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

23 March 2011

Dear Mr Stawick,

Re: RIN 3038-AC98 Risk Management Requirements for Derivatives Clearing Organizations

LCH.Clearnet Group Limited[1] ("LCH.Clearnet" or "the Group") is pleased to have the opportunity to comment on the Commodity Futures Trading Commission's ("Commission's" or "CFTC's") Notice of Proposed Rulemaking that was published in the Federal Register on January 20, 2011.

The Group strongly supports the policy goals underpinned by the statutory provisions contained in Sections 725(c), 805(a) and 807(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). In its Proposing Release the Commission seeks to implement these provisions by: establishing risk management standards for Derivatives Clearing Organizations ("DCOs"); prescribing the methods by which a DCO sets margin for Swaps[2] contracts; enhancing legal certainty for clearinghouses, clearing members and their clients; and providing a regulatory framework to support risk management practices.

Whilst we broadly concur with the proposals set forth under RIN 3038-AC98, the Group has some grave concerns in so far as these proposed rules govern a DCO's Swaps clearing activity.

Firstly, the Group is troubled by the proposed membership requirements for a DCO offering Swaps clearing services. In our view the separation of participation from risk underwriting and default management responsibilities will compromise well-tested and proven default management processes, upon which the integrity of clearinghouses depends. Further, these proposed lower entry standards for Swaps clearing membership may restrict the ability of DCOs to extend and develop Swaps clearing services in the future. As such, the proposed rules would seem to run contrary both to the Commission's intent and to its statutory and prudential responsibilities by compromising stability and market integrity, thereby potentially increasing rather than decreasing systemic risk.

Secondly, we have a number of concerns regarding the detailed risk management provisions in these proposed rules. Some of the provisions would appear to be more appropriate to futures clearing and neither apposite nor adequate for a DCO clearing Swaps. This is because the current disparity between Swaps and futures contracts requires different risk management techniques and clearing processes. Over time we expect contract convergence as Swaps become more futures-like, but it would be inappropriate at this stage to impose futures clearing criteria on long-dated, idiosyncratic and less liquid instruments.

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[1] LCH.Clearnet Group Limited was formed out of the merger of the London Clearing House Ltd and Clearnet SA and operates two clearinghouses, LCH.Clearnet Limited in London and LCH.Clearnet SA in Paris. The Group serves major international exchanges and platforms, as well as a range of OTC markets and its CCPs clear a range of asset classes, including cash equities, exchange-traded derivatives, energy, freight, interest rate swaps and cash bonds and repos. LCH.Clearnet Ltd is regulated by, *inter alia*, the Financial Services Authority of the United Kingdom and by the Commodity Futures Trading Commission (as a "Derivatives Clearing Organization"). LCH.Clearnet SA is regulated as a Credit Institution and Clearing House by a regulatory college consisting of, amongst others, the market regulators and central banks from the jurisdictions of: France, Netherlands, Belgium and Portugal. LCH.Clearnet SA is also regulated as a Recognised Overseas Clearing House by the UK Financial Services Authority.

[2] "Swaps" as defined in section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010.

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The Group is fully supportive of the "fair and open access" requirements laid out under Section 723 of the Dodd-Frank Act, but does not believe these provisions invite the Commission to force a DCO to abandon objective risk-based membership criteria, nor to restrict a DCO's ability to clear Swaps. Rather, the Dodd-Frank Act requires that a DCO's membership criteria be transparent, appropriate, and enforced even-handedly, and that more Swaps be submitted into clearing. We would therefore urge the Commission to ensure that its implementation of these provisions does nothing to limit a DCO's Swaps clearing capabilities, compromise a DCO's integrity, nor restrict a DCO's ability to handle extreme market events and the default of large market participants.

LCH.Clearnet's SwapClear

The Group has a long and distinguished history in Swaps clearing, having pioneered the development of over the counter derivatives ("OTC derivatives" or "Swaps") clearing in 1999 with the SwapClear interest rate swap ("IRS") clearing service.

LCH.Clearnet's SwapClear has expanded since its inception to extend direct clearing membership to over 49 clearing members[3] across North America, Europe and Asia, to offer client clearing services to buy-side customers and other firms, and to support IRS clearing in fourteen currencies out to a maximum maturity of 50 years. In addition to the client clearing service already in use in Europe, we recently extended this capability to include a Futures Commission Merchant ("FCM") clearing service for U.S. clients, and have since successfully cleared our first trades under the FCM structure. LCH.Clearnet's SwapClear is the largest and, importantly, the only proven IRS clearing service; it is recognized globally as a major contributor to financial stability[4] and is the most-commonly cited example of a successful Swaps clearing service. The only truly global clearing service for IRS, it clears over 50 per cent of the world's IRS market[5], with over $266 trillion in notional value outstanding.

This important capability was put to the ultimate test during the collapse of Lehman Brothers when LCH.Clearnet Limited was required to default-manage Lehman Brothers' cleared portfolio of 66,000 IRS trades across five major currencies, with a notional value in excess of $9 trillion. Together with SwapClear clearing members, who are contractually obligated to participate in the default management process and to bid in the ensuing auctions, LCH.Clearnet Limited successfully neutralized and sold off the entire swap portfolio.

The management of the default involved:

- At default (Monday, 15 September 2008) the Default Management Group seconded experienced traders to work alongside LCH.Clearnet Limited's risk management team to execute IRS hedges with SwapClear clearing members and to neutralize first the macro and then the micro levels of market risk on the defaulter's portfolio. All participants adhered to strict confidentiality rules throughout.
- LCH.Clearnet Limited's risk position was constantly reviewed and recalibrated in real time, and additional hedges continued to be executed in response to changing portfolio and volatile market conditions.
- From Wednesday, 24 September to Friday, 3 October, the competitive auctions of the five hedged currency portfolios were successfully completed and the group transferred all 66,000 trades to the successful bidders, all of whom were surviving SwapClear clearing members.

