

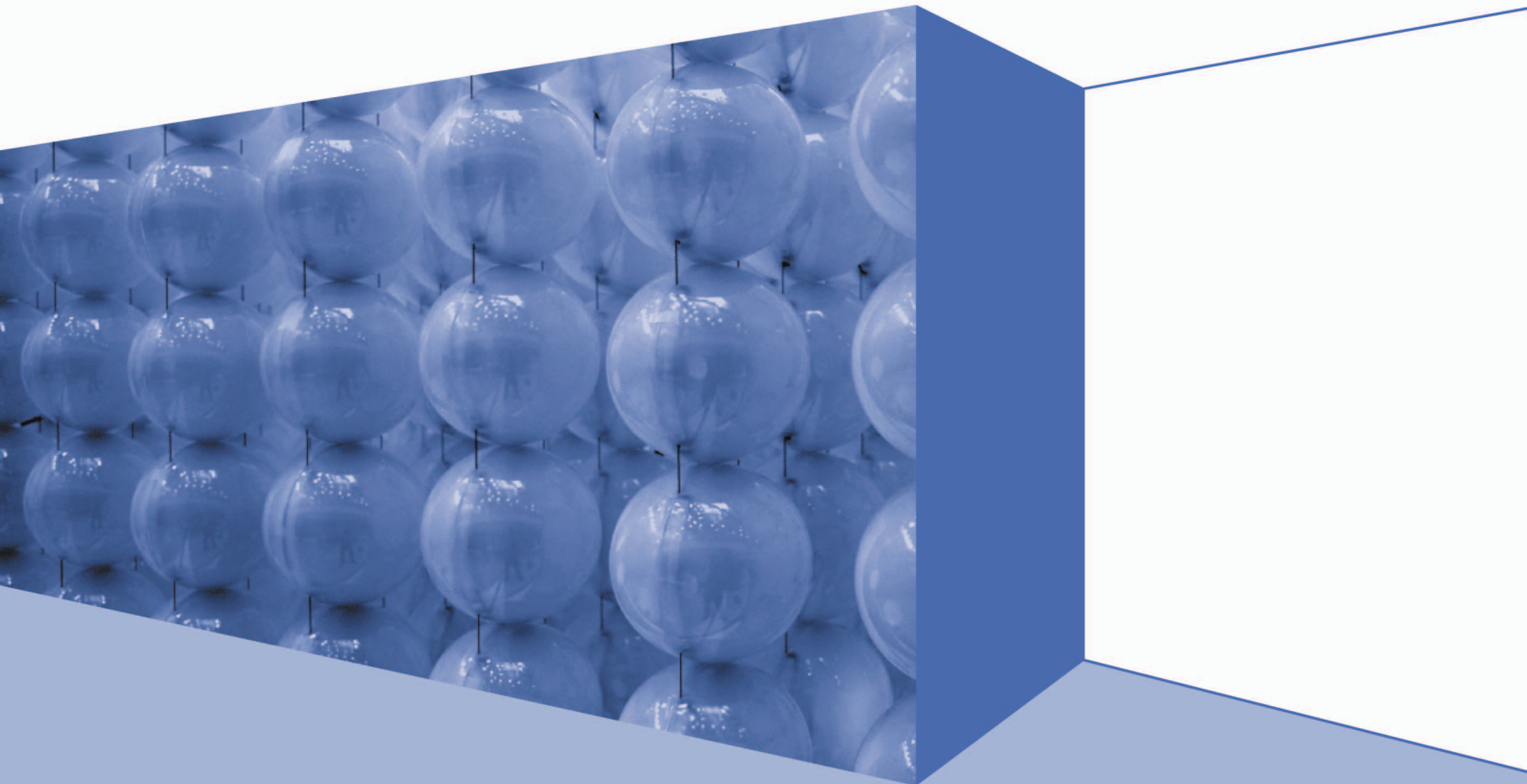


London
Stock Exchange

SERVICE DESCRIPTION

Competitive Clearing

2008



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1. Introduction

1.1 Objectives of competitive clearing

The London Stock Exchange (“the Exchange”) started using the London Clearing House (“LCH”) as the central counterparty for its UK equity order book, SETS¹, in 2001. Since then, the service has been enhanced in a number of ways: the range of stocks has expanded considerably, SETSqx has been introduced for less liquid stocks and settlement netting has also been introduced. During this period, LCH has become part of LCH.Clearnet Group.

