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David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

14 February 2011

Dear Mr Stawick,

Re: RIN 3038-AD01, "Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest"

The LCH.Clearnet Group ("LCH.Clearnet") is pleased to add further comment to its previous letters[1] in response to the Commodity Futures Trading Commission's (the "CFTC's" or "Commission's") proposing release: "Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest."

These additional comments are made in relation to the submission of the United States Department of Justice ("DoJ")[2].

LCH.Clearnet strongly supports the policy goals underpinned by the statutory provisions contained in Section 726 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). As enacted, this Section gives the CFTC discretionary authority to write rules limiting the control of, or the voting rights with respect to, a Derivatives Clearing Organization ("DCO"), a Designated Contract Market ("DCM"), or a Swap Execution Facility ("SEF") by an individual Enumerated Entity[3].

In our understanding, Section 726 neither authorizes, nor recommends, the CFTC to limit aggregate ownership of a DCO, DCM or SEF by bank holding companies or other specified entities. Indeed, LCH.Clearnet believes that Congress correctly rejected any collective or aggregate limits on the ownership of clearing and trade execution facilities in the Dodd-Frank Act.

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[1] Letters from Roger Liddell, Chief Executive, LCH.Clearnet Group Limited, to David Stawick, Secretary, Commodity Futures Trading Commission (November 5 and 17).

[2] Submission from Christine A. Varney, Assistant Attorney General, U.S. Department of Justice, Antitrust Division, 28 December 2010; http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26809&SearchText=

[3] "Enumerated Entities" include a Swap dealer, a major Swap participant, and a large bank holding company or non-bank financial company regulated by the Federal Reserve.

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For this reason, and as noted in our earlier submissions, the Group is concerned by the Commission's proposed Rule 39.25(b)2(i) under RIN 3038-AD01, which provided that participants should not collectively own or vote on more than 40 percent of any class of securities or other ownership interest.

The group is similarly troubled by the DoJ's recent submission on this matter and respectfully wishes to contest some of the comments raised therein. The DoJ asserts that a DCO controlled by Enumerated Entities: would have an incentive not to clear certain over-the-counter derivatives ("OTC" derivatives or "Swaps"), or to submit Swaps to the CFTC for review if clearing should be required; would restrict access to new clearing members to insulate them from competition in market-making; and could resist clearing certain kinds of instruments in an effort to disadvantage rivals.

LCH.Clearnet's experience disproves these comments. The Group has adopted a number of corporate governance safeguards to ensure that conflicts of interest do not affect the safety and soundness of its clearinghouses and its ability to serve markets by developing clearing services for new asset classes. These include limitations on voting rights by individual shareholders, independent Board Members and objective and transparent clearinghouse membership criteria. The Group believes that such limitations would serve as a useful precedent for the Commission in its final rulemaking.

The involvement of banks and other Enumerated Entities in the ownership and governance of our CCPs has made a significant contribution towards the development of innovative and proven clearing services – particularly in the OTC markets. Examples of this include the Group's OTC Interest Rate Swap ("IRS") and Repo clearing services SwapClear[4] and RepoClear[5].

SwapClear is recognized globally as a major contributor to financial stability[6] and is the most-commonly cited example of a successful Swaps derivative clearing service. SwapClear is the only truly global clearing service for OTC IRS. Launched in 1999, it clears approximately 43 per cent of the world IRS market, with over $252 trillion in notional trades outstanding. SwapClear has over 37 major members from around the world, offers third-party clearing service to smaller firms and buy-side customers, and supports IRS clearing in fourteen currencies. Neither the initial development, nor the subsequent advancement of the SwapClear service would have been possible absent support and investment from the Swap dealer community and, in our view, such

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[4] Further information on the SwapClear® service can be found at: http://www.Swapclear.com.

[5] Information on the Group's repo and fixed income service can be found at http://www.lchclearnet.com/fixed_income.

[6] *New developments in clearing and settlement arrangements for OTC derivatives*, Committee on Payment and Settlement Systems, BIS, Basel; March 2007. Link: http://www.bis.org/publ/cpss77.htm

Central Counterparty Clearing and Settlement: Implications for Financial Statistics and the Balance of Payments, Chris Wright Bank of England, Date, Link: http://www.imf.org/external/pubs/ft/bop/2004/04-8.pdf

Report on Improvements of Post-Trade Processing of OTC Derivatives Trades in Japan, The Study Group on Post-Trade Processing of OTC Derivatives Trades, March 2009, Tokyo. Link: http://www.jscc.co.jp/en/news/2009/15.html

Central Counterparties in Over-the-counter Derivatives Markets, Financial Stability Review, Reserve Bank of Australia, March 2009, Sydney, Link: http://www.rba.gov.au/publications/fsr/2009/mar/pdf/0309.pdf

Deciphering the 2007-08 Liquidity and Credit Crunch, Markus K. Brunnermeier, Princeton University, Journal of Economic Perspectives, 2008. Link: http://www.newyorkfed.org/research/conference/2008/rmm/Brunnermeier.pdf

support would not have been forthcoming under a restricted ownership or governance model such as that recommended by the DoJ.