[3] SwapClear membership has expanded by 50% on a year-on-year basis since 2009, and as at 21 March 2011 a further nine firms were in the process of joining the SwapClear service as clearing members.
[4] 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. 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
[5] The other 50% of the Interest Rate Swap market remains uncleared.

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The success of this process was largely due to the strong commitment and contractual relationship between the SwapClear clearing members and LCH.Clearnet Limited. The process relied on SwapClear clearing members' dedicated resources, including key and experienced front office, risk, technology and operations personnel who worked closely alongside the clearinghouse.

LCH.Clearnet Limited used only 35 per cent of Lehman Brothers' margin in managing the default and returned the remaining funds, in excess of $850 million, to their administrators. No LCH.Clearnet Limited counterparties incurred any loss as a result of the default, and the clearing services operated by the Group continued to function in full, with no disruption to member firms or clients, before, during or after the Lehman Brothers' default. The Group thereby fulfilled its commitment to its members, clients and the wider financial system by ensuring market integrity and providing much-needed stability at a critical juncture.

Participant and Product Eligibility

LCH.Clearnet is fully committed to ensuring the continued stability of its clearinghouses, to the reduction of systemic risk and the provision of longstanding safeguards to the financial system. To ensure the safe and sound operation of its clearinghouses, the Group employs open and transparent membership eligibility criteria[6] for each market that it clears. These membership criteria are approved by both clearinghouses' Risk Committees and Boards of Directors, all of which are chaired by Public (or Independent) Directors, and the criteria are subject to subsequent regulatory approval. The membership criteria for the different clearing services offered by the Group's clearinghouses vary according to market and product and are published on the Group's website.

It is our belief and experience that in undertaking to clear certain Swaps products, particularly those that are long-dated and less liquid than futures-based equivalents[7], a DCO will need to rely on clearing member participation in the event of a default. We are open to keeping our SwapClear admission criteria under constant review and to materially modifying the current entry requirements for members. Provided that potential members prove they have the required risk underwriting and default management capabilities and commit to full participation in both, we will welcome their entry.

Upon reviewing the proposed rules for DCO access, the Group has asked itself whether the Commission's proposals would improve or lessen a DCO's ability to manage a large member or client default, and has concluded that such proposals would be detrimental to a DCO's ability to do so.

The default rules and procedures that underpin the SwapClear service are designed to facilitate the continued functioning of the clearinghouse in the event that a clearing member fails to meet its obligations, and helps to limit the effects of one participant's failure spreading to other participants and their clients. As demonstrated in the management of the Lehman Brothers' default, such participation requires: firms to second staff to the clearinghouse for default management purposes; clearing members to trade as counterparts with the clearinghouse to neutralize the defaulting entity's risk; and firms to purchase the hedged Swaps portfolios from the clearinghouse. *In extremis*, clearing members may also have to accept forced allocations of portions of the defaulting entity's Swaps portfolio, which may not be hedged and therefore have open risk. In addition to managing this market risk, SwapClear clearing members must also be able to handle the substantial operational and administrative challenge of accepting Swaps portfolios containing large numbers of cleared trades which might be many multiples of their average daily volumes.

Given the reliance that the DCO must put on its clearing members in order to clear such Swaps, it is critical that a DCO is able to rely on, and continually test for, member firms' technological, operational, trading and risk management capabilities and expertise. SwapClear members must be able to prove they can protect the clearing house from the default of other large members, as well as resolve the default of any clients they introduce to the service.

[6] http:///www.lchclearnet.com/membership/

[7] Estimates from Morgan Stanley and Oliver Wyman published in the February 2011 report, *The future of capital market infrastructure*, put global turnover in the IRS market at 3,000-3,500 trades per day. In contrast, over 2 million Eurodollar contracts are traded per day on the CME (based on 2010 ADV figures published by CME Group).

We believe that the most appropriate means of ensuring that such Swaps clearing services are safely extended to the widest possible user base is to ensure that a DCO is able to offer client clearing[8] with the highest levels of individual customer protection. In this regard we would respectfully point the Commission to the submission made by the Group in response the Commission's Advance Notice of Proposed Rulemaking ("ANPR") on *Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies*. In this letter the Group advocates the introduction of higher levels of customer protection than those currently afforded under the Futures Commission Merchant ("FCM") client clearing model[9].

The "Legally Segregated, Operationally Commingled" client clearing structure outlined by the Commission in its ANPR and supported by the Group in our response will, in our view, best enable a DCO to ensure that clients are protected both from the risks of their clearing members and from the risks of the other clients of their clearing members. Furthermore, such a structure would ensure that the DCO remains stable and is able to continue fulfilling its core objectives of enhancing safety and efficiency, limiting systemic risk and fostering financial stability, whilst being able to extend its protections to the widest possible community[10].

The initial development, subsequent advancement and demonstrably proven success[11] of LCH.Clearnet's SwapClear service would not have been possible without clearing member commitment to participate in our default management process. In our view, the stability and reliability of SwapClear in both normal and stressed market environments is entirely dependent on this process, and the service is wholly consistent with the goals set forth under Title VII of the Dodd-Frank Act. For this reason we have significant risk-based concerns about any proposal that would require a DCO to put in place membership criteria for Swaps that are entirely separate from default management and risk underwriting arrangements. Such arrangements would necessarily require the DCO to either: (a) establish a two-tier clearing membership structure under which the top tier assumes default management responsibilities and the second tier is absolved from such; or (b) allow clearing members to "outsource" their default management responsibilities to third parties.

