LONDON METAL EXCHANGE

24 August 2012

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

CROSS BORDER APPLICATION OF CERTAIN SWAPS PROVISIONS OF THE COMMODITIES EXCHANGE ACT; RIN 3038-AD57

Dear Mr. Stawick:

The London Metal Exchange Limited ("LME" or "Exchange") is pleased to submit this comment letter in response to the June 29, 2012 Proposed Interpretive Guidance and Policy Statement ("Proposed Interpretive Guidance") published by the Commodity Futures Trading Commission ("CFTC" or the "Commission") regarding the cross-border application of certain swaps provisions of the Commodity Exchange Act. ("CEA").[1] We believe that the Proposed Interpretive Guidance could be interpreted to subject LME to the regulatory requirements of different jurisdictions depending upon which of its trading venues is available to its members, a result we believe would present significant operational difficulties for the LME and would be counter to, and inconsistent with, the Dodd-Frank Act ("DFA"). Accordingly, we recommend that the Commission adopt an unequivocal position that the clearing of a swap entered into by any counterparty by a derivatives clearing organization ("DCO") that is subject to a comparable regulatory regime will satisfy the clearing requirements of the DFA as to both the counterparties and the DCO, regardless of whether the counterparties are U.S. swap dealers and/or U.S. Persons (as defined in the Proposed Interpretive Guidance) or affiliates of U.S. Persons. In addition, we urge the Commission to adopt the position that clearing such swaps on a DCO that is affiliated with a registered Foreign Board of Trade ("FBOT") and satisfies the requirements contained in the FBOT rules applicable to such a DCO will be deemed conclusively to be subject to a comparable regulatory regime without further action required.

I Introduction

The LME was organized in London more than 130 years ago and is the world's premier base metals market, offering futures and options contracts for aluminium, copper, tin, nickel, zinc, lead, aluminium alloy and NASAAC, steel billet, cobalt and molybdenum. The LME is regulated by the U.K. Financial Services Authority as a recognized investment exchange. While certain contracts traded on the Exchange fit within the traditional definition of "futures" contracts, given the broad definition of "swap" in the DFA, certain other contracts traded on the LME may be deemed to be "swaps" under the DFA.

[1] 77 Fed. Reg. 41214-42 (July 12, 2012).

One of three venues for trading on the LME is the LME's electronic trading system, which is known as LMEselect. The other two venues for trading on the LME are open outcry (known as "ring trading" due to the shape of the physical trading location in London) and inter-office trading, which can take place 24 hours a day with dealers providing bids and offers over the telephone.

Some members of the LME trade on LMEselect through their subsidiaries or agent branches located in the United States and access the LMEselect through U.S. persons or while located in the U.S. The LME does not currently have nor intends to open or locate an office or staff in the United States.

Open outcry only takes place in London. There are twelve ring dealing members, and all business within the ring must be passed through one of them. Membership of the LME is divided into different categories giving different trading rights. For the purposes of this letter, it is worth noting that Category 1 members have the right to trade on all three of the LME's trading venues – the ring, LMEselect and the inter-office market. Category 2 members can trade on LMEselect and the inter-office market but not on the Ring. Category 1 and 2 members could be U.S. entities. At the present time only one Category 2 member is a U.S. entity, which has a branch office in the U.K. for the purposes of compliance with the LME's rules.

In March 2001, the LME obtained no-action relief from the CFTC authorizing it to provide LME members located in the United States with direct address to LMEselect, its electronic trading and order matching system.[2] On December 23, 2011, the CFTC adopted final registration rules for FBOTs ("FBOT Registration Rules")[3] that provide direct access to its electronic trading system to persons in the U.S. The LME intends to register as an FBOT and recently submitted its Form FBOT for filing with the Commission.

