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ICE Launches Credit Default Swap Clearinghouse

Intercontinental Exchange, Inc. (“ICE”), a leading global exchange and over-the-counter (“OTC”) market operator, launched a clearinghouse for credit default swaps (“CDS”) through its subsidiary ICE US Trust LLC (“ICE Trust”), a New York limited purpose limited liability trust company and member of the Federal Reserve System. Regulators have sought a comprehensive CDS clearinghouse solution since 2004, a push that took on new urgency during 2008’s financial turmoil. Shearman & Sterling LLP advised ICE on the formation of ICE Trust and the associated acquisition of The Clearing Corporation (“TCC”).

What Are CDS?

CDS currently trade as bilateral contracts in which the seller, for a fee, agrees to provide protection to the buyer in case a referenced entity, usually an issuer of some kind of bond, experiences any number of “credit events”, such as bankruptcy or payment default. Upon the occurrence of such an event, CDS typically provide for (i) physical settlement of the CDS, in which the protection buyer may deliver the bond to the protection seller and receive its face value, or (ii) cash settlement of the CDS, in which case the protection buyer is entitled to receive a net payment calculated on the basis of the underlying credit instrument’s market value after the credit event. It is not necessary for a CDS buyer to be the beneficial owner of the underlying credit instrument.

CDS expanded in popularity throughout the 1990’s, as they quickly became an extremely important and widely used tool for the mitigation and transfer of credit risk. The Bank for International Settlements estimated that as of December 2007 the outstanding notional amount of CDS was just under \$58 trillion; after a series of voluntary netting initiatives, the figure is now estimated at just over \$28 trillion. Today, CDS are used not only to hedge credit risk, but also to engage in capital structure arbitrage and

as part of structured transactions, including collateralized debt obligations.

The Importance of ICE Trust

As early as 2004, the Federal Reserve Bank of New York (“FRBNY”) articulated the need for a central clearinghouse in the burgeoning CDS market. Amid the financial turbulence of 2008, the need became clearer.

By assuming counterparty credit risk and enforcing participation standards, a clearinghouse will diminish the systemic risk posed by a CDS-counterparty default. Regulators and the market will benefit from the transparency a clearinghouse will provide. By replacing the current “web” of CDS exposures with a “hub and spoke” architecture, a clearinghouse will vastly simplify containing the failure of any major market participant. Furthermore, by interposing itself between participants and thereby assuming counterparty risk, a clearinghouse enables market participants to accept the best bids and offers without concern that a particular counterparty may default.

On November 14, 2008, the President’s Working Group on Financial Markets stated that the successful implementation of central counterparty services for CDS was its top OTC derivatives priority. To that end,

the Board of Governors of the Federal Reserve System (“Fed”), the Securities and Exchange Commission (“SEC”), and the Commodity Futures Trading Commission (“CFTC”) entered into a Memorandum of Understanding (“MOU”) to memorialize their intent to cooperate to support the establishment of a central counterparty. The MOU observed that “[a] well-regulated and prudently managed CDS central counterparty can provide immediate benefits to the market by reducing the systemic risk associated with counterparty credit exposures.”

In Europe, political pressure for the development of a clearing solution for CDS has also been acute, especially following the fall out from Lehman Brothers’ insolvency. At least from October 2008, the European Commission has applied pressure on the major CDS dealers active in Europe to develop a CDS clearing solution. Following various perceived delays in achieving a clearing solution, in mid-February 2009, the European Commission proposed to introduce new legislation on regulatory capital that would have subjected financial institutions with CDS positions to additional capital requirements unless positions were held with a European regulated clearinghouse as counterparty. Major dealers have subsequently committed to using a European central counterparty for CDS by the end of July 2009.

ICE Trust’s CDS Clearinghouse

The Road to ICE Trust

ICE operates regulated global futures exchanges and OTC markets for commodities and derivative products and already operates central party clearinghouses in the U.S., Canada, and Europe.

On September 12, 2008, ICE announced the completion of its acquisition of Creditex Group Inc. (“Creditex”), a leader in trade execution and processing of CDS in markets spanning the U.S., Europe, and Asia. On October

10, 2008, ICE announced that it had joined forces with TCC,¹ Markit Group, and Risk Metrics to support a joint global CDS clearing solution to accomplish the objectives established by the FRBNY. Later that month, ICE announced that it would acquire TCC, which occurred on March 6, 2009.