Our key concerns about putting in place such arrangements are outlined below:

- a membership structure which permits some members to introduce risk to the DCO but discharges them from default management responsibilities (under either model (a) or (b) as outlined above), could lead to moral hazard;

- a two-tiered or outsourced model could compromise the DCO's commitment to its members and their clients, and a DCO operating such a model might compromise its duty to provide safety and stability to the wider financial marketplace;

- the establishment of an "outsourced" model for default management introduce another layer of risk at the clearing level. Further, it could be contractually insecure and/or unenforceable by the DCO, especially in times of market disruption and we are unsure how risk committees and regulators would be able to satisfy themselves of the efficacy of such arrangements;

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[8] SwapClear clearing members may provide access to the clearing service for all of their clients, and LCH.Clearnet does not set any criteria or otherwise discriminate among clients or third-parties.

[9] http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27157&SearchText=

[10] "The individual account structure provides a high degree of protection to customers of participants in CCPs. Under this approach, each customer's collateral is held in a separate, individual account and, depending on the legal framework applicable to a CCP, a customer's collateral may only be used to cover losses associated with the default of that customer. This account structure also facilitates the clear and prompt identification of a customer's collateral which can expedite the return of collateral to the customer, and supports full portability of an individual customer's positions and collateral. Since all collateral maintained in the individual customer's account is used to margin that customer's positions only, the CCP should be able to transfer these positions from a defaulting participant to another participant with sufficient collateral to cover the exposures. By using individual accounts, and collecting on a gross margin basis, the CCP may have more flexibility in how it ports a customer's portfolio to another participant or group of participants." Extract from: *Principles for financial market infrastructures*, Consultative Report CPSS-IOSCO, March 2011.

[11] *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, May 2008. Link: http://www.newyorkfed.org/research/conference/2008/rmm/Brunnermeier.pdf

- the DCO's ability to oblige firms to participate in the top tier of the membership structure outlined in (a) above, is limited. We are also concerned about such firms' willingness to provide the DCO with the necessary liquidity in extreme scenarios, given that the two-tier structure would result in a disproportionate allocation of default management responsibilities;

- outsourced default management responsibilities will tend to be concentrated amongst firms that may already be SwapClear clearing members and, further, firms may seek to offer outsourcing services which prove to be beyond their capabilities. An outsourced structure may thus result in a greater concentration of risk than is currently the case; and

- an outsourced structure might impose contagion risk owing to the correlation and counterparty effects, thereby creating an additional challenge and set of risks for the DCO and its regulators.

For these reasons, we would strongly urge the Commission to ensure that its access rules for DCOs do nothing to compromise prudential concerns. Such rules should not inhibit a DCO's ability to clear such Swaps; not weaken the longstanding surety of a DCO's safeguards, nor otherwise constrain a DCO from the fulfilment of its duties as laid out under Title VII of the Dodd-Frank Act.

Risk Management

The Group is fully supportive of the Commission's intent to prescribe strong risk management requirements for DCOs.

The Group's primary objective is to ensure the strength and solidity of its clearinghouses. We have long adopted risk management standards that are designed to ensure the protection and survival of the clearinghouses, their members, their members' clients and the clearinghouses' guaranty funds, as well as the persistence of client and member risk positions[12]. We have an unrivalled reputation for managing risk across a wide span of markets globally, and are committed to setting and maintaining the very highest standards across all the markets that we clear.

Notwithstanding this, the Group has a number of concerns regarding the apparent "futurisation" of Swaps in the detailed provisions set out by the Commission in this and other Proposing Releases. We set forth our more detailed comments on this in the attached annex, but would meanwhile respectfully point the Commission to the recent consultative report from the Committee on Payment and Settlement Systems, Technical Committee of the International Organization of Securities Commissions ("CPSS-IOSCO")[13].

In this consultative report, the Committee lays down guidance for central counterparties ("CCPs") clearing OTC derivatives, explicitly recognizing that OTC derivatives have unique characteristics that may require CCPs clearing such instruments to employ different risk management methods than they would for futures or cash instruments.

The CPSS-IOSCO report said:

> *"In addition to typical risk-management tools used by CCPs in listed markets, CCPs in OTC derivatives markets may employ other risk-management processes designed for the unique risks of the cleared OTC derivatives product. Participant requirements, margin requirements, financial resources and default procedures are particular areas where a CCP may need to consider additional tools tailored for OTC derivatives markets."*

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[12] "*Principle 14: Segregation and portability: A CCP should have rules and procedures that enable the segregation and portability of positions and collateral belonging to customers of a participant.*" Principles for financial market infrastructures, CPSS-IOSCO Consultative Report, March 2011

[13] Principles for financial market infrastructures, CPSS IOSCO Consultative Report, March 2011.

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As a more general matter, we would urge the Commission to ensure that its rules dovetail to the greatest extent possible with the standards for financial market infrastructures now being considered by the CPSS-IOSCO, so that there is global convergence in such standards. Any opportunity for regulatory or jurisdictional arbitrage would in our view undermine the Commission's important work and lessen the safeguards against systemic risk.

LCH.Clearnet recognizes the hard work undertaken by the Commission in order to develop these proposed rules and is grateful for the opportunity to comment on these issues.

Given the very detailed nature of this submission and the importance of these proposed rules, we would be more than happy to enter into further dialogue with the Commission and its staff at your convenience. For this reason, please do not hesitate to 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

ANNEX

Part 39 Derivatives Clearing Organizations - Subpart B – Compliance with Core Principles

39.12 Participant and Product Eligibility

(a) *Participant Eligibility*
These rules prescribe that the DCO should establish appropriate admission and continuing participation requirements for clearing members that are objective, publicly disclosed, and risk-based.

LCH.Clearnet generally concurs with the provisions set out under rule 39.12(a).