II Discussion

1. General

The Proposed Interpretive Guidance is targeted at providing to the counterparties to "cross-border swaps" guidance as to entity level and transaction level requirements. It does not address in detail how the requirements of the DFA may apply in such contexts to derivatives market participants, such as DCOs. Hence, with respect to the clearing requirement in the DFA, the focus is on who the counterparty is to the trade, namely whether one of the counterparties is a U.S. swap dealer, a U.S. Person, a foreign affiliate of a U.S. Person or a Non-U.S. Person guaranteed by a U.S. Person. As set forth in the tables to the Proposed Interpretive Guidance,[4] if any of the counterparties is a U.S. Person, regardless of where the DCO is located, or provides access to the U.S. Person, then according to the Proposed Interpretive Guidance, the clearing requirements of the DFA will apply without regard to substituted compliance with a comparable regulatory regime. If the counterparty is a Non-

[2] CFTC Letter No. 01-11 (March 12, 2001).

[3] 76 Fed. Reg. 80674-80723 (December 23, 2011).

[4] 77 Fed. Reg. 41237.

U.S. Person whose swaps are guaranteed by a U.S. Person, then substituted compliance will apply.

The Proposed Interpretive Guidance states in another part of the release (the "DCO Statement") that "it expects to find comparability with foreign regulatory regimes when (i) the swap is subject to a mandate issued by the appropriate government authorities in the home country of the counterparties to the swap, provided that the foreign mandate is comparable and comprehensive to the Commission's mandate; and (ii) the swap is cleared through a DCO that is exempted from registration under the CEA."[5]

The DCO Statement appears to be inconsistent with the conclusions set forth in the tables to the Proposed Interpretive Guidance. It is unclear whether clearing a swap on a DCO that is subject to a comparable foreign regulatory regime and that is exempt from registration under the CEA will satisfy the requirements of the DFA for only those counterparties where substituted compliance is expressly permitted as set forth in the tables in the Proposed Interpretive Guidance, or whether the DCO Statement applies regardless of whether there is a U.S. Person as a counterparty. In other words, must a U.S. Person (or an affiliate of a U.S. Person) that is a counterparty to a trade always clear a trade on a U.S. registered DCO, even if the trading is done outside of the U.S. on a non-U.S. exchange?

Further, in the DCO Statement, the Commission does not provide any guidance on how a non-U.S. DCO may obtain an exemption from such registration requirements.

2. Jurisdiction of the DCO, not the counterparty, is relevant for satisfaction of the clearing requirement

The relevant analysis for determining whether the clearing requirement is satisfied should be whether the swap is cleared on a DCO which is subject to regulation that is comparable to the DCO requirements under the DFA, not the jurisdiction of the person that is clearing the swap. If a DCO meets the equivalent of U.S. DCO requirements, any counterparty should be able to satisfy the clearing requirement regardless of who is doing the trading. The clearing requirement is intended to provide transparency to the swaps market and centralize and mitigate risk. If the foreign regulatory regime which governs the DCO applies similar rules and principles to DCOs registered thereunder, then the purposes of the DFA clearing requirement will be satisfied.

The bifurcation of the clearing requirement in this manner would require a DCO to police and monitor the jurisdiction of the counterparties. Section 5b(a)(1) of the CEA makes it unlawful for a DCO to clear a swap unless it is registered with the CFTC as a DCO. Would it be lawful for a foreign DCO to clear the swaps of non-U.S. Persons guaranteed by U.S. Persons, but not clear swaps of U.S. Persons? What level of diligence would a foreign DCO have to perform in order not to be deemed to have violated this provision?

Accordingly, we recommend that the Commission clarify in the final guidance, that for purposes of determining whether the clearing requirement has been met, the comparability

[5] Proposed Interpretive Guidance, 77 Fed. Reg. 41234.

analysis should be applied at the level of the DCO, and the jurisdiction of the counterparties is not relevant.

3. The CFTC should issue guidance on when a non-U.S. DCO may obtain an exemption from DCO registration requirements

The Proposed Interpretive Guidance is silent on when, and under what circumstances, a non-U.S. DCO can obtain an exemption from DCO requirements. This lack of clarity could result in uncertainty on the part of swap counterparties as to where they should clear the transaction. Should the trade be cleared on a U.S. registered DCO or a foreign DCO? Who will make the determination as to whether the foreign DCO is subject to comparable and comprehensive clearing requirements? Must the foreign DCO register in the U.S. in order for clearing on the registered DCO to be available for the exemption?

