

LONDON NOTICE No. 3159

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NYSE LIFFE CLEARING INTRODUCTION OF NEW CLEARING AGREEMENTS AND AMENDMENTS TO LIFFE RULES

Executive Summary

This Notice advises Members of the introduction of new clearing agreements and certain proposed amendments to Book II of the LIFFE Rules, in each case to support the new NYSE Liffe Clearing arrangements which are targeted to come into force on Monday 27 July 2009. Members wishing to comment on the amendments to the Rules, or to seek further clarification thereof, should do so by Friday 26 June 2009.

1. Introduction

- 1.1 London Notice No. 3158, issued on 26 May 2009, advised Members that LIFFE Administration and Management (“LIFFE”) will replace LCH.Clearnet Ltd (“LCH”) as the Central Counterparty (“CCP”) in respect of LIFFE Contracts from the go-live of the proposed NYSE Liffe Clearing arrangements. Following this, LIFFE will outsource, amongst other things, the existing clearing guarantee arrangements and related risk functions to LCH, which will remain responsible (as today) for the positions of a defaulting Clearing Member and for applying its rules and resources to manage the impact of any such default. The termination of the existing clearing arrangements and commencement of the new arrangements between LIFFE and LCH are targeted for **Monday 27 July 2009** (the “Go-Live Date”), on which date NYSE Liffe Clearing will commence operations.
- 1.2 This Notice provides Members with further information relating to the execution of new Member agreements and notifies Members of the necessary amendments to Book II of the LIFFE Rules to support the introduction of NYSE Liffe Clearing.

2. New Clearing Agreements

- 2.1 The new NYSE Liffe Clearing arrangements will necessitate the replacement of the existing clearing agreements with the following:
- (a) **Tripartite Clearing Membership Agreement (“TCMA”)** – this agreement is between a Clearing Member (i.e. an Individual Clearing Member, a General Clearing Member or a Commodity Clearing Member), LIFFE and LCH; and

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The **Euronext Derivatives Markets** comprise the markets for derivatives operated by Euronext Amsterdam, Euronext Brussels, Euronext Lisbon, Euronext Paris and LIFFE Administration and Management, referred to respectively as the Amsterdam, Brussels, Lisbon, Paris and London markets. Euronext is part of the NYSE Euronext group.