(a)1 *Fair and Open Access*
In this subsection the Commission requires that the DCO should: (i) establish participation requirements that permit fair and open access; (ii) not adopt restrictive clearing member standards if less restrictive requirements that would not materially increase risk to the DCO or clearing members could be adopted; and (iii) allow all market participants who satisfy the participation requirements to become clearing members. The Commission further proposes that the DCO should not exclude or limit clearing membership to certain types of market participants unless it can demonstrate that the restriction is necessary to address credit risk or deficiencies in the participants' operational capabilities that would prevent them from fulfilling their obligations as clearing members.

The Group is fully supportive of all the above recommendations and believes that the Commission has adequately addressed membership participation standards. The Group does, however, have some serious concerns with the provisions set forth under Subparagraph 39.12(a)1(iv)with regard to Swaps clearing. In this section the Commission prescribes that the DCO shall not require that clearing members must be Swap Dealers.

As described in the main body of this submission, LCH.Clearnet's SwapClear clearing service is wholly dependent on the participation of clearing members in default events, since clearing members must contractually commit to participate in the management of a fellow clearing member or client default. We rely on surviving clearing members: to be able to hedge defaulting member's Swaps portfolio; to provide liquidity for such hedging; to bid on hedged portfolios; and, *in extremis*, to accept a forced allocation of Swaps. Clearing members must also be able, and are contractually required, to perform all the above in relation to the default of any clients that they introduce into clearing. For these reasons, SwapClear clearing members must be able to demonstrate that they can support a Swaps book from a front office, risk, technology and operations perspective. LCH.Clearnet regularly tests and confirms that its clearing members maintain such a capability.

In an extreme scenario a clearing member might be allocated a risky, unhedged Swaps portfolio. The Group therefore must stringently test the technological, operational, risk management functions, together with the infrastructure and expertise of its SwapClear clearing members both before allowing firms to join the service, and on an ongoing basis. In this regard we would again point the Commission to the provisions set out in the CPSS-IOSCO consultative report on Financial Market Infrastructures, in particular to the footnote set out on page 64 of this report, which stipulates:

"An OTC derivatives CCP may need to consider requiring participants to agree in advance to bid on the defaulting participant's portfolio and, should the auction fail, accept an allocation of the portfolio. A CCP that employs such procedures should carefully consider, where possible, the risk profile and portfolio of the receiving participant before allocating positions so as to minimise additional risk for the surviving participant."

For all the above reasons, the Group does not believe that the provisions set out under Subparagraph (iv) should override the DCO's risk-based rules for Swaps participation. We would therefore respectfully urge the Commission to strike this language.

(a)2 *Financial Resources*
Under 39.12(a)2 the Commission prescribes the financial resources require that a DCO must require its clearing members to hold.

LCH.Clearnet generally concurs with all the provisions set forth by the Commission in this subsection, however we do not believe that “credit facilities” or “funding arrangements” should be allowed for the purposes of fulfilling these financial standards. In our view all clearing members’ resources should be immediately and unconditionally available. Since a CCP must ensure these financial resources are sufficient and available without recourse or delay, even in times of crisis all such resources should be pre-funded.

A further observation that we would make is that Swaps clearing members must be required to have sufficient resources to cover their own clients’ defaults, and the potential cost and risk incurred in an allocation following a fellow member’s default. For this reason we have some concerns about the “minimum” capital requirements provision set forth under 2(iii).

Whilst we agree that capital requirements could reasonably be set on a scalable basis, we are unsure how the DCO can properly ensure compliance with such a provision in a situation where such scalable capital requirements are based on a minimum capital requirement of just $50mn. The reasons for this are set out below:

Firstly, there is a practical question as to whether a member with such a low net capital base could realistically offer a Swaps clearing service – at least in the current market.

Secondly, there is the very significant question of availability: a DCO would need to consider how much of a clearing member’s net capital would be available in the event of its default. It is unclear from the Commission’s rules as to whether the $50mn minimum net capital requirement would enable a clearing member to join one clearinghouse, or several. In the event that a clearing member with a net capital base of just $50mn were a member of two or more clearinghouses, the funds available to each DCO would necessarily only be a fraction of the $50mn – an insufficient amount to ensure both DCOs’ ongoing stability. We would therefore suggest that any such net capital requirement be set *per* member and *per* DCO.

Thirdly we would ask the Commission to consider the following scenario: a small clearing member, (“Member A”) accounts for 1% of total ‘risk’ in the service. In the event of the default of a larger fellow clearing member (“Member B”), Member A could be allocated 1% of Member B’s Swaps portfolio. The portion of Member B’s Swaps portfolio allocated to Member A might actually be larger than Member A’s entire cleared and uncleared Swaps portfolio. It is unclear to the Group how smaller clearing members such as Member A would manage the risk in such a scenario.

Finally, the Commission’s proposal constitutes a 99% reduction from the Group’s existing participation requirements for SwapClear. These capital levels have been hardwired for over a decade and have enabled the clearinghouse and its members to weather the largest clearing member default experienced by any clearinghouse to date, without loss or impact on its surviving members or clients.

The Group reiterates its support for the policy goals underlying the Commission’s proposals for participation, but would like to underscore the importance of counterbalancing the facilitation of broader participation in a clearinghouse with prudential risk-based considerations.

Following implementation of the Dodd-Frank Act, DCOs will play an even more critical role in upholding financial stability and reducing systemic risk. Lowering participation criteria to unreasonable levels could introduce unwarranted risks and instability to the very infrastructures that must be most robust and offer important safeguards to the system particularly in times of crisis.

(a)3 *Operational Requirements*

The Group believes the Commission has correctly identified the operational requirements a DCO should require its clearing members to fulfil and agrees with all the provisions set forth hereunder.

(a)5 *Reporting*

In this Subparagraph the Commission lays forth the reporting requirements that the DCO should impose on its members.