The Exchange now intends to provide its member firms with a choice of central counterparty between LCH and SIX x-clear AG (“x-clear”) because of the belief that competition enhances markets and delivers lower costs and increased service levels to market participants.

The introduction of choice of central counterparty is intended to provide more flexibility for members and to ensure that central counterparty services are of higher quality and are delivered at lower prices through open competition between central counterparties as well as a level playing field between CCPs.

1.2 Key characteristics of competitive clearing

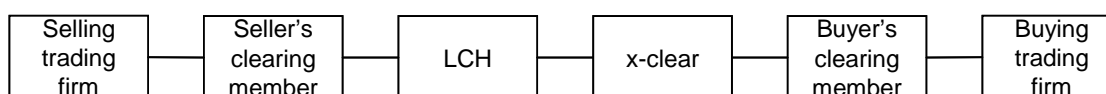
1. Customers will have freedom of choice regarding which of the central counterparties above to use.
2. The two central counterparties will operate on equal terms, i.e. neither central counterparty will operate as a “sub-CCP” of the other.
3. The solution will be based on existing and/or proposed infrastructure to reduce the impact for all stakeholders where reasonably possible.
4. There will be no material impact for customers that choose to keep their current clearing arrangements.
5. Routing of trade information to the relevant central counterparty(s) will be carried out centrally. For the initial implementation, this will be by the Euroclear UK and Ireland Limited (“EUI”) system.

¹ In this document, the term “SETS” should be taken to include those segments of SETSqx that use central counterparty clearing.

6. No material change is expected to current settlement arrangements in the near future.
7. Customers will only have to interact with their chosen central counterparty. It should make no difference to them whether their trading counterparty is using the same central counterparty or a different one. All the clearing and settlement processes for the customer will be the same in either case.

Under the competitive clearing service, three possible scenarios exist:

1. Both the buyer and the seller use LCH as their central counterparty.
2. Both the buyer and the seller use x-clear as their central counterparty.
3. One of the buyer and seller uses LCH and the other uses x-clear as their central counterparties. In this case, the contractual chain will be as follows (the diagram below depicts the flow of cross-CCP trades with the seller using LCH and the buyer x-clear):



1.3 Purpose of this service description

This service description provides a high level description of the initial implementation of competitive clearing and its impact on users of the market. Information about the future development of the service is provided in section 0.

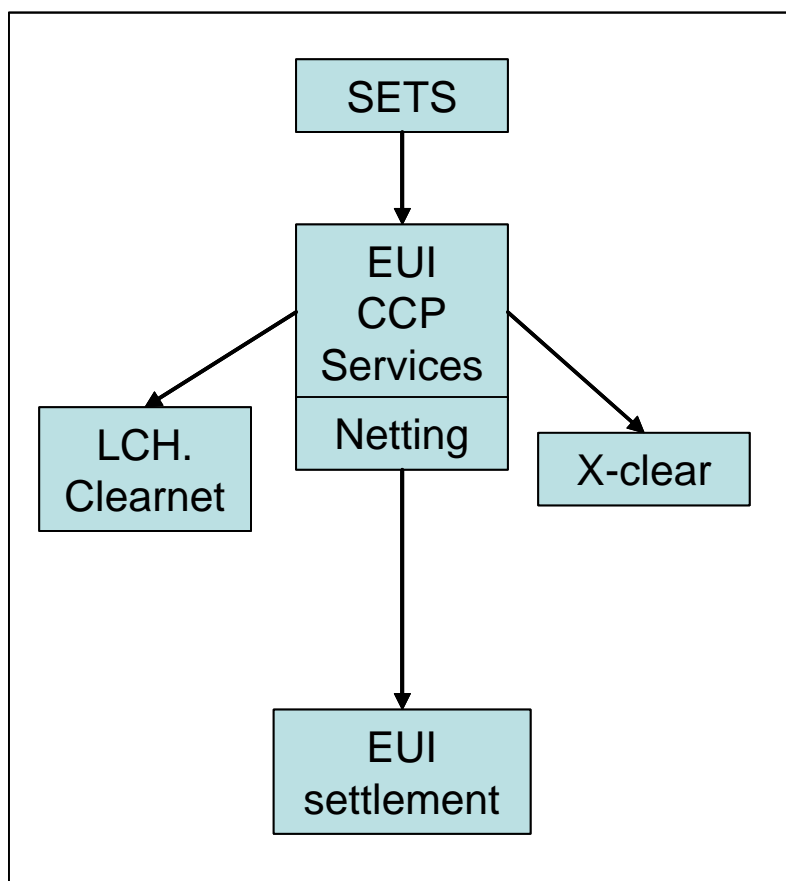
The service description also outlines the proposed implementation approach.