- (b) **Non Clearing Membership Agreement (“NCMA”)** – this agreement is between a Non-Clearing Member, its General Clearing Member and LIFFE. It should be noted that LCH has agreed, notwithstanding that it is not a signatory to the NCMA, that the existing four party NCMA shall terminate at the Transfer Time (as identified in 2.2 below).
- 2.2 Following signature, these agreements give effect to the new clearing arrangements at 00.05am on the Go-Live Date (the “Transfer Time”) at which point there is a novation of the CCP from LCH to LIFFE.
- 2.3 Under the NYSE Liffe Clearing arrangements, LIFFE will be CCP to all Registered Exchange Contracts executed on the London market of NYSE Liffe following the Go-Live Date. It is LIFFE’s Rules that will govern day-to-day central counterparty operations, e.g. marking to market, netting of positions and so on.
- 2.4 As part of these arrangements, LIFFE has appointed LCH as provider of certain clearing services, including the management of positions of any LIFFE Clearing Member that is declared a defaulter. These arrangements provide that, in the event of a Clearing Member default, each outstanding Registered Exchange Contract between the defaulting Clearing Member and LIFFE is automatically novated so as to substitute LCH as party in place of LIFFE (the Default Novation), thus enabling LCH to undertake its default management services. As a result of this, Clearing Members continue to benefit from Cover being calculated and collected on a net basis by LCH across all of the markets in respect of which it provides clearing services. LCH also collects and pays premiums, variation margin and other cash payments arising under Registered Exchange Contracts and manages the settlement and delivery obligations of contracts upon expiry, ensuring that Clearing Members continue to benefit from the same single set of Cover and tender accounts and netting of collateral and payment obligations at the LCH level as today. These arrangements have the additional benefit of making the transition from the *status quo* to the NYSE Liffe clearing arrangements as straightforward as possible.
- 2.5 To reflect the role of LCH, and in particular the netting of Clearing Member financial obligations across markets, the TCMA provides that LIFFE’s central counterparty financial obligations are satisfied on each trading day from the time that the Clearing Member’s overall financial position is made up on a net basis in the accounts of LCH following marking to market of open contracts on the LIFFE Market and other markets for which LCH provides services. Following this time, a Clearing Member’s financial rights and obligations to or against LIFFE as CCP in respect of individual LIFFE positions are, to the extent reflected in such Member’s updated accounts with LCH, discharged and replaced by financial rights and obligations on a net basis to or against LCH, as today. Similarly, the TCMA provides for delivery obligations following the expiry of an open contract on the market to be discharged and replaced by delivery obligations between the relevant Clearing Member and LCH.
- 2.6 As a result of the above, whilst LIFFE remains CCP, a Clearing Member’s counterparty insolvency risk in respect of variation margin, net liquidating value and the performance of outstanding delivery obligations under LIFFE contracts remains that of LCH, which continues to collect and manage Cover as principal and maintains its current default resources. The NYSE Liffe Clearing arrangements provide some further protections to Clearing Members in the unlikely situation that LCH’s resources should prove insufficient, resulting in it being unable to meet its obligations. In this situation, LIFFE’s role as CCP would enable it to bring certainty to the market in relation to open contracts, and its activity in this respect would be underpinned by its own capital. Members should note that, in such circumstances, the LIFFE Board would take emergency action to suspend the LIFFE Market and close out all positions by invoicing back under existing LIFFE Rule 4.16. Following this process, as today, Clearing Members would have a claim against LCH (and not against LIFFE) in respect of any variation

margin, net liquidating value and outstanding delivery obligations under LIFFE contracts, to the extent reflected in such Member's accounts with LCH. Subject to any overriding fiduciary duties or the instructions of a regulatory body, the LIFFE Board's discretion would be exercised to select such last price as was used to mark to market open positions as the price for invoicing back such positions; any new positions that resulted from trading on the relevant day would be invoiced back at their trade price. The TCMA also provides for the initial novation of Clearing Member contracts from LCH to LIFFE as CCP at the Transfer Time:

- 2.7 In conjunction with the publication of this Notice, copies of the TCMA and relevant NCMA's have been sent to each Clearing Member for review and signature. Members are asked to return completed documents to LIFFE by **Friday 17 July 2009**.

3. Rules (including Contract Specifications)

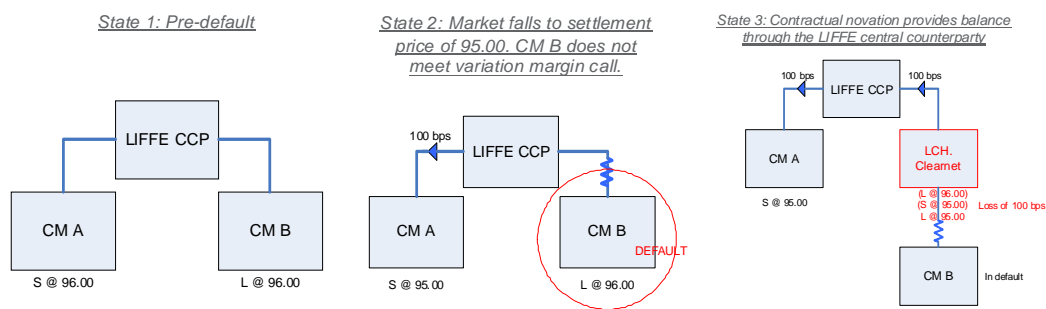
- 3.1 As outlined above, the new clearing arrangements require both LIFFE and LCH to make amendments to their Rules and Regulations. The proposed amendments to LIFFE Rule Book II, the substance of which have been reviewed and approved by the Membership, Rules and Trading Committee and the Board, form the Attachment to this Notice. In summary, the main changes are as follows:

- (a) modification of the Default Rules (Section 9) to reflect the revised mechanism pursuant to which LCH will be responsible for managing any default of a LIFFE Clearing Member. In the event that LIFFE, or LCH as its Clearing Services Provider ("CSP"), declares a default of a LIFFE Clearing Member, the market contracts to which that Clearing Member is party with LIFFE will novate to LCH;
- (b) the replacement of end-of-day registration of contracts with real-time registration at the point of trade (LIFFE Rule 4.12);
- (c) a new Section 13 of the LIFFE Rules governing clearing functions to be performed by LIFFE as CCP or LCH as its Clearing Services Provider;
- (d) changes to the membership section of the Rules (Section 3) to allow LCH to become a Special Member of the LIFFE Market. This is necessary in order to facilitate the novation device in the event of a Clearing Member default (for the same reason, LIFFE will also become a special member of LCH);
- (e) changes to Rule 4.16 to clarify further the circumstances in which the LIFFE Board would exercise its emergency powers, and the price at which any invoicing back would take place (as outlined in 2.6 above)
- (f) revised Rules on arbitration (Section 6) which reflect LIFFE's role as CCP; and
- (g) consequential changes made to other parts of the Rulebook to maintain consistency in definitions.

- 3.2 The remainder of this Notice focuses on the substantive changes which have been made to the LIFFE Rules. Co-incidental changes to defined terms or "boilerplate" provisions will not be commented on, except to the extent that they materially change the effect of the LIFFE Rules. Members should note that LIFFE does not require Members to put in place new contractual arrangements with their non-Member customers in order to reflect the change in clearing arrangements.

DEFAULT RULES

- 3.3 Amendments have been made to Sections 9.1 and 9.2 of the current Default Rules to reflect the fact that LCH will be responsible for managing any default of a LIFFE Clearing Member. The effect of the modifications is explained in the remainder of this section of the paper. In addition, the Default Rules have been further amended to incorporate two changes, including an expanded definition of “Market Contract”, arising from changes to Part VII of the Companies Act 1989.
- 3.4 Should a Clearing Member be declared a defaulter, the market contracts to which that Clearing Member is party with LIFFE will novate to LCH under LIFFE’s new Default Rules. Following a default novation, balancing contracts will be created between LIFFE and LCH.
- 3.5 The points and diagrams below set out the principles of the default novation process:
- On declaration of a Clearing Member default, LCH becomes intermediate counterparty to the Clearing Member and LIFFE.
 - The price at which novation takes place will leave no loss (or profit) for LIFFE.
 - LCH will manage the practical consequences of the Clearing Member default.
 - LIFFE Default Rules will apply to back-to-back Non-Clearing Member or client contracts (as at present).



LIFFE AS CCP AND CONTRACT FORMATION

- 3.6 LIFFE will act as CCP to all trades effected on the LIFFE market or accepted by LIFFE within Bclear. The CSP will be a Special Member of LIFFE, subject only to those of its rules necessary to facilitate the novation device outlined above.
- 3.7 LIFFE Rule 4.12 has been amended to reflect the way that the contract formation process will work in future. Formation of contracts under the new arrangement differs from the way contracts are formed currently. LIFFE will introduce real time registration meaning that at the moment an Original Contract is made on the LIFFE market, it will be discharged and replaced by two “Registered Exchange Contracts”, one between the buying Clearing Member and LIFFE as CCP and the other between the selling Clearing Member and LIFFE as CCP. In respect of business done by non-clearing members and clients, there will be a chain of back-to-back contracts with each party in the contractual chain acting in the capacity of principal, as is the case today. In consequence, where a client has dealt through a non-clearing member, there will be the following chain of contracts:

- (a) between client and Non-Clearing Member;
 - (b) between Non-Clearing Member and Clearing Member (i.e. a Parallel Contract under LIFFE Rules); and
 - (c) between Clearing Member and LIFFE as CCP.
- 3.8 As a result, some nomenclature has changed. In addition, “Related Contracts” (as defined in the existing Rules) no longer exist in the new LIFFE Rules as a consequence of real-time registration, since back-to-back contracts between two Clearing Members will no longer need to be created prior to registration.
- 3.9 Consequential changes to the Link Rules have been made to give LIFFE the appropriate protections as CCP on the default of a Member party to a Linked LIFFE Contract.