The Group concurs with the general provisions set forth by the Commission, but has some concerns about the proposals as they affect clearing members based outside the U.S. The provisions state that the DCO "should also require clearing members that are not FCMs to make such periodic financial reports available to the Commission upon the Commission's request". DCOs based outside the U.S. may have clearing members that are not subject to the Commission's jurisdiction and which will instead be regulated in their home jurisdiction. For this reason the Group would recommend this provision be amended such that only FCMs and U.S.-based members that are not FCMs are required to provide this information to the Commission upon request. All other members should be required to submit the information to the DCO only, or to their equivalent local regulator.

In Subparagraph (ii) of this Section, the Commission proposes that the DCO should adopt rules that require clearing members to provide to the DCO any information that concerns any financial or business developments that may materially affect the member's ability to comply with participation requirements.

In our view the obligations in this particular provision would be more appropriately imposed on clearing members themselves, rather than on the DCO.

(b) Product Eligibility

In Section 39.12(b) the Commission lays forth the requirements the DCO should have for determining the eligibility of agreements, contracts, or transactions submitted to DCO for clearing, taking into account the DCO's ability to manage the risks associated with such agreements, contracts, or transactions.

Generally the Group concurs with all the provisions laid out in this Section, but would urge the Commission to consider effecting three changes to the proposed rules.

Firstly we have some concerns about Section (b)(1)(iv), wherein the Commission proposes that a DCO must consider the ability of market participants to use portfolio compression facilities for a particular Swap product. Whilst the Group strongly supports the use and development of such compression services we do not believe that the ability of the DCO to clear a given Swap should be in any way conditional on the availability of such services. In addition to clearing IRS, for which there are now well-established compression facilities, the Group clears a large range of OTC products and markets. Many of these markets do not yet have access to, and/or are not suited to, compression facilities, owing to the size of the market and range of participants.

In our experience, compression services have been developed only when Swaps markets are relatively large and well-established, and the introduction of cleared facilities has largely pre-dated their introduction. For these reasons, we would urge the Commission to encourage the use of compression services where suitable and available, but in no way to constrain the ability of the DCO to clear a given Swap based on the availability of such services. Making Swaps clearing contingent on Swaps compression may have the perverse effect of permitting fewer Swaps to be cleared.

Secondly, we would respectfully suggest the Commission might make a small alteration to the provision laid out under 39.12(b)(1)(v). This provision sets out a further product eligibility factor for the DCO to consider, and requires that both the DCO and its clearing members should be able to

"gain access to the relevant market for purposes of creating and liquidating positions". In our view it is imperative that the DCO also have the ability to "transfer", "auction" or "allocate" cleared Swaps. For this reason we would suggest that the drafting of this Section be amended as follows:

39.12(b)(1)(v) "Ability of the derivatives clearing organization and clearing members to gain access to the relevant market for purposes of creating, transferring, auctioning, liquidating and or allocating positions".

Thirdly, we would refer the Commission to paragraph (3) of rule 39.12(b). Herein the Commission prescribes that the DCO should "select contract unit sizes that maximize liquidity, open access and risk management".

Whilst the Group is fully supportive of any measure that helps to maximize liquidity, open access and risk management, we do not believe that it is either appropriate or necessary to prescribe rules for contract sizes. Swaps may be submitted for clearing through SwapClear in any denomination of $1 upwards and, in our view, DCOs accepting Swaps for clearing should be able to accept such Swaps in any given denomination, rather than in any pre-defined unit sizes.

For this reason, Swaps submitted for clearing should not subsequently need to be broken down into sub-units. Should the Commission seek to address the average size of exposures traded in the swaps market, we would submit that this would better be addressed in rules pertaining to trading and execution venues. We would therefore respectfully urge the Commission strike 39.12(b)(3) in its entirety.

39.13 Risk Management

This Section prescribes the rules by which the DCO shall ensure that it possesses the ability to manage the risks associated with discharging its responsibilities through the use of appropriate tools and procedures.

LCH.Clearnet generally concurs with all the provisions set forth by the Commission under proposed rule 39.13, however we would respectfully submit the modifications described below for the Commission's consideration.

(e)(1) *Measurement of Credit Exposure*

Herein the Commission recommends that the DCO should measure its credit exposure to each clearing member and mark to market such clearing member's open positions "<u>at least once each business day</u>".

In our view this provision is insufficient to ensure the DCO discharges its responsibilities. We would suggest that in order to do so the DCO must firstly measure its credit exposures "<u>*several times each business day*</u>", and that the DCO should be obliged to recalculate the Initial and Variation Margin requirements for each member and each member's client more than once each business day.

(g) *Margin Requirements*

In this subparagraph the Commission prescribes the methodology that the DCO should use to set initial margin requirements.

Whilst we uphold the Commission's intent of ensuring adequate margining by the DCO and broadly agree with the Commission's proposal we have outlined a number of observations and recommendations for this Section below.

(g)(2) *Methodology and Coverage*

(g)(2)(i) *The Commission proposes that a DCO that clears credit default swaps shall appropriately address jump-to-default risk in setting initial margins.*

We would respectfully submit that this clause should either be struck out or amended to cover all other products that are subject to jump-to-default risk.

(g)(2)(ii) *The Commission proposes that a DCO should use models that generate Initial Margin requirements sufficient to cover the DCO's potential future exposures.*

The Group has a number of recommendations for this sub-section: Firstly, we would observe that "or transfer" should be inserted after "liquidate". Secondly, we would posit that the proposed time interval of one business day in this section is too short a period on the basis that:

a) the maximum movement between the DCO's last collection of Variation Margin and an intraday margin run is usually half a day;

b) there is no reference to updated Initial Margin being calculated intra-day in the Commission's drafting, and therefore this proposed rule does not capture intra-day position changes; and

c) the timeframe within which the DCO may establish a default is not necessarily immediate. This means that it can, and often will, be impossible for the DCO to close out the defaulting member's position within a one-day liquidation period. This is particularly important for DCOs clearing less liquid Swaps.

