



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

July 30, 2009

Interpretive Letter #1122
August 2009

Subject: [] (“Bank”) Membership in ICE Clear Europe Limited
 (“ICE Europe”) Credit Default Swap Clearinghouse

Dear []:

This responds to your request that the Office of the Comptroller of the Currency (“OCC”) confirm that it is permissible for the Bank to become a clearing member (“CM”) of ICE Europe,¹ to clear over-the-counter (“OTC”) credit default swaps (“CDS”). The parent company of ICE Europe is The IntercontinentalExchange, Inc., which is also the parent company of US ICE Trust.²

For the reasons discussed below, we conclude that the Bank may participate as a CDS CM of ICE Europe, provided the Bank, prior to becoming a CM of ICE Europe, establishes a comprehensive risk management framework³ to govern the risks associated with its membership and receives a written supervisory no-objection from its examiner-

¹ ICE Europe is incorporated in England and Wales as a private limited company.

² The OCC addressed the permissibility of national banks becoming members of US ICE Trust, a clearinghouse for CDS on North American indices, in OCC Interpretive Letter No. 1113 (March 4, 2009). Membership in ICE Trust and ICE Europe are not reciprocal (*i.e.*, membership is required by ICE Trust to clear North American CDS products and membership is separately required by ICE Europe to settle European CDS products).

³ The risk management framework should focus on the qualitative controls necessary to address the risks of the Bank’s activities and, in addition, provide for the Bank’s compliance with quantitative restrictions discussed below.

in-charge (“EIC”).⁴ Banks’ exposures to ICE Europe are subject to 12 U.S.C. § 84 (“Section 84”) and thus must be limited to amounts equal to or below their Section 84 limits, as determined by their EIC.

Background

Currently, ICE Europe clears listed and over-the-counter energy products.⁵ ICE Europe is expanding its clearing services to provide clearing for CDS index-based products in Europe on iTraxx indices,⁶ and later intends to clear European single name CDS contracts.

ICE Europe will provide CDS clearing services to its CMs.⁷ Membership is open to market participants that meet ICE Europe’s membership criteria. The Bank proposes to become an ICE Europe CDS self-clearing member.

ICE Europe will novate and clear the trades executed by its CDS CMs.⁸ Bilateral contracts entered into by its CDS CMs will be replaced by two superseding CDS contracts between ICE Europe and each party to the bilateral transactions. Under the new contracts, ICE Europe will assume the counterparties’ obligations under the original contracts and effectively become the central counterparty (*i.e.*, the buyer to every seller and the seller to every buyer) to CDS trades.

For admission to ICE Europe, a CM applicant or its parent must have a minimum tangible net worth (Tier 1 capital) of \$5 billion.⁹ At the time of admission, a CM or its parent must also have a minimum long term rating of at least “A” or its equivalent from designated or equivalent rating agencies (which may not fall below designated levels after admission) or otherwise demonstrate to ICE Europe that it satisfies stringent credit criteria (which it must continue to satisfy after admission).¹⁰ A CDS CM must demonstrate operational competency in CDS contracts substantially similar to those cleared by ICE Europe, including having a portfolio of bilateral CDS with an outstanding

⁴ This letter addresses the permissibility of national banks becoming self-clearing members of ICE Europe. Before a national bank ICE Europe CDS CM may clear trades on ICE Europe for customers, the bank must provide its EIC with prior written notice and obtain a written EIC supervisory no-objection.

⁵ The Bank’s affiliate, [], is an ICE Europe Energy CM.

⁶ CDS Clearing Solution: Explanatory Memorandum (May 12, 2009) (“EM”) VIII CDS Procedures @ § 8.1. The iTraxx indices are broad-based indices based on European reference names.

⁷ VIII CDS Procedures @ § 4.2.

⁸ Rule 401.

⁹ VIII CDS Procedures @ § 2.2(a); EM § 2.3(i).

¹⁰ VIII CDS Procedures @ §§ 2.2(b) and (c); EM §§ 2.3(ii) and (iii).

notional amount of at least \$500 billion.¹¹ A CDS CM must belong to the International Swaps and Dealers Association, Inc. (“ISDA”) and Deriv/SERV and other industry organizations related to CDS as designated by ICE Europe.¹² A CDS CM must execute an ISDA Master Agreement with ICE Europe and agree to the ISDA’s March 2009 Supplement (“Supplement”).¹³ US CMs must be “eligible contract participants” under Section 1(a)(12) of the Commodity Exchange Act.¹⁴ CMs must provide initial and mark-to-market margin,¹⁵ and make contributions to ICE Europe’s CDS guaranty fund (“CDS Fund”),¹⁶ which is available to cover CM defaults.¹⁷ A CM’s CDS Fund contribution is based on the risk profile of the CM’s portfolio and subject to a 15 million minimum in euros (“€”).