ICE’s acquisition of TCC was subject to the reporting and waiting period requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the “HSR Act”), as amended. ICE and TCC filed their respective Notification and Report Forms with the Federal Trade Commission and the Antitrust Division of the Department of Justice and were granted early termination of the HSR Act waiting period on Monday, March 2, 2009.

Regulatory Status

ICE Trust is chartered as a New York limited purpose limited liability trust company and is a member of the Federal Reserve System. The Banking Board of the New York State Banking Department (“NYBD”) approved the application to charter ICE Trust on December 4, 2008.² Under New York law, a limited purpose trust company may not accept deposits from the general public and may only engage in fiduciary activities.

ICE Trust also applied for membership in the Federal Reserve System. The Fed approved the application on March 4, 2009.³ ICE Trust is thereby subject to direct supervision and examination by both the NYBD and the Fed. The sole member of ICE Trust is ICE US Holding Company L.P., an exempted limited partnership formed under the laws of the Cayman Islands which will be

¹ Prior to its acquisition by ICE, TCC was a closely held corporation owned by eleven major financial institutions, three leading OTC derivatives inter-dealer brokers, an international exchange, and a leading OTC services provider. TCC’s shareholders included Bank of America, Barclays, Citigroup, Creditex Group, Deutsche Bank, Eurex, GFI Group, Goldman Sachs, ICAP, JPMorgan Chase, the Markit Group, Merrill Lynch, MF Global, Morgan Stanley and UBS. TCC had cleared futures contracts as an independent clearinghouse since 1925.

² The NYBD’s announcement of its approval is available at <http://www.banking.state.ny.us/pr081204.htm>

³ The Fed’s Order is available at <http://www.federalreserve.gov/newsevents/press/orders/20090304a.htm>

controlled indirectly by ICE and in which the former TCC shareholders have a nonvoting interest.

As a state-chartered member of the Federal Reserve System, ICE Trust is authorized to act as a multilateral clearing organization for OTC derivatives under Section 409 of the Federal Deposit Insurance Corporation Improvement Act of 1991.

On March 6, 2009, the Office of the Comptroller of the Currency (“OCC”) authorized national banks to become clearing members of ICE Trust, subject to certain conditions.⁴ The OCC found that such clearing activities are within the authorized powers of national banks under the National Bank Act and that the national banks that proposed to become Participants of ICE Trust may do so subject to certain conditions.

The Mechanics of ICE Trust’s CDS Clearing

ICE Trust offers its CDS clearing services to those firms that are found to meet certain objective membership criteria (each a “Participant”). At least initially, the ICE Trust Participants will be Bank of America, Barclays Capital, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Merrill Lynch, Morgan Stanley, and UBS. Future participation will also be open to any entity meeting ICE Trust’s eligibility requirements.

At least initially, all CDS to be cleared by ICE Trust will first be submitted to the Deriv/SERV comparison and confirmation service of The Depository Trust & Clearing Corporation.

Upon submission of a CDS to ICE Trust for clearing, the contract will be novated to ICE Trust, such that ICE Trust becomes a counterparty to each party under a separate CDS. For example, if Party A sells protection to Party B, ICE Trust would novate the contract so that it buys protection from Party A and sells that same protection to Party B. ICE Trust will be able to net the overall

positions between it and each Participant, and will receive payments from and make payments to each Participant on a net basis. ICE Trust will thereby reduce the volume of settlement payments among Participants and reduce the counterparty credit risks associated with CDS contracts. TCC will act as a service provider for conducting the ICE Trust operations pursuant to a service agreement.

Initially, ICE Trust will only clear CDS entered into between Participants. Participants may continue to trade CDS with non-Participants under their existing trading documentation. Participants will, after an initial period, be obligated under ICE Trust rules to offer non-Participants the option to segregate initial margin for eligible CDS contracts that mirror cleared CDS, on terms to be agreed between the Participant and non-Participant. In a subsequent phase, ICE Trust envisions establishing a framework intended to provide additional protections for CDS transactions of non-Participants, including segregation of certain initial margin posted by non-Participants in segregated accounts at ICE Trust and provisions to enhance the transferability of such transactions.

Immediately upon the novation occurring, the terms and conditions of the bilaterally negotiated CDS submitted for clearing will be amended so as to be on ICE Trust’s standard terms. Such amendment ultimately allows netting of positions to take place and ensures that ICE Trust is not exposed to any unusual terms of the original CDS contract.