MEMBERSHIP

- 3.10 The existing provisions in the Rules and LCH Rules relating to Clearing Membership have been largely retained. There will continue to be an obligation on Clearing Members to be a member of the CSP. The only material change to the LIFFE Rules concerning membership is the addition of “Special Member” as a new membership category. This is necessary in order for the CSP to be a member of the LIFFE market which, in turn, is required in order for the operation of the new default management arrangements.

CLEARING

- 3.11 A new Section 13 of the Rules has been created to explain how trades will be settled and cleared by LIFFE and to provide general provisions enabling LIFFE to perform clearing-related activities (such as setting up and holding accounts, calling and holding margin and registering contracts and delivery obligations), either itself or to outsource these activities to the CSP.
- 3.12 Rules on Settlement and Marking-to-Market have been incorporated into Section 13. These Rules explain that all Registered Exchange Contracts are marked-to-market daily (i.e. they are valued on a daily basis) and a sub-set of Registered Exchange Contracts¹ are settled-to-market (i.e. they are closed out on a daily basis with reference to the latest daily settlement price, giving rise to Daily Settlement Amounts which are credited to or debited from the relevant Clearing Members’ accounts, and are re-opened at the latest daily settlement price). Liquidating value in respect of those contracts not settled-to-market (e.g. premium up-front option contracts) shall be credited to or debited from the relevant Clearing Members’ accounts.

ARBITRATION

- 3.13 The key changes to the arbitration section of the LIFFE Rules are aimed at simplifying the handling of disputes between contractual counterparties in relation to any Contract in the Terms of an Exchange Contract and ensuring transparency. The main structural change is to encourage arbitrations to proceed between those parties ultimately interested in the outcome of the dispute, enabling intermediary counterparties to be passive in the ongoing process of the arbitration, albeit that any award granted by the arbitrators will be binding upon all those in the contractual chain with the intention that such award flows through the chain. The revised rules also place a greater emphasis on the independence of arbitrators and decision making, reflecting LIFFE's role as CCP.

¹ i.e. futures contracts and those option contracts for which premium is paid upon exercise rather than up front.

CONTRACT SPECIFICATIONS

3.14 It is LIFFE's intention in due course to issue updated Contract Specifications to reflect the new clearing arrangements. Until such time, from the Go-Live Date, any references to the "Clearing House" in any contract in the terms of a LIFFE exchange contract or its associated administrative procedures shall be read as being a reference to LIFFE, acting as central counterparty, save where LCH is carrying out obligations as CSP, as further set out in the TCMA and the Rules.

4. Consultation on the proposed amendments to the LIFFE Rules

4.1 There has already been substantive communication and discussion between the Exchange and Members on the broad operation of NYSE Liffe Clearing and in particular the replacement of LCH by LIFFE as the CCP. Members wishing to comment, or to obtain clarification, on the proposed amendment to the Rules are asked either to contact those Exchange staff listed below or, alternatively, to submit comments in writing, addressed to the Market Secretary, to reach the Exchange by **Friday 26 June 2009**.

For further information in relation to this Notice, Members should contact:

Declan Ward	(+44) 20 7379 2322	dward@nyx.com
Neil Carter	(+44) 20 7379 2097	ncarter@nyx.com
Nick Carew Hunt	(+44) 20 7379 2104	ncarewhunt@nyx.com
Chris Herman	(+44) 20 7379 2367	cherman@nyx.com
Laurence Walton	(+44) 20 7379 2782	lwalton@nyx.com