ICE Europe maintains a separate Energy Guaranty Fund (“Energy Fund”) for energy CMs.¹⁸ CDS CMs that are also Energy CMs are liable to make and maintain both CDS Fund contributions and Energy Fund contributions.¹⁹ The total amount required in each guaranty fund will be established by ICE Europe under its Procedures and published in a Circular.²⁰ The total amount of the Energy Fund is expressed in U.S. dollars and reviewed by ICE Europe quarterly.²¹ The total amount of the CDS Fund will be expressed in € and reviewed periodically by ICE Europe in advance of each CDS

¹¹ VIII CDS Procedures @ § 2.2(d); EM § 2.3(iv).

¹² VIII CDS Procedures @ § 2.2(e); EM § 2.3(v).

¹³ VIII CDS Procedures @ § 2.2(f); EM §§ 2.3 (vi) and (vii).

¹⁴ VIII CDS Procedures @ § 2.2(g).

¹⁵ ICE Europe Clearing Rules (“Rules”) 202 (viii), 301, 501, 502, 503 and 504.

¹⁶ Rules 202 (ix) and Part 11; EM §§ 3.9 and 4.2. The Fund is designed to provide adequate fund to cover losses associated with the default of two members with the greatest potential losses.

¹⁷ Rules @ Part 11. The ICE CDS Fund includes a capital contribution from ICE Europe. ICE will participate in the CDS Fund up to \$50 million. ICE Europe's participation represents its commitment to ensuring that the economic interests of the clearinghouse are aligned with the CMs. The ICE Contribution will be of two types, each up to \$25 million: (a) a first loss “ICE Europe CDS Initial Contribution” and (b) a second loss “ICE Europe CDS Fund Contribution.”

¹⁸ Rule 1101(a).

¹⁹ *Id.*

²⁰ The “Circular” is a publication issued by ICE Europe for the attention of all CMs and posted on its website. Rules 101 and 109(f).

²¹ Rule 1101(a).

guaranty fund period (“GFP”).²² Each CM’s CDS Fund contributions at the start of each CDS GFP will be calculated with reference to the total amount of the CDS Fund.²³

ICE Europe reviews the level of CDS Fund Contributions on a monthly basis and, on a daily basis, the performance of the CDS Fund.²⁴ If a CM’s day-over-day required CDS Fund Contribution exceeds either 5% of the CM’s prior day’s calculated contribution or 5% of the total CDS Fund requirement, ICE Europe will make a demand for additional CDS Fund contributions for payment by the next business day.²⁵

The Rules define acts that constitute CM defaults and describe the actions ICE Europe may take once it declares a CM in default.²⁶ In the event of a CM default, ICE Europe’s use of a defaulting CDS CM’s margin and CDS Fund contributions will vary, depending on whether the defaulting member is solely a CDS CM or both a CDS and an Energy CM.²⁷ Where there is a default by a CDS CM who is *not* an Energy CM, the defaulter’s CDS Fund Contribution may be used to pay the costs of closing out the defaulting CDS CM’s liabilities that exceed the defaulting member’s cash/collateral (margin accounts) or guarantee.²⁸ If such funds are insufficient to cover the CDS defaulter’s loss, ICE Europe may use any other of the defaulter’s assets that the defaulter has any rights or claims over.²⁹ If a loss still remains, ICE Europe may liquidate the losses resulting from a CDS CM’s default using this priority schedule: (1) the ICE Europe Initial Contribution;³⁰ (2) the non-defaulting members’ contributions (including any surplus CDS Fund Contribution, if two or more defaults take place concurrently and such surplus is available);³¹ and (3) ICE Europe’s CDS Fund Contribution.³² If a loss remains outstanding, ICE Europe may exercise powers of assessment and call for an CDS

²² In general, the CDS GFP for the CDS Fund means a period for which the total amount of CDS Fund contributions for the CDS Fund are fixed. Rules 101 and 1101(a).

²³ Rules 1101 and 1102(a) and (b).

²⁴ EM § 4.11.

²⁵ *Id.*

²⁶ A CM is in default if, for example, the CM is: (1) in breach of any ICE Europe Rule, Procedure, CM or other agreement with ICE Europe; (2) unable or likely to be unable to meet the CM’s obligations with ICE Europe; (3) unable to pay any margin, guaranty fund contribution or other amount due; or (4) insolvent. Rule 901.

²⁷ Rule 1103(c) and (d).

²⁸ Rule 1103(c)(i) and (ii).

²⁹ Rule 1103(c)(iii).

³⁰ Rule 1103(c)(iv).

³¹ Rule 1103(c)(v)(A).

³² Rule 1103(c)(v)(B).