The Group's OTC repo clearing service, RepoClear, meanwhile clears a large proportion of the European government bond repo market and has been recognized as a major source of stability during the Eurozone crisis[7]. LCH.Clearnet is now the largest clearer of fixed income and repo products in the EU, and the second-largest globally, currently clearing 13 European government bond markets on behalf of 70 firms, with an average daily nominal value in excess of €500 billion. The innovative service enables participants to benefit from centralized risk management, balance sheet netting, settlement netting and operational efficiencies.

Restrictions on the Control of DCOs – Cost and Competition Concerns

In its submission to the Commission, the DoJ argues that Enumerated Entities might attempt to protect their profitability by refusing to allow DCOs in which they have substantial aggregate ownership stakes to make certain products available for clearing. Firstly, and as evidenced earlier, the Group's own OTC clearing services disproves such assertions. Secondly, we would point to evidence from outside the Group, noting that most of the recent entrants[8] that have attempted to compete with the incumbent clearing and trading providers have been largely - if not wholly - financed by Enumerated Entities.

Thirdly, we would observe that under the Dodd-Frank Act and emerging global capital accords, non-cleared Swaps will be subject to higher capital and margin requirements than cleared ones. Such measures will provide an incentive to move more products to centralized clearing. They will also induce further substitution away from non-cleared products to cleared ones. Differential margin and capital requirements, together with the efficiencies provided by centralized clearing, are a far more efficient and effective means by which to affect the incentives to utilize a DCO, than aggregate ownership limits or limitations on DCO governance.

Any aggregate restriction on DCO ownership or governance is, in our view, likely to lead to increased cost, with no commensurate benefits. Indeed, any regulation directed at limiting the aggregated involvement of Enumerated Entities in the ownership and control of DCOs will have the likely effect of reducing competition and reinforcing vertical ownership models wherein an exchange or other trading venue owns or substantially controls a DCO.

In this context we would draw the Commission's attention to the DoJ's letter to the US Department of the Treasury, dated January 2008[9] and to the September 2010 report of the BIS's Committee on Payment and Settlement Systems ("CPSS")[10].

[7] *Peer Review of Spain*, Financial Stability Board, January 2011, http://www.financialstabilityboard.org/publications/

[8] Examples include: EuroCCP, Turquoise, BrokerTec, BrokerTec Futures, BrokerTec Clearing Company, U.S. Futures Exchange, LLC. ("USFE"), EMCF, Tradeweb and FXAll.

[9] US Department of Justice Letter on the *Review of the Regulatory Structures Associated with Financial Institutions*, January 2008; TREAS-DO-2007-0018; http://www.justice.gov/atr/public/comments/229911.htm

[10] *Market structure developments in the clearing & settlement industry: implications for financial stability,* (pp. 58-59), CPSS, September 2010, Basel. http://www.bis.org/publ/cpss92.pdf

The DoJ letter concluded that: *"... Significant benefits might be achieved if regulatory policy were changed so as to foster exchange competition by, inter alia, ending exchange control of clearing (in conjunction with appropriate regulation to ensure that clearinghouses could not in turn exercise market power)."*

The CPSS report similarly analyzed differing structures of ownership and control of clearing houses, noting that: *"... Vertical integration could prove detrimental to innovation if the exchange and the CCP within the vertical group agree to an exclusive relationship (a so-called tie-in)... when such an exclusive relationship is formed, the vertical group may obtain significant market power at the clearing level, thereby reducing competition and with it potentially the incentive to innovate."*

Restrictions on the Control of DCOs – Prudential Concerns

The Dodd-Frank Act requires the Commission to promulgate rules that ensure the safety, soundness and robustness of critical market infrastructures such as DCOs. Competition factors, whilst important, must therefore be subordinate to such considerations.