We would also observe here that the liquidation period employed by the DCO should not be prescribed across all Swaps or Futures products, but rather be an objective function of the DCO's measurement of observed market volumes in the given products and set at a period that would be sufficient to enable the DCO to adequately hedge or close-out a defaulting member's risk.

Finally we would observe that the rules should not prescribe differential margining treatment for Swaps with equivalent economic and risk profiles based on whether these are executed on a Designated Contract Market ("DCM") or elsewhere. As stated above, we believe that the liquidation period employed by the DCO should be an objective function of the DCO's measurement of observed market volumes and liquidity in each given product, and should be sufficient to enable the DCO to adequately hedge or close-out the risk.

(g)(2)(iii) *In subparagraph (iii) the Commission sets out the coverage parameters that the DCO should use for calculating Initial Margin requirements. The Commission proposes that that the requirements should meet an established confidence level of at least 99% based on data from an appropriate historic time period.*

The Group would respectfully submit that the Commission's approach to setting product-based margin and spreads, whilst wholly appropriate for futures, is neither suitable nor sufficient for Swaps products. Instead we would propose that the key requirement should be for the DCO to ensure that it has enough margin and guaranty fund to cover its exposures, and for the DCO to prove this on an individual client and clearing member basis.

The DCO should further be required to measure each client and clearing member's observed Variation Margin losses over the liquidation time against Initial Margin held. The requirement should therefore be a factual calculation of exposures and margins – i.e. back-testing, rather than an estimate based on inputs to statistical models. Finally we would recommend that the Commission define the 'historic time period' that the DCO should employ for these purposes, and would suggest that in order to provide for adequate historical observations this should be at a minimum of one calendar year.

(g)(4) Spread Margins

In this section the Commission sets forth how the DCO may allow for reductions in Initial Margin requirements for related positions.

Whilst the Group is fully supportive of any safe and secure means by which the DCO is able to reduce Initial Margin requirements for clearing members and their clients, it would respectfully submit that the spread margin measure which the Commission proposes the DCO uses for such purposes, whilst a tried and tested method for recognizing correlations between standardized contracts, is unsuited and inappropriate for Swaps clearing. The Commission's proposed method was considered by LCH.Clearnet for margining swaps in 1999, along with a Principal Component Analysis (PCA) which attempted to isolate key risk drivers in Swap portfolios. Both methods were abandoned in 2001 and replaced by a historical simulation method more suitable to non-standardized Swaps; the Portfolio Approach to Interest Rate Scenarios ("PAIRS").

The PAIRS calculation is a VAR-based approach based on historical simulation re-scaled to today's observed volatility. All positions in each currency are re-valued under a series of cross-portfolio yield curve scenarios to estimate the highest forecast loss and therefore the Initial Margin that would have required at previous points in time. As such, PAIRS does not allow for the recognition of correlations in the manner proposed by the Commission; instead it implicitly recognizes both inter-maturity and inter-currency risk offsets to a very high confidence interval, based on a demonstrable picture of risk correlations over a five-year historical period. The back-testing that is routinely carried by LCHC using PAIRS margining will adequately demonstrate that that each clearing member and client will have been appropriately margined.

The PAIRS method is both more intuitive and more transparent than all other alternatives considered by the Group and captures all the risk drivers in a Swaps portfolio. LCH.Clearnet has utilized PAIRS for close to ten years, the system was in place at the time of the Lehman default and some other DCOs clearing non-standardized Swaps products have also adopted this method. For these reasons we would urge the Commission to amend its proposed rule for margin reductions to afford recognition of this more advanced and proven technique.

(g)(7) *Back Tests*

The Commission proposes in this Section how and when the DCO should conduct back tests.

Whilst the Group agrees with the broad provisions outlined by the Commission we would submit that the DCO should be required to undertake such back tests at least on a *daily basis* and that back-testing should be required for *all* products cleared by the DCO. Further, we would submit that the DCO should conduct such back tests at a portfolio level and that, for the tests to be statistically meaningful, the time period should be set at a minimum of one calendar year.

In subsection (i) of this paragraph the Commission proposes that the back tests should be conducted on products that experience significant market volatility.

Again we would submit that in order to ensure adequate margin is held, the DCO should back test for all products that it clears. Finally, in our view, the back test measure can only be truly meaningful if conducted by the DCO at a portfolio level. This is because margining techniques appropriate for Swaps (as outlined above) do not allow for the disaggregation of Initial Margin and Spread Margin requirements at a product level.

I*n subsection (ii) of this paragraph the Commission lays out the back test requirements that the DCO should employ to ensure the adequacy of its margin coverage.*

As above, we would observe that Initial and Spread Margins cannot be tested in this way by modern margining techniques for Swaps and, further, that any such testing must be carried out by the DCO daily, regardless of market volatility levels.

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In subsection (iii) the Commission lays out the back test requirements the DCO should employ to ensure the adequacy of the Initial Margin held for each clearing member and each clearing member's clients.

We would again respectfully submit that such tests must be carried out by the DCO on a daily basis.

(g)(8) *Customer Margin*
Under subparagraph 8 Commission sets out the process by which the DCO must collect margin for its clearing members and their clients.

(g)(8)(i) *Under 8(i) the proposed rulemaking states that the DCO shall collect Initial Margin on a gross basis, and may not net positions of different customers against one another.*

Firstly, the Group understands and is fully supportive of the Commission's intent in this regard, and believes that this proposed drafting will adequately provide for the safety of the DCO, its clearing members and their clients when clearing under the well-proven house and FCM structures in the U.S. We would however submit that DCOs operating from other jurisdictions may offer "net omnibus" account structures for associated clients. Such structures are not suitable for all clients and do not afford the level of protections[14] that we believe DCO's should be able to offer clients. Nonetheless net omnibus accounts may be apposite for associated entities operating under the same group or umbrella structure. We would therefore respectfully suggest that the Commission amends this paragraph to allow DCOs to offer net margining to such clients outside the U.S.