Assessment Contribution (“CAC”) payable by each CDS CM.³³ The size of a CM’s CAC is based pro rata on a multiple of the CM’s then current CDS Fund contributions capped at one times the original CDS Fund contribution.³⁴ The total CDS Assessment Amount (“CAA”) is certified by ICE Europe and published in a Circular, at which time the CDS CMs become liable to pay their CACs.³⁵

If the CAA is not met by a CM (or CMs) for any reason, ICE Europe may direct that the shortfall be re-assessed against all CDS CMs, as if the shortfall were the CAA, provided that no CDS CM shall be liable to pay CACs for a single default in an amount greater than its CDS Fund Contribution immediately prior to the relevant default.³⁶ ICE Europe may assess additional CACs until the entire CAA has been met in full by the CACs.³⁷

After a CAC becomes payable, each CM has the option to terminate membership in ICE Europe, effective immediately and prior to the time when CDS Fund Contribution replenishments are payable.³⁸ A Retiring Member must pay all required CAC relating to defaults prior to resignation.³⁹ A Retiring Member’s obligation to pay a CAC will apply only with respect to events of CDS CM defaults occurring prior to the Retiring Member’s Termination Date⁴⁰ and any CDS CM defaults occurring after the Termination Date provided the Retiring Member still has a CDS Fund Contribution with ICE Europe.⁴¹ A Retiring Member’s aggregate CAC shall be capped at an amount equal to the Retiring Member’s CDS Fund Contribution immediately prior to the first default event(s) being declared which led to the application of CDS Fund contributions or an amount equal to the Retiring Member’s CDS Fund Contribution on the date of service of the relevant

³³ Rule 1106(a).

³⁴ Rule 1106(h).

³⁵ Rule 1106(b). The CAC is calculated by multiplying the CAA by the CM’s CDS Fund contribution immediately preceding the relevant default event (less the defaulter’s CDS Fund contributions) and dividing that number by the CDS Fund contribution of all CDS clearing members (“CGFALL”) immediately preceding the relevant default event. Rule 1106.

³⁶ Rule 1106(a) and (d).

³⁷ Rule 1106(a), (c) and (d).

³⁸ Rule 1106(h). A CM that elects to terminate its status as a CDS clearing member is referred to herein as a “Retiring Member.”

³⁹ *Id.*

⁴⁰ “Termination date” means the date on which a CM’s membership in ICE Europe terminates. Rule 101.

⁴¹ Rule 1106(c).

notice of termination.⁴² A Retiring Member's CACs are included for the purpose of calculating the cap.⁴³

In the event that a CM is both a CDS CM and an Energy CM, a default of the CM in either of these products constitutes a default in both.⁴⁴ Once any losses are determined, and to the extent that there is any excess default margin or guaranty fund contributions with respect to one membership, those excess assets may be applied to losses associated with the other membership, *i.e.*, following a default, the defaulter's assets from its other membership are applied before those of the non-defaulting CMs.

In general, ICE Europe will return a CM's CDS Fund Contributions following termination of the CM's membership on the first date of the first new CDS GFP beginning after the transfer or liquidation of all the CM's positions at ICE Europe and the payment of all other amounts due to ICE Europe.⁴⁵

Upon termination of a CDS CM's membership, the relevant CM shall remain liable to transfer, deposit, maintain and pay all margin, make CDS Fund contributions when due and make all other payments due under contracts and shall be obliged to: (1) transfer, liquidate, make settlement and delivery (as applicable) under contracts; and (2) take such other actions as ICE Europe at its discretion deems appropriate or necessary.⁴⁶

Discussion

The National Bank Act ("NBA") permits national banks to engage in foreign and domestic clearing activities, subject to safety and soundness limitations, as activities that are part of the business of banking because the activities are functionally equivalent to bank permissible credit and financial intermediation activities.⁴⁷ The NBA also permits national banks to join foreign and domestic clearinghouses that require members to cover a portion of the losses arising from the default of other members, as bank permissible guaranties, where the bank has a substantial interest⁴⁸ in being a member and its liability to the clearinghouse does not exceed Section 84 or lower EIC-established limits.⁴⁹

⁴² *Id.*

⁴³ Rule 1106(c) and (h).

⁴⁴ EM § 4.6.

⁴⁵ Rule 1102(g).

⁴⁶ Rule 209(d).

⁴⁷ *See, e.g.* OCC Interpretive Letter No. 1014 (Jan. 10, 2005) ("IL No. 1014"); IL No. 929 (Feb. 11, 2002) ("IL No. 929"); OCC Interpretive Letter 892 (Sept. 8, 2000) and OCC Interpretive Letter No. 494 (Dec. 29, 1989) ("IL No. 494").

