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Melissa Jurgens
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

25 January 2013

Dear Ms. Jurgens:

Re: RIN No. 3038-AD88, Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations

LCH.Clearnet Group Limited ("LCH.Clearnet" or "The Group") is pleased to respond to the request for comment on the Commodity Futures Trading Commission's ("the CFTC" or "Commission") proposed rules Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivative Clearing Organizations ("proposed rules" or "proposal").[1]

The Group strongly supports the policy goals underpinned by the proposed rules and the statutory provisions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

The Commission proposes to adopt new regulations and to amend existing regulations to require enhanced customer protections, risk management programs, internal monitoring and programs, capital and liquidity standards, customer disclosures, and auditing and examination programs for futures commission merchants ("FCMs"). Some of the provisions of the proposal apply to derivative clearing organizations ("DCOs"). The Group's letter primarily addresses the portions of the proposal that concern DCOs but it also addresses some proposed rules applicable only to FCMs that could have a potential negative impact on customers, FCMs, and the clearing of swaps.

LCH.Clearnet Overview

LCH.Clearnet is the leading independent clearing house group, serving major international exchanges and platforms, as well as a range of OTC markets. It clears a broad range of asset classes including: securities, exchange traded derivatives, commodities, energy, freight, foreign exchange, interest rate swaps, credit default swaps, and euro and sterling denominated bonds and repos. LCH.Clearnet works closely with market participants and exchanges to identify and develop clearing services for new asset classes.

The Group consists of three operating subsidiaries: LCH.Clearnet Limited, LCH.Clearnet LLC, and LCH.Clearnet SA. LCH.Clearnet Limited is registered with the Commission as a DCO and is regulated as a Recognised Clearing House by the UK Financial Services Authority. Several of

[1] 77 FR 67866 (November 14, 2012).

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LCH.Clearnet Limited's business lines, SwapClear, ForexClear, and EnClear, clear swaps. LCH.Clearnet LLC, formerly International Derivatives Clearinghouse, LLC ("IDCH") was recently acquired by the Group and is registered with the Commission as a DCO. LCH.Clearnet LLC is domiciled in the US.[2] LCH.Clearnet SA has filed an application with the Commission for a DCO license, is regulated as a credit institution by a regulatory college of the market regulators and central banks of France, the Netherlands, Belgium and Portugal, and is regulated as a Recognised Overseas Clearing House by the UK Financial Services Authority. LCH.Clearnet SA's CDSClear service clears swaps and security-based swaps. LCH.Clearnet Limited and LCH.Clearnet SA are subject to the European Markets Infrastructure Regulation ("EMIR") and will have to apply for reauthorisation in 2013 under EMIR.

Both LCH.Clearnet Limited and LCH.Clearnet SA operate global swap clearing services in multiple jurisdictions. Our clearing members for these services include global banks as well as banks that limit their swap activities to their domestic markets. The clients of these clearing members include a wide variety of US and non-US participants in the swaps market including banks, asset managers, hedge funds, insurance companies, and corporations. LCH.Clearnet Limited is well-placed to assist our clearing members and their clients in discharging clearing mandates under both Dodd-Frank and EMIR because it is registered and conducts business in both the United States and European Union. We are also committed to seeking appropriate recognition to allow counterparties in other G-20 countries to discharge their clearing mandates by clearing on LCH.Clearnet Limited. LCH.Clearnet SA is following a similar approach by seeking a DCO license. Our approach allows counterparties in two different jurisdictions to discharge the clearing mandate in their respective jurisdictions at the same CCP, and is consistent with the global nature of the swaps industry.

Proposed Rules Applicable to DCOs

Proposed Rule 1.20 (g)(4)

Proposed Rule 1.20(g)(4) would require a DCO to obtain a written acknowledgement in the form prescribed in the proposed Appendix A to Rule 1.20 from each depository in which it deposits futures customer funds.[3] Rule 22.5(a) currently contains a requirement to obtain a written acknowledgement letter from a depository in which a DCO deposits Cleared Swaps Customer Collateral. If the proposed rules are adopted, the written acknowledgement letter required under Rule 22.5(a) would have to conform to the final form of the letter in Appendix A to Rule 1.20. The proposed Acknowledgement Letter contains language requiring the depository to grant—at all times—read-only electronic access to such accounts to the Commission. The proposed Acknowledgement Letter specifically requires the depository to provide the Commission "with the

[2] On August 14, 2012, the Group acquired IDCG, and its subsidiary IDCH, from The NASDAQ OMX Group, Inc. LCH.Clearnet changed the name of IDCH to LCH.Clearnet LLC. After regulatory approval of conforming rule changes, LCH.Clearnet LLC will clear all of the interest rate swaps currently cleared by LCH.Clearnet Limited using existing LCH.Clearnet technology and procedures. Pending regulatory approval, LCH.Clearnet LLC is expected to launch in the first quarter of 2013. Prior to that launch, LCH.Clearnet LLC is not accepting interest rate swaps for clearing.