The description is applicable to UK equity trading and not to other markets operated by the Exchange.

1.4 Implementation approach

In the initial implementation of competitive clearing, x-clear will make use of an enhanced version of the EUI CCP Services that will support multiple CCPs. The basic operation will however be essentially the same as with a single CCP. This means that both central counterparties will primarily provide risk management, with EUI providing most of the transaction processing.

The diagram below illustrates the high-level flow between the Exchange, LCH, x-clear and EUI for the exchange of transaction information as a result of the introduction of competitive clearing.



1.5 Interoperability

Interoperability between the CCPs allows for a choice of CCP service provider for the trades executed on the Exchange. As the trading system maintains full anonymity, trading participants are not able to determine which CCP their trading counterparty is using, and it makes no difference to their post-trade processing, which is only with their own CCP. The cross-CCP positions that arise are dealt with between the two CCPs without member involvement.

1.6 Information about x-clear

X-clear is part of the SIX Group, based in Switzerland. X-clear currently provides central counterparty services to SWX Europe and SIX Swiss Exchange.

X-clear has been recognized by the Financial Services Authority in the UK (FSA) under the Financial Services and Market Act 2000 (FSMA) as a Recognized Overseas Clearing House (ROCH) since 2004. The company also has a banking license under Swiss law and is thus regulated and supervised by the Swiss Federal Banking Commission (SFBC) and under the oversight of the Swiss National Bank.

More information about x-clear can be found at www.ccp.sisclear.com/ccp/index.htm.

1.7 Information about LCH

LCH currently provides central counterparty services for cash equity trades to the London Stock Exchange and SWX Europe. It also provides central counterparty services in other products to other markets. LCH is regulated as a Recognized Clearing House by the Financial Services Authority.

More information about LCH can be found at www.lchclearnet.com.

1.8 Further information about competitive clearing

Information about the use of EUI systems to support competitive clearing can be found at www.euroclear.co.uk.

Further information about the Exchange's use of central counterparties can be found at www.londonstockexchange.com.

2. Description of competitive clearing

The description is intended to highlight key impacts arising from the move from one to two central counterparties and to answer other likely questions.

It is not intended to be a complete description of either the LCH.Clearnet or x-clear services, especially those areas that are not impacted by the introduction of competitive clearing and/or do not need to change.

Exchange members execute trades on the SETS order book. After each trade is executed, it is confirmed to the Exchange members involved. LCH.Clearnet and x-clear act as the CCPs for all SETS trades.

Details of the CCP-eligible trades are transmitted from the Exchange to EUI using a proprietary data format.

Either LCH.Clearnet or x-clear or both will act as the CCP(s) for a SETS trade, depending on the clearing arrangements of the buyer and seller. Each member will see their central counterparty identifier as its trading counterparty, providing post-trade anonymity for these trades. Members will not be able to tell which CCP is being used by their trading counterparty on SETS.

