be requested from time to time by, and otherwise cooperate with, the Commission or its staff.
- 7. CMECE will share information and otherwise cooperate with other recognized and exempt clearing agencies, as appropriate.

**SUBMISSION TO JURISDICTION AND AGENT FOR SERVICE**

- 8. For greater certainty, CMECE will submit to the non-exclusive jurisdiction of (i) the courts and administrative tribunals of Ontario and (ii) an administrative proceeding in Ontario, in a proceeding arising out of, related to or concerning or in any other manner connected with the activities of CMECE in Ontario.
- 9. For greater certainty, CMECE will file with the Commission a valid and binding appointment of an agent for service in Ontario upon whom may be served a notice, pleading, subpoena, summons or other process in any action, investigation or administrative, criminal, quasi-criminal, penal or other proceeding arising out of or relating to or concerning the activities of CMECE in Ontario.