[3] Proposed Rule 1.26(b) contains a substantively similar requirement for customer funds invested in money market mutual funds. LCH.Clearnet's comments on proposed Rule 1.20(g)(4) also apply to Proposed Rule 1.26(b).

necessary software, a user log-in, and password that will allow the Commission to have read-only access to the accounts at the depository that hold customer funds on the depository's website or via an alternative electronic medium on a 24-hour a day basis."[4] In the proposal, the Commission recognizes that depositories may not have the capability of providing customers or other parties, including the Commission, with real-time account balances and position information. The Commission states that it would be satisfactory for the depository to provide read-only access to account information as of the close of the prior business day.[5]

LCH.Clearnet agrees that the Commission has the authority to monitor compliance with the provisions of the Commodity Exchange Act and implementing regulations that concern the protection of customer funds[6]. However, LCH.Clearnet does not think that requiring all depositories holding customer funds to provide direct access to Commission staff to account balance information for the many accounts maintained by DCOs and FCMs for routine inquiries is the most efficient way for the Commission to exercise that authority.

LCH.Clearnet recommends that the Commission consider alternative approaches for routine access to account balance information at depositories holding customer funds that will make more efficient use of the Commission's scarce resources. For customer funds held in an account at a central bank, the Commission should accept confirmation of balance information directly from the central bank in a form acceptable to the central bank. For customer funds held at other depositories, the Commission should consider following the lead of the National Futures Association ("NFA"). NFA recently amended its rules to require its members to instruct each depository at which it holds customer funds to report the balances in the accounts containing customer funds to a third party designated by NFA and in the form and manner prescribed by NFA.[7] This approach gives the NFA staff the ability and flexibility to quickly and efficiently access information on customer account balances at particular depositories or for particular NFA member either manually or on an automated basis. This approach leverages technology to increase efficiency by dispensing with the need to log-in manually to obtain balance information. This approach also eliminates the need to keep current the large number of passwords and any related security devices necessary to support online access to all accounts holding customer

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[4] 77 FR at 67942.

[5] 77 FR at 67886.

[6] LCH.Clearnet is not recommending any changes to the language in the proposed Acknowledgement Letter providing for examination of an account holding customer funds "at any reasonable time," requiring a custodian "to respond promptly and directly" to requests for account balances from an appropriate employee of the Commission without notice to or consent from the FMC or DCO account holder, or requiring immediate access to information on accounts holding customer funds at the instruction of the Director of the Division of Swap Dealer and Intermediary Oversight or the Division of Clearing and Risk. These provisions of the proposed Acknowledgement Letter appear to give the custodian ample notice that the Commission may seek balance and other information on an emergency basis on any account holding customer funds.

[7] Letter from Thomas W. Sexton, NFA, to Sauntia Warfield, Assistant Secretary of the CFTC, re: National Futures Association: Use of Technology to Monitor FCM Segregation Compliance—Proposed Amendments to NFA Financial Requirements Section 4 (November 27, 2012), available at http://www.nfa.futures.org/news/PDF/CFTC/FR_Sec4_UseOfTechnologyToMonitorFCM_SegregationCompliance_111512.pdfCitation to NFA rule filing.

funds. LCH.Clearnet urges the Commission to consider amending the proposed Acknowledgement Letter to reflect the use of the system employed by NFA, or a similar system, for routine balance inquiries by CFTC staff.

The Commission seeks comment on the appropriate timeframe to implement the requirement to obtain new Acknowledgement Letters that conform to the final version of Appendix A to Rule 1.20 and to gain access to read-only access to balance information on accounts holding customer funds. LCH.Clearnet recommends that the Commission adopt a compliance date of six months after publication of the final rules in the Federal Register for DCOs and FCMs to obtain new Acknowledgement Letters. Each DCO and FCM is likely to have to obtain Acknowledgement Letters for a number of accounts some of which may be outside the United States. Further, it is likely that many DCOs and FCMs hold at least some portion of customer funds in the same depositories requiring some depositories to sign a large number of new Acknowledgement Letters. In light of these factors, six months after Federal Register publication of the final rules should be sufficient time to permit DCOs and FCMs to obtain new Acknowledgement Letters. If the Commission adopts LCH.Clearnet's recommendation on an alternative approach to accessing balance information on a routine basis for accounts holding customer funds, this requirement could also take effect six months after Federal Register publication of the final rules.