1.9 Scope

The scope of the service will be the same range of securities, participants and trades as today (subject to any changes that occur before implementation).

The Exchange does not intend to change the operation of its markets as a consequence of introducing competitive clearing. In particular, there will be no change to market hours or to the processing of contra trades.

1.10 Trade feed

The Exchange will continue to send its trade feed to the EUI system in real time as today.

1.11 EUI trade processing and routing

1.11.1 SDRT, Irish stamp duty and transaction reporting

These processes will continue to be carried out by the EUI system using the information in the trade feed.

1.11.2 Transaction processing

Transaction processing will be similar to processing today, with the EUI system carrying out most of the processing, including trade registration on behalf of the central counterparties and optional settlement netting, and the central counterparties carrying out the counterparty risk management. Settlement will continue to be in EUI.

The EUI system will validate trade messages received from the Exchange. If the trade is valid, then it will create the relevant transactions for both central counterparties, including the inter-central counterparty settlements when required. If the trade is not valid, then none of the transactions will be created until the problem is resolved.

1.11.3 Trade routing

Each trade will be routed so that it can be processed by the relevant central counterparty(s). The routing is expected to occur very shortly after the trade execution.

Where the buyer and the seller are using different central counterparties, the trade information will be made available to both central counterparties with the other central counterparty identified in place of the participant using it.

The process will create the resulting inter-central counterparty settlements; this will be invisible to participants other than the central counterparties.

The routing will be based on the preferences expressed by the participants.

The routing will be static, ie it will not be possible for a trading participant to route different trades to different central counterparties unless they operate effectively as two different trading participants (ie with different Member IDs on the Exchange's trading system). This is similar to the way that the EUI system currently determines which clearing members and settlement participants apply to each side of a trade.

1.12 Risk management

Each central counterparty will be free to determine and operate its own risk management processes independently of the other central counterparty.

The central counterparties do not have to operate the same methods of risk management.

The Exchange expects that the central counterparties will operate risk management processes between each other to manage the counterparty risk that they will generate against each other.

1.13 Operating calendar

Both LCH and x-clear will accept trades for clearing purposes on all days on which the Exchange is open for trading.

1.14 Settlement with the central counterparties

Trades on the Exchange and cleared by LCH and/or x-clear are settled at EUI.

Participants will continue to settle with their chosen central counterparty as they do today.

Both central counterparties will offer a choice of gross settlement or net settlement using trade date netting (the current approach to netting).

1.15 Corporate actions

The EUI system will handle corporate action processing on the open trades which are eligible for corporate action benefits, as it does today.

The potential presence of two CCPs in the transaction chain will have no impact on end customers.

1.16 Settlement fails

1.16.1 Current mechanisms

Settlement fails due to lack of stock are currently handled by a combination of four different mechanisms. It should be noted that the FSA requires that exchanges and clearing houses regulated by it have methods of monitoring and dealing with settlement fails as part of the FSA Recognition Requirements.

1. The EUI settlement discipline regime, which fines participants with settlement performances below pre-set limits.
2. Buying-in at buyer request by the Exchange. Buyers can request action by the Exchange once individual settlements are more than a fixed number of days late.
3. Buying-in by LCH. LCH can choose to buy in against individual settlements that are more than a fixed number of days late (currently 30 days). The LCH threshold for this is after the Exchange's threshold for buying-in at the buyer's request – ie the buyer will have had an opportunity to ask the Exchange to take action before LCH reach their threshold.
4. Invoicing Back by LCH. This is a process of canceling an outstanding transaction, with cash compensation paid, that LCH would use if there was no realistic prospect of the transaction settling.

1.16.2 The impact of competitive clearing

The EUI settlement discipline regime is not expected to change.

The Exchange will continue to offer buying-in at the buyer's request.

Both central counterparties will be able to operate their own buying-in or invoicing back procedures. It is not a requirement of competitive clearing that the two regimes are identical. In some cases, the action of one central counterparty could be to buy in against the other central counterparty.