⁴⁸ Under 12 C.F.R. § 7.1017(a), a national bank is permitted to guarantee the obligations of another party if the bank has a substantial interest of its own in the transaction. This regulation provides, in part, that "[a] national bank may lend its credit, bind itself as a surety to indemnify another, or otherwise become a guarantor . . . if: (a) The bank has a substantial interest in the performance of the transaction involved." A

Recently, the OCC addressed the ability of national banks to join US ICE Trust, a domestic CDS clearinghouse.⁵⁰ The OCC determined that a national bank had a substantial interest in becoming a CM of the clearinghouse, where CMs were subject to potentially unlimited liability for the defaults of other CMs. In the event that the CDS clearing fund was not sufficient to cover a member default, the clearinghouse had the right to require non-defaulting members to pay additional assessments sufficient to restore each CM's required contributions to the guaranty fund prior to the opening of business the next business day. Although CMs could limit their liability to the clearinghouse to an amount equal to their required fund contribution by terminating membership in ICE Trust, ICE Trust Rules and Procedures did not expressly limit member liability to the clearinghouse to Section 84 limits. Accordingly, in IL No. 1113, the OCC clearly established that where a bank seeks to join a clearinghouse that does not specifically limit member exposure to a set amount that is within a bank's Section 84 limits, a bank must provide its EIC with prior written notice of its proposed clearinghouse activities and obtain a written no-objection before becoming a member of the clearinghouse. The written no-objection is based on the EIC's evaluation of the adequacy of a bank's risk measurement and management systems and controls to enable the banks to engage in CM activities on a safe and sound manner, and other supervisory considerations.

We conclude that it is permissible under the NBA for the Bank to become an ICE Europe CDS CM, subject to the same criteria espoused in IL No. 1113. The Bank must establish a comprehensive risk management framework and limit its exposures to ICE Europe to its Section 84 limits or a lower exposure limit established by the EIC, in light of the size of the Bank, the nature and volume of its activities, and the characteristics of the

nexus between a bank permissible transaction and a guaranty may provide the "substantial interest" for the bank. *See, e.g.*, IL No. 929, *supra* (bank's provision of a default fund contribution/guaranty was incidental to the business of bank's clearing and execution activities and satisfied substantial interest needed for issuance of a guarantee) and OCC Interpretive Letter No. 376 (Oct. 25, 1986) (national bank's guarantee of third party securities borrowers' conduct was incidental to the bank's securities lending program and constituted a sufficient substantial interest). The OCC has determined that national banks have a substantial interest in agreeing to cover a portion of the losses of defaulting members as a condition to clearinghouse membership where this obligation is an integral part of bank permissible clearing activities. *See, e.g.*, IL No. 1113, *supra*; OCC Interpretive Letter No. 1102 (Oct. 14, 2008) and IL Nos. 1014 and 929, *supra*.

⁴⁹ *See, e.g.* OCC Interpretive Letter No. 1071 (Sept. 6, 2006) and IL Nos. 1014 and 929, *supra*.

⁵⁰ IL No. 1113, *supra*.

clearinghouse.⁵¹ The Bank's membership in ICE Europe should enable the Bank to reduce its counterparty credit risk and operational risk from CDS transactions because the clearinghouse will act as the central counterparty and net self-clearing members' positions. However, because each CM assumes obligations to cover losses from other defaulting CMs, membership also can create a complex, contingent forward credit exposure. Accordingly, prior to joining ICE Europe, the Bank should establish a comprehensive risk management framework to measure and manage the risk arising from these exposures. The attributes of such a comprehensive risk management framework are addressed in IL No. 1113.

Conclusion

We conclude that the Bank may participate as a CDS CM of ICE Europe, provided the Bank, prior to becoming a CM, establishes a comprehensive risk management framework to govern the risks associated with its membership and receives a written supervisory no-objection letter from its EIC. The Bank's exposure to ICE Europe is subject to Section 84 and must not exceed Section 84 limits. Our conclusions are specifically based on the Bank's representations, and any change in facts or circumstances could result in a different conclusion. If you have any questions concerning this letter, please contact Tena M. Alexander, Senior Counsel, Securities and Corporate Practices Division, at (202) 874-4625.

Sincerely,

signed

Julie L. Williams
First Senior Deputy Comptroller
And Chief Counsel

⁵¹ Under the lending limit, 12 U.S.C. § 84 and 12 C.F.R. Part 32, a national bank's loans and extensions of credit to one borrower are limited to 15 percent of the bank's capital and surplus, subject to certain exceptions and with the application of certain loan combination rules. Additionally, a bank's credit exposures must be consistent with safe and sound banking practices. Accordingly, the Bank must limit its exposure to ICE Europe so that amounts of funds advanced as margin or CDS Fund contributions do not exceed an amount equal to, if not below, the Section 84 limits, in light of the size of the Bank, the nature and volume of its activities, and the characteristics of the clearinghouse.