Proposed Rule 1.25

Proposed Rule 1.25(b)(3)(v) would apply the current 25 percent counterparty concentration limit for reverse repurchase agreements not only to a single counterparty, but to all counterparties under common control or ownership. The Commission also proposes amending Rule 1.25 by deleting paragraph (b)(6) which requires a DCO or FCM to prepare a record, on a daily basis, detailing the type of instruments in which customer funds were invested, the original costs of the investments, and the current market value of the investments. LCH.Clearnet supports both of these proposed changes to Rule 1.25. LCH.Clearnet's current investment policy is consistent with proposed Rule 1.25(b)(3)(v). In the case of the proposed elimination of rule 1.25(b)(6), LCH.Clearnet is pleased to see the Commission taking a careful look at its regulations and proposing to eliminate those regulations which are duplicative.

Proposed Rules Applicable to FCMs

LCH.Clearnet strongly supports the core proposition of Title VII of Dodd-Frank that the clearing of swaps by DCOs will reduce systemic risk and promote transparency. Unfortunately, LCH.Clearnet is concerned that some of the rules proposed by the Commission would have unintended consequences that threaten these goals by making clearing more capital intensive for customers and FCMs without providing any additional protection for customer funds. Our comments on rules applicable to FCMs address only the impact of the proposed rules on swaps clearing.

Proposed Rules 1.20(i)(4) and 22.2(f)(6)

Proposed Rules 1.20(i)(4) and 22.2(f)(6) would require that the FCM's residual interest in the customer segregated account must at all times be sufficient to exceed the sum of the margin deficits that the FCM's customers have in their accounts.[8] In effect, proposed Rules 1.20(i)(4)

[8] One of the intentions of proposed Rules 1.20(i)(4) appears to be to require FCMs to perform the calculation required by the current version of the Commission's Part 22 rules, often referred to as the

and 22.2(f)(6) would require an FCM to continuously perform the "LSOC[9] Compliance Calculation" required by the current version of the Commission's Part 22 rules only to be performed by an FCM prior to meeting a DCO margin call.[10] The LSOC Compliance Calculation is designed to ensure that one customer's funds are never used to meet the obligation of any other customer thus delivering one of the key protections promised by LSOC, the elimination of fellow customer risk. This calculation is the cornerstone to providing the individual legal segregation for cleared swaps customers required by Rule 22.15. After an exhaustive consultative process between Commission staff and industry representatives on implementation of the Part 22 rules, it was agreed that the LSOC Compliance Calculation would be required to be performed by an FCM prior to meeting any DCO margin call. By requiring the calculation to be performed prior to meeting any margin call, the CFTC is ensuring that an FCM never uses the collateral value of one customer to meet the obligation of any other customer. This is the case, since prior to meeting a call for an increased requirement, a customer may be under collateralized, but is not collateralized by another customer. Prior to meeting a margin call, an FCM performs the LSOC Compliance Calculation to ensure that the call is met with either the funds of the individual customer generating the call or the residual interest of the FCM. Therefore, the LSOC Compliance Calculation need only be performed prior to a DCO margin call in order to protect customer collateral.

The continuous application of the LSOC Compliance Calculation required by proposed Rules 1.20(i)(4) and 22.2(f)(6) would not provide additional protection to customers but would make the clearing of swaps less attractive by, in essence, requiring an FCM to pre-fund all customer initial margin requirements, a cost that would surely be passed on to customers. In order to comply with proposed Rules 1.20(i)(4) and 22.2(f)(6), an FCM would need to perform the LSOC Compliance Calculation within the 60-second window provided in Rule 1.74 prior to accepting a customer trade for clearing. If accepting the trade would cause an initial margin increase that was not pre-funded, the FCM would either have to reject the trade or fund the "margin deficiency," within the 60-second window, prior to accepting the trade. FCMs understandably want to avoid rejecting customer trades if at all possible so the requirement to perform the LSOC Compliance Calculation continuously puts an FCM in the position of either pre-funding all customer trades or risking a violation of the Commission's rules. Additionally, it is almost impossible for an FCM to anticipate the magnitude of changes in variation margin. Therefore, regardless of the amount of capital an FCM dedicated to continuous compliance, FCMs would still be at risk of a violation. Fortunately for both customers and FCMs, the LSOC Compliance Calculation method currently followed provides a means to avoid this dilemma. LCH.Clearnet urges the Commission to address this issue by conforming the final version of proposed Rules 1.20(i)(4) and 22.2(f)(6) to the current method of making the LSOC Compliance Calculation by dropping the words "at all times."[11]

"LSOC Compliance Calculation," for both cleared swaps and for futures. LCH.Clearnet does not have a view on whether the Commission should require this calculation for futures.

[9] The acronym "LSOC" stands for "legally segregated, operationally commingled."