ICE Trust has entered into an agreement with Markit Group Limited to produce daily prices required for mark-to-market pricing, margining, and clearing. ICE Trust will thereby promote greater market transparency by making available the closing settlement price and related volume and open interest data for each cleared product.

⁴ The OCC’s Interpretive Letter is available at <http://www.occ.treas.gov/interp/mar09/int1113.pdf>

ICE Trust's Credit Support Framework: Margin and the Guaranty Fund

As the central counterparty to each of the Participants, ICE Trust will have exposure to the risk of their default. To address this counterparty credit risk, ICE Trust (i) requires Participants to provide collateral for their obligations under cleared CDS transactions, and (ii) has rules that mutualize the risk of a Participant default across all Participants.

Each Participant, therefore, is required to both post margin and make contributions to a guaranty fund. Each Participant is required to make an initial, uniform contribution to the guaranty fund, as well as contributions made on an ongoing basis based on the Participant's actual and anticipated CDS position exposures. ICE will also contribute to the guaranty fund. As a result, the guaranty fund will grow in proportion to the position risk associated with the aggregate volume of CDS cleared by ICE Trust.

If a Participant defaults, ICE Trust would draw on the margin collateral the Participant has posted. If that is insufficient, ICE Trust would then look to the defaulting Participant's guaranty fund contribution. ICE Trust may use other guaranty fund contributions to satisfy any remaining obligations of the defaulting Participant. If the total guaranty fund is inadequate to cover losses on the defaulted obligations, ICE Trust would have the ability to assess an additional guaranty fund contribution from all nondefaulting Participants, subject to certain limitations in ICE Trust's rules.

Exemptive Relief from the SEC and Treasury

Although both the Securities Act of 1933, as amended ("Securities Act") and the Securities Exchange Act of 1934, as amended ("Exchange Act") provide that "security-based swap agreements" are not securities, Section 206B of the Gramm-Leach-Bliley Act of 1999 requires a swap to be subject to individual negotiation in order to qualify as a security-based swap agreement. Although bilateral, uncleared CDS contracts clearly

are security-based swap agreements, some observers have questioned the status of cleared CDS subject to a clearinghouse's uniform credit support and contractual terms. For avoidance of legal uncertainty, ICE Trust and its affiliates applied for an exemption from the Exchange Act requirements applicable to a securities clearing agency. ICE Trust also applied for an exemption, on behalf of itself and its Participants, from broker-dealer registration and regulatory requirements that potentially would apply if cleared CDS were viewed as securities. The SEC granted such exemptive relief on March 6, 2009 on public policy grounds, but did not decide the question whether cleared CDS are swap agreements or securities.⁵ The SEC also issued a temporary final rule on January 14, 2009 that would, subject to compliance with certain enumerated conditions and to certain exceptions, provide a comprehensive exemption for qualifying cleared CDS from the provisions of the Securities Act.⁶

ICE Trust also applied to the U.S. Department of the Treasury for exemptive relief. A CDS that has one or more reference or deliverable obligations that are government securities and that does not qualify as a security-based swap agreement may potentially be subject to characterization as a government security under the Government Securities Act of 1986. As a consequence, any person dealing or issuing such CDS referencing government securities would potentially be subject to regulation as government securities brokers or dealers.

⁵ The SEC's Order is available at <http://www.sec.gov/rules/exorders/2009/34-59527.pdf>

⁶ The temporary final rule is available at <http://www.sec.gov/rules/final/2009/33-8999.pdf>

For the avoidance of legal uncertainty, ICE Trust and its affiliates applied for an exemption pursuant to Section 15C(a)(5) of the Exchange Act from the provisions of Sections 15C(a), (b) and (d) of the Exchange Act (other than subsection (d)(3)) and the rules and regulations of the U.S. Department of Treasury thereunder, applicable to government securities brokers and government securities dealers. Temporary exemptive relief was granted on March 6, 2009.⁷

Moving Forward

The establishment of ICE Trust is expected to benefit financial markets significantly. ICE Trust provides CDS market participants with a clearing solution and enhances the stability of the overall financial system by reducing systemic risks associated with counterparty credit exposures in CDS transactions. ICE Trust will also promote greater market transparency, making publicly available the closing settlement price and related volume for each cleared product. Market participants would be well-served to keep abreast of developments and opportunities.

⁷ 74 Fed. Reg. 10,647 (Mar. 11, 2009), available at http://www.treasurydirect.gov/insiti/statreg/gsareg/gsareg_tresexemptiveorder309.pdf

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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