The FBOT Registration Rules provide requirements for clearing through the FBOT even though the FBOT may not be registered as a DCO in the U.S. These standards could be used to provide the basis for an exemption for clearing on a non-U.S. DCO that is not registered in the U.S. We do not believe that each non-U.S. DCO, however, should be required to register in order to prove that it is eligible for an exemption from registration - this would defeat the purpose of the exemption. Rather, we believe that the comparability determination in this context should be made on a jurisdiction-by-jurisdiction regulatory approach and those DCOs that are registered in jurisdictions that the CFTC determines meet the FBOT clearing standards should be exempt from the DCO registration requirement on an omnibus basis.

4. The comparability analysis should be framed and applied in such a manner so that it is integrated and consistent with comparability determination exemptions that apply to all market participants in the same transaction

A singular swap transaction may involve several derivatives market participants, including counterparties to the swap, futures commission merchants ("FCMs") and exchanges. Each of these derivatives market participants may be the subject of a compliance-related DFA provision. In these circumstances, substituted compliance should be applied for each derivatives market participant in the transaction chain. Otherwise, this may result in different and incompatible operational results.

For example, the rules on gross margining apply directly to FCMs. These rules require FCMs to post to DCOs the gross margin required by the DCO of each of the FCM's cleared swaps customers, instead of the net margin obligation of all of the FCM's cleared swaps customers in the aggregate. Whether gross margining or net margining applies is, however, not only relevant to the FCM, but is also relevant to the DCO. If the FCM is required to post gross margin, the DCO will have to segregate margin, account and value differently than if only net margin was required. Applying substituted compliance to the DCO in this instance, however, and not to the FCM, could lead to incompatible results. For example, if substituted compliance applied only to the DCO in this context it would not be required to accommodate and be operationally compatible with gross margining. International standards applicable to

DCOs, such as the Recommendations for Central Counterparties ("RCCP"),[6] and their successor, the Principles for Financial Market Infrastructures ("FMI Principles"),[7] do not contain a requirement or recommendation for gross margining by FCMs on DCOs. If substituted compliance did not apply to the FCM requirements in this context, the FCM would be required to post gross margin even though a DCO would not be subject to parallel requirements with respect to its obligations. Accordingly, we believe that the substituted compliance analysis should be applied uniformly with respect to all derivatives market participants in the same transaction.

5. Registration as an FBOT should provide the basis for an exemption to the DCO registration requirements for all swaps

The FBOT Registration Rules, and the corresponding exemption from DCO registration for FBOTs that self-clear, expressly apply only to swaps which are entered into by persons located in the U.S. through direct access to the FBOT's trade matching system. This FBOT registration should serve as a basis and be conclusive that the non-U.S. DCO used by the FBOT does not have to register in the U.S. as a DCO regardless of the trading venue used. Otherwise, we may be faced with the anomalous result that a counterparty that is provided with direct access and is trading from within the U.S. may clear its trades on a non-U.S. registered DCO while a counterparty trading through the ring or inter-office market in London would have to clear such trades through a registered DCO in the U.S. or would have to provide an independent basis to show why trading on the non-U.S. registered DCO would satisfy DFA requirements.

The LME appreciates the opportunity to comment on the Proposed Interpretive Guidance. We would be pleased to discuss any of the comments or recommendations in this letter with the Commission or its staff in greater detail.

Yours sincerely

Tom Hine
General Counsel & Head of Enforcement

[6] Explanatory note 1 to recommendation 4 in the RCCP states that both net margin and gross margin systems are acceptable as long as central counterparties understand the risks pertaining to those systems and take appropriate measures to minimize these risks. See http://www.bis.org/publ/cpss64.pdf.

[7] Section 3.14.8 of the FMI Principles, like the RCCP, does not mandate gross margins but merely states that central counterparties should understand, monitor and manage risks relating to the way initial margin is collected.