[10] Joint Audit Committee Regulatory Update #12-03, available at http://www.wjammer.com/jac/, describes the LSOC Compliance Calculation.

[11] LCH.Clearnet also recommends that the Commission also drop the words "at all times" from proposed Rule 22.2(b)(4). This would leave Rule 22.2(b)(4) unchanged.

Proposed Rules 1.23(d) and 22.17(c)

Proposed Rules 1.23(d) and Rule 22.17(c) would require an FCM to obtain the signature of the Chief Executive Officer, Chief Finance Officer or other senior official prior to removing 25% or more of the FCM's residual interest in the customer segregated account for its own proprietary use on any business day. LCH.Clearnet understands that the Commission's goal in proposing Rules 1.23(d) and 22.17(c) is to provide an additional layer of protection for customer funds in segregated accounts. While LCH.Clearnet agrees with this commendable goal, we are concerned that, as written, the proposed rules would create a disincentive for an FCM to use its own funds to provide a substantial buffer of funds in the customer segregated account at the DCO level. Such an FCM buffer in the customer segregated account provides a benefit for all of the FCM's customers at the DCO. The Commission's rules should encourage FCMs to provide such a buffer at the DCO level.

Proposed Rule 1.11(e)(3)(i)(D) would require an FCM to develop policies and procedures for establishing a targeted amount of residual interest that the FCM seeks to maintain in customer segregated funds accounts in order to ensure that the FCM is at all times in compliance with the Commission's segregation requirements. This targeted amount of residual interest is crucial to ensuring that customer segregated funds are not intentionally or unintentionally misused by an FCM. This targeted amount of FCM funds in customer segregated accounts should be carefully monitored by the FCM and regulators, and substantial withdrawals of the targeted amount of residual interest of FCM funds in a customer segregated account should be subject to stringent controls. However, an FCM may choose to post significantly more than the minimum required targeted amount at the DCO level and the Commission's rules should not contain disincentives to doing so. In the context of cleared swaps, the willingness of an FCM to post a significant amount of its own funds at the DCO, an amount that is often far in excess of any targeted amount, is vital to ensuring that sufficient collateral is available so that swaps submitted by customers for clearing are accepted by the DCO. FCMs should not be hindered in withdrawing this "elective excess" buffer amount to meet other needs so long as doing so does not impinge on the targeted amount of residual interest that they are required to maintain in customer segregated funds accounts. For this reason, LCH.Clearnet urges the Commission to make changes to proposed Rules 1.23(d) and 22.17(c) to focus these rules on the withdrawal of FCM funds in excess of 25% of the FCM's *targeted* residual interest rather than on 25% of the total residual interest in the customer segregated account. This change could be accomplished by inserting the word "targeted" before "residual interest" in both proposed Rules 1.23(d) and 22.17(c).

Proposed Rule 30.7(e)(3)

Proposed Rule 30.7(e)(3) would prohibit an FCM from commingling any funds held for Part 30.7 Customers with funds deposited with the FCM by futures customers, Cleared Swaps Customers, or account holders of positions unrelated to trading foreign futures or foreign options except as the Commission may otherwise permit by rule or order. Proposed Rule 30.7(e)(3) would supersede guidance previously issued by Commission staff permitting an FCM to commingle and carry non-foreign futures positions, including over-the-counter positions, in a Part 30.7 Account.[12] LCH.Clearnet does not have a position on whether the Commission should adopt proposed Rule 30.7(e)(3) and prohibit commingling of Part 30.7 Customer Funds with the funds of futures customers and Cleared Swaps Customers. However, if the Commission does decide to adopt

[12] 77 FR at 67896.

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proposed Rule 30.7(e)(3),LCH.Clearnet urges the Commission to preserve the ability to allow such commingling pursuant to a Commission rule or order.

LCH.Clearnet provides clearing services to Nodal Exchange. Nodal Exchange is an exempt commercial market that has submitted an application for designation as a contract market (DCM). As permitted, customer funds held to margin Nodal contracts are currently held in 30.7 Accounts. If the Commission prohibits the commingling of funds related to over-the-counter positions with Part 30.7 Customer Funds before Nodal's DCM application is granted, a Commission order permitting such commingling will be necessary to permit Nodal to continue to operate until its DCM registration is granted.

Conclusion

LCH.Clearnet appreciates the opportunity to share our views on the Commission's proposed rules to enhance the protection of customer funds. We look forward to working with the Commission as it continues to implement the Dodd-Frank Act. Please do not hesitate to contact Lisa Rosen at +44 (0)207 426 7541 regarding any questions raised by this letter or to discuss these comments in greater detail.

Yours sincerely

Ian Axe
Chief Executive Officer