8(i) *also states that the DCO may collect Initial Margin for its clearing members' house accounts on a net basis.*

The Group has very significant reservations about the Commission's proposal that the DCO may collect Initial Margin for its clearing members' house accounts on a net basis. In our view the DCO should collect margin from all affiliated legal entities within a house account on a gross basis. This is because the DCO's exposure is to the individual affiliated legal entities, rather than to the group, and whilst the DCO might hold cross-affiliate positions that (theoretically) net to zero risk across all the legal entities and therefore attract minimal-to-no Initial Margin, it is uncertain that the DCO would be permitted to offset those risks in the event of the default of the group or one or more of its affiliated legal entities. Net margining should only be permitted on the house account where there is legal certainty of the DCO's right to offset across affiliates.

(g)(8)(ii) *Customer Initial Margin Requirements*
Herein the Commission prescribes how the DCO shall require its clearing members to collect customer Initial Margin. The Commission's proposal requires that the DCO distinguish between the customers' hedge and non-hedge positions, and that the DCO should prescribe that their clearing members margin their customers by an amount greater than that the DCO requires.

The Group does not believe that the DCO or the clearing member should distinguish in any way between a customer's hedge and non-hedge positions. This is because, if the two parts of the hedge are carried by the same clearing member within the same DCO, such hedges would in any event implicitly be recognized by the DCO's risk calculations and the provision unnecessary. If, however, one or other leg of the hedge is uncleared, or is carried by a different clearing member, or by the same or another clearing member at another DCO, no recognition of the offsetting hedge should be allowed either by the DCO(s) or by the clearing member(s), as neither party would have the economic benefit of the hedged transaction.

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[14] The Group refers to the "Legally Segregated, Operationally Commingled" (or "Option 3") client clearing structure outlined by the Commission in its ANPR on *Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies*. http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27157&SearchText=

We would also respectfully suggest that if clearing members are to be required to margin their customers over and above the amount called by the DCO for the customers, the requirement for such over-margining should be imposed on the clearing member and should therefore be removed from the DCO Risk Management Rules. Parallel requirements should instead be set out in the Commission's rules for clearing members.

(g)(8)(iii) *Withdrawal of Customer Initial Margin*

In this section the Commission prescribes that the DCO should require its clearing members to ensure that their customers do not withdraw funds from their accounts unless the customer account holds funds that are sufficient to meet Initial Margin requirements.

Whilst the Group concurs with the underlying requirement, we believe that it should more properly be imposed on clearing members rather than on the DCO and that for this reason the paragraph should be struck out and instead inserted into the Commission's proposed rules for clearing members.

(g)(9) *Time Deadlines*

Under subparagraph 9 the Commission proposes that the DCO should establish and enforce time deadlines for Initial and Variation Margin payments to the DCO.

The Group again concurs with this provision, but would observe that since the DCO has no direct relationship with clients of its clearing members, the provision should apply to the DCO's clearing members only. Any provision applying to the clients of clearing members should therefore again be more properly addressed in the Commission's proposed rules for clearing members.

(h) *Other Risk Control Mechanisms*

(h)(3) *Stress Tests*

In subparagraph (i) of Section 39.13(h)(3), the Commission requires that the DCO should conduct stress tests on a daily basis with respect to each Large Trader who poses significant risk to a clearing member or to the DCO.

The Group concurs with the requirement that such tests be conducted daily, however we do not believe that the stress-test requirement should be extended to cover all Large Traders, since many of these may be clients of clearing members.

DCO client clearing models should be designed to enable the DCO to transfer clients in the event of the clearing member's default. Clearing members must be able, and are contractually required, to default manage any clients that they introduce into clearing and must therefore be able to withstand the default of such clients.

In subparagraph (ii) of Section 39.13(h)(3), the Commission sets out how a DCO should stress test each of its clearing members.

As stated above, the Group believes that such tests should occur daily. Additionally we would recommend that the Commission prescribe that the stress scenarios used by the DCO in its testing should be adapted for current market conditions such that price or market shifts should not be translated literally, but rather proportionally.

By way of example: in computing the effect of a sharp move in oil prices, the DCO might consider the $6 shift in oil pricing that occurred in 1991. At that time oil was trading at $18 dollars a barrel, whilst today it is trading at in excess of $100 a barrel. Rather than apply the shift in absolute terms of a $6 per barrel move, the DCO would therefore need to consider the 1991 move in percentage terms, and apply this percentage move (or some other relative expression) to today's prices.

(h)(4) *Portfolio Compression*
In this Section, the Commission lays out the requirement that a DCO should offer portfolio compression exercises and require its members to participate in all such exercises to the extent that any swap is applicable for inclusion in the exercise.

As stated above in Section 39.12(b), the Group strongly supports the use of compression services and believes that they should be encouraged by the Commission to the greatest extent possible. Notwithstanding this, the Group does not believe that it would necessarily always be appropriate for the DCO to require its clearing members to participate in all such exercises. There are several reasons for this.

Firstly a DCO's clearing members may not always be subject to the Commission's supervision and may not be required to engage in such compression activities. Imposing such a requirement on the DCO may thus discourage such firms from becoming members of that DCO and thereby have the perverse effect of discouraging that firm from clearing.

Secondly, a clearing member may have legitimate reasons for not participating in such compression exercises at all times, or for not submitting all eligible Swaps to such exercises. The use of compression services should be encouraged – but not compulsory.

For these reasons we would suggest that the Commission strike subparagraph (h)(4)(ii) in its entirety.

(h)(5) *Clearing Members' Risk Management Policies and Procedures*
This section sets out the policies and procedures that DCOs must impose on their clearing members.