The two central counterparties are also free to operate other processes that would tend to improve settlement efficiency, for example borrowing stock to cover unsettled deliveries. It is possible that none, one or both central counterparties could offer this.

There is no proposal to introduce fining for late settlements.

1.17 Default

Each central counterparty will operate its own protection mechanisms against the default of clearing members, including its own approach to calculating margin levels and default fund contributions. There is no requirement that the two central counterparties use identical methods or parameters in these areas.

1.18 Migration

The migration approach for firms to move between central counterparties will be to set a date for change for each such firm. From that date, new trades will be routed to the new central counterparty for that firm. It will not be possible to transfer outstanding positions between the central counterparties if a firm changes central counterparty, however it would be expected that most outstanding positions would disappear within three days as a result of normal settlement.

1.19 Validation

Where a validation failure occurs, the Exchange, together with EUI and the relevant CCP(s), will work together to resolve it and have the trade processed by the CCP(s). If resolution of the validation problem is not possible, then the trade will become a bilateral trade between the trading counterparties and will not be centrally cleared. Further information is available in the Exchange rules at: www.londonstockexchange.com/products/marketdata/directcustomers/services/rules.htm.

3. Impact on market participants

1.20 Trading

There will be no impact on trading. There are no changes to any TradElect messages as a result of competitive clearing.

1.21 Clearing

1.21.1 Impact of competitive clearing

The introduction of competitive clearing should cause no material impact on clearing members that choose to continue to clear through LCH.

1.21.2 Membership of both CCPs

Customers can also be participants of more than one CCP at the same time, however all trades executed under the same Member ID and dealing capacity must be cleared through the same CCP.

There is no requirement from the Exchange for General Clearing Members (or any other clearing member) to be members of both central counterparties. This is entirely the decision of the clearing member. It will be possible for a General Clearing Member to use both central counterparties with the trades for some of its non-clearing members being cleared by one central counterparty and trades of the others being cleared by the other central counterparty.

1.21.3 Changing CCP

Clearing members that choose to change central counterparty will have to go through the relevant membership processes for their new central counterparty and agree an effective date for the change with the Exchange and the new central counterparty. Trades done before the effective date will be sent to the previous central counterparty. Trades done on or after the effective date will be sent to the new central counterparty. The settlement of trades done before the effective date will remain with the previous central counterparty and will not be transferred to the new one.

1.22 Settlement

It is not expected that participants that change central counterparty will have to change their settlement procedures to settle with the new central counterparty.

4. General requirements

The general membership requirements are published on the London Stock Exchange website www.londonstockexchange.com.

To have trades effected on the Exchange and cleared by LCH or x-clear, Exchange members are also required to be members of the LCH or x-clear or to use a GCM that is a member of one of those CCPs, and also to be either participants in EUI or to make use of a settlement agent.

Each member must comply with the infrastructure requirements of the Exchange, LCH, x-clear and EUI, as applicable.

5. Implementation

1.23 Project approach

TradElect and the systems operated by LCH, x-clear and EUI have all been updated to support competitive clearing.

The Exchange's rule changes were carried out as part of the rule review for MiFID.

1.24 Timescale

Information about the timescale is available from x-clear.

1.25 Testing

Please contact your Technical Account Manager for more details on testing and development.

1.26 Exchange rules

There will be no change to the Exchange rules as a result of the introduction of competitive clearing (the necessary changes were made as part of the pre-MiFID review).

6. Future enhancements

During 2009, the Exchange intends to introduce its own routing service, X-TRM, to provide the multi-CCP aspects of its service. X-TRM will also support clearing of markets that do not settle in EUI and the Exchange's forthcoming CFD product.

With regard to the clearing of UK equities, X-TRM will support:

1. Real-time information feeds to traders, clearing members and CCPs.
2. Support of multiple CCPs in a standard model.
3. The ability for customers to choose which system provides settlement netting for them: X-TRM itself, their CCP or EUI.
4. Optional routing of settlement instructions to EUI.

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