As direct users of DCOs, Enumerated Entities have the strongest incentives to ensure that DCOs manage their risks properly and do not erode risk management standards in order to increase profitability or gain market share. Indeed, in its recent Financial Stability Report[11], the Bank of England recognized the importance of the alignment of CCP and user interests, when it stated that: *"Resilience of CCPs will rely on appropriate loss-sharing and incentive arrangements, allied with effective ownership and governance. From a risk perspective, not-for-profit, user-owned CCPs provide strong incentives for effective risk management. They closely align the interests of CCPs and providers of risk capital. These incentives are weaker among CCPs operating on a for-profit basis and/or those which are not user-owned. The Bank believes governance reform of CCPs might be needed over time given their increasing systemic importance."*

User-owned DCOs may also be viewed as more likely to survive a catastrophe than for-profit or exchange-owned DCO, as the ratings agency Standard & Poor's observed in a November 2010 report[12]: *"The ratings may consider explicit financial support from exchange or clearinghouse members, usually in the form of assessments or implicit support from the broader capital markets. We believe member support is stronger at exchanges and clearinghouses that list financially important products (e.g., government bonds) and operate as member-owned utilities than at those institutions that are units of publicly owned corporations."*

In the Group's view, imposing disproportionate restrictions on the ability of market participants to invest and participate in the governance of DCOs could result in a perverse allocation of

[11] http://www.bankofengland.co.uk/publications/fsr/2010/fsrfull1012.pdf9
[12] *"Are Exchanges and Clearinghouses Too Big to Fail?",* 11 November 2010, Standard & Poor's, London, http://www2.standardandpoors.com/spf/pdf/media/AreExchangesAndClearinghousesTooBigToFail.pdf

counterparty risk. Enumerated Entities, as an inevitable consequence of restriction on their involvement in a DCO, might in the future limit the amount of risk they are willing to bear and cap the amount of capital that they are willing to contribute to absorb the risks of loss arising from the default of fellow member firms. DCOs manage defaults by replacing the positions of defaulting members. In doing so for Swaps markets, they rely on non-defaulting member firms to step in and bid for the defaulted positions. Overly onerous restrictions on control, whether on ownership or through Board and Committee representation, are likely to reduce the willingness of the restricted entities to participate fully in this essential process, and thereby limit the scope of a DCO's activities.

As the largest sources of risk capital, Enumerated Entities are the best placed to bear the default risks in DCOs and provide their capital. They also have the greatest expertise in pricing and managing Swaps risk, and are best able to absorb and manage the risks of defaulted Swaps positions. Constraining their ability to exercise control over DCOs will limit the amount of these services that they will supply and thereby constrain the ability of DCOs to develop new Swaps clearing services in support of the Dodd-Frank Act. Under such limitations, DCOs would also likely be less well-capitalized, and less able to absorb and manage member defaults. This result would be directly contrary to the Dodd-Frank Act's important objective of enhancing the safety and soundness of the financial system.

Conclusion

The Group shares the DoJ's interest in ensuring a healthy competitive environment and believes that the marketplace as a whole will benefit if there are appropriate checks and governance safeguards to prevent any form of exclusionary or uncompetitive behaviour.

The DoJ's submission to the CFTC casts doubts on the suitability of uncapped DCO ownership and proposes disproportionate controls on the structure of DCOs' governance and decision-making. The imposition of such elaborate constraints on composition of DCO Boards will make these more prone to conflict, more cumbersome to manage, and less effective at responding to changes in the marketplace. In our view such proposals would also weaken the safeguards currently offered by clearing providers, such as the proven CCPs already operated by the Group.

Finally, and rather than improve competition, the DoJ's recommendations would increase uncertainty, raise barriers to entry into the trading and clearing industries and limit the incentives for Enumerated Entities to contribute intellectual capital toward the development in these sectors, thereby stifling innovation and impeding progress.

Forestalling the ability of users to contribute capital to such ventures will promote the for-profit "vertical silo", and disadvantage proven utility-like models which seek to provide low or at-cost services, thereby leading to increased prices and limited competition.

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For all the aforementioned reasons we would strongly urge the Commission, as stated in our letter dated November 5, not to introduce any form of aggregate cap on ownership or voting, and not to adopt the DoJ's proposals. The Group's corporate governance safeguards adequately ensure that conflicts of interest neither affect the safety and soundness of its clearinghouses nor limit their ability to innovate, and believes that these would serve as a useful precedent for the Commission in its final rulemaking.

LCH.Clearnet looks forward to extending its clearing services in the US marketplace, thereby introducing the safeguards of its proven structures deeper into the US customer base.

We recognize the hard work undertaken by the Commission in order to develop these proposed rules and value its open and thoughtful approach in this task. LCH.Clearnet appreciates the opportunity to comment on these important issues and would be pleased to enter into a further dialogue with the Commission and its staff. Please contact Simon Wheatley at +44 (0)20 7426 7622 regarding any questions raised by this letter or to discuss these comments in greater detail.

Yours sincerely,

Roger Liddell
Chief Executive