The Group concurs with the provisions but would respectfully suggest that the Commission limit the requirements set out under (h)(5)(C) such that these be applicable only to those clearing members that are subject to the Commission's oversight and not to all members of a DCO regardless of the jurisdiction in which they operate.

As before our concern here is that such a provision may run contrary to the Commission's intent, and discourage such firms from joining a CFTC-regulated clearinghouse.

39.14 Settlement Procedures
In this Section the Commission sets forth its proposed settlement procedures for DCOs.

The Group agrees with the Commission's proposals for settlement procedures.

39.15 Treatment of Funds

(b)(1) *Segregation of Funds and Assets*
This section requires that the DCO comply with the segregation requirements of section 4d of the Commodity Exchange Act ("CEA") and Commission regulations thereunder, or any other applicable Commission regulation or order requiring that customer funds and assets be segregated, set aside, or held in a separate account.

LCH.Clearnet believes that it may not always be clear what the Commission intends by "segregated" and would therefore respectfully suggest that the Commission clarify this term and limit the segregation requirement to the funds of clearing members' clients. We would also respectfully urge the Commission to limit these requirements to client business cleared by the DCO under the FCM clearing structure. A DCO based outside the U.S. may offer client clearing services through alternative structures and we do not believe it would be appropriate for clients clearing under these non-U.S. structures to be subject to the segregation requirements of section 4d of the CEA, but rather to the requirements set out by the DCO's home or other regulators.

(b)(2) *Commingling of Futures, Options on Futures and Swaps Positions*
In this Section the Commission lays out the rules that the DCO and its clearing members must observe in order commingle customer positions in futures, options on futures, and swaps, and any money, securities, or property received to margin, guarantee or secure such positions.

The Group has a long history of clearing both futures and Swaps, as well as other repo and cash instruments, and recognizes the economic benefits that may accrue to clearing members and their clients if a DCO is able to offset between such instruments.

The Group believes that the Commission has correctly identified most of the factors that must be considered before a DCO or its clearing members should be able to offer such offsets, but would respectfully suggest that a number of additional factors be considered.

We set out these additional factors in points 1 to 4 below:

1. Account Structures

   For the DCO or one of its clearing members to afford commingling of and offsets between such instruments for clients, the clients must hold their futures, options on futures and Swaps positions under the same account structure and within the same legal entity.

2. Margining

   For the DCO or its clearing members to safely enable risk offsets between such instruments, the DCO must margin futures, options on futures and Swaps positions on the same model so as to ensure that inherent risk assumptions about correlation, liquidity, basis and convexity are incorporated into the margin calculations for the portfolio of risk in its entirety. Using different margin models for different assets and then applying individual risk offset ratios to these assets is highly subjective and could result in the DCO introducing inconsistent assumptions across different margin models, and lead to the DCO being 'under-margined'.

3. Holding Periods

   For the DCO to afford commingling of and offsets between such instruments for clearing members and clearing members for their clients, the DCO and the clearing members must apply the longest holding period for *any* of these instruments consistently across *all* such instruments. Thereby, if a client or clearing member wishes to offset their futures, options on futures and Swaps positions, the DCO would have to set a minimum holding period for the client's or the clearing members' futures, options on futures and Swaps positions of at least five days, as per the CFTC's prescription on holding periods for Swaps. This is because the holding period for the offset instruments must be the same in order to ensure the DCO has sufficient coverage for the entire portfolio from beginning to end of the default management process.

4. Default Funds.

   For the DCO or its clearing members to afford commingling of and risk offsets between such instruments, the DCO must have a single guaranty fund covering all 'offsettable' futures, options on futures and Swaps. All risk exposures have to be covered by the Initial Margin and the guaranty fund, therefore these contributions must be comprised of and dedicated to the underlying products that are being offset. Furthermore, all offset assumptions in the DCO's margin calculations for such offsets provided must, as a minimum, be replicated in the DCO's stress testing in order to ensure adequate guaranty fund coverage and the offset assumptions must be recalibrated frequently.

(c) *Holding of Funds and Assets*
In this Subparagraph the Commission sets forth how a DCO should hold funds and assets belonging to clearing members and their customers.

The Group agrees with all the provisions set forth under this subsection - the only additional observation we would make is that the rules might more properly require that the DCO must be able to convert any funds and assets held promptly into cash, and should prove this requirement on an ongoing basis.

39.16 Default Rules and Procedures
In this section the Commission sets forth its proposed rules and procedures for the efficient, fair, and safe management of clearing member defaults on their obligations to the DCO.

The Group concurs with all the provisions set out under proposed rule 39.16 and commends the Commission for its acuity in setting out these prescriptions.

39.18 System Safeguards
In this section the Commission puts forward its proposals for DCO controls and recovery procedures.

The Group concurs with all the provisions set out under proposed rule 39.18. Our only concern here would be to encourage the Commission to consider the alignment of these provisions with international standards, and in particular, by those that will be set out by the CPSS-IOSCO. We would also urge the Commission to consider a phase-in of such standards, again in alignment with international recommendations.

39.19 Reporting
In this section the Commission sets out its proposed reporting requirements for DCOs and their clearing members.

The Group concurs with all the provisions set out under proposed rule 39.19 and again commends the Commission with its insight in this regard.

39.21 Public information
Under proposed rule 39.21 the Commission sets out the parameters by which the DCO must make public its rules and procedures.

The Group generally concurs with these requirements, but would respectfully request that the public dissemination of the information requirements set out under 39.21 should be limited to broad-based rules for default management, since the rules governing a DCO's default management process are proprietary to the DCO. For this reason, whilst the default management rules of the DCO should be public, the DCO should only be required to make the detailed rules and processes underlying these available to its supervisors and participating members.

.... ***ENDS***