COMMODITY FUTURES TRADING COMMISSION

Order Granting the London Clearing House's Petition for An Exemption Pursuant to Section 4(c) of the Commodity Exchange Act

AGENCY: Commodity Futures Trading Commission

ACTION: Final Order

SUMMARY: In response to a Petition for Exemption Pursuant to Section 4(c) of the Commodity Exchange Act ("CEA" or "Act") submitted by the London Clearing House Limited ("LCH"), the Commodity Futures Trading Commission ("CFTC" or "Commission") is adopting an order that exempts certain swap agreements submitted for clearing through LCH's newly-developed swaps clearing operation ("SwapClear") from most provisions of the Act and Commission regulations. The order provides a similar exemption to specified persons who engage in certain activities with respect to such agreements. This order is being adopted pursuant to the exemptive authority granted to the Commission by the Futures Trading Practices Act of 1992. The Commission believes that the relief provided by this order is appropriate because a centralized swaps clearing operation may provide substantial benefits to the over-the-counter ("OTC") derivatives market and because the SwapClear operation satisfies the statutory criteria for an exemption pursuant to Section 4(c) of the Act.

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SUPPLEMENTARY INFORMATION:

I. Introduction

By a petition dated June 15, 1998, LCH requested that the Commission grant an exemption pursuant to Section 4(c) of the CEA[1] to qualified persons using "SwapClear," a proposed facility for clearing swap transactions that satisfy specified criteria ("LCH Petition"). The LCH Petition specifically requested that the Commission exempt such persons from all provisions of the CEA and Commission regulations, except for Sections 2(a)(1)(B);[2] 4b and 4*o* of the Act;[3] the provisions of Sections 6(c) and 9(a)(2) of the Act[4] to the extent that such

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1 7 USC 6(c).

2 Section 4(c) of the CEA expressly prohibits the Commission from exempting any transaction from Section 2(a)(1)(B) of the Act. Section 2(a)(1)(B) sets forth the division of the jurisdiction between the CFTC and the Securities and Exchange Commission ("SEC") over specified instruments and restricts or prohibits certain types of securities derivatives. 7 USC 2a.

3 Sections 4b and 4*o* of the Act prohibit fraudulent conduct with respect to futures and option transactions. 7 USC 6b and 6*o*.

4 7 USC 9 and 13(a)(2).

provisions prohibit the manipulation of the market price of any commodity in interstate commerce or for future delivery on or subject to the rules of any contract market; and Rule 32.9.[5] The Commission published a notice of the LCH Petition and a request for public comment in the *Federal Register* on July 7, 1998.[6] The comment period was originally sixty days, but it was extended until September 23, 1998, in response to a request by the International Swaps and Derivatives Association, Inc. ("ISDA").[7] The Commission received four letters in response to its request for comments. Two of these letters were from futures exchanges, and two were from trade associations.[8] The comments are summarized in Section V below.

Based upon the Commission's review and consideration of the LCH Petition, as supplemented by correspondence from counsel for LCH, the comments received in response to the LCH Petition, and the Commission's independent analysis, the Commission is adopting an order pursuant to the authority granted in Section 4(c) of the Act that exempts specified swap agreements submitted for clearing to SwapClear and specified persons who engage in certain activities with respect to those agreements from most provisions of the CEA to the extent that such persons and agreements are subject to the Act and the Commission's regulations. The exemptive relief provided by the order is subject to the terms and conditions set forth therein.

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5 Rule 32.9 prohibits fraud in connection with commodity option transactions. 17 CFR 32.9.

6 *Petition of the London Clearing House Limited for an Exemption Pursuant to Section 4(c) of the Commodity Exchange Act,* 63 FR 3665 (July 7, 1998)(Request for Comments).

7 *Petition of the London Clearing House Limited for an Exemption Pursuant to Section 4(c) of the Commodity Exchange Act,* 63 FR 49094 (Sept. 14, 1998)(Extension of Comment Period).

8 The Commission received comments from the Chicago Board of Trade ("CBOT"), the New York Mercantile Exchange ("NYMEX"), ISDA, and the OTC Derivatives Products Committee of the Securities Industry Association ("SIA").

II. Statutory and Regulatory Background

Section 2(a)(1)(A) of the CEA grants the Commission exclusive jurisdiction over "accounts, agreements (including any transaction which is of the character of . . . 'an option'), and transactions involving contracts of sale of a commodity for future delivery traded or executed on a contract market or any other board of trade, exchange, or market."[9] The term "commodity" is not limited to tangible products, but rather has been defined broadly to include "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."[10]

The CEA and Commission regulations require that transactions in futures contracts and commodity option contracts, with narrowly defined exceptions, occur on or subject to the rules of a contract market designated by the Commission.[11] Specifically, Section 4(a) of the CEA provides, *inter alia*, that it is unlawful to enter into a futures contract that is not made on or subject to the rules of a board of trade which has been designated by the Commission as a "contract market."[12] Pursuant to Sections 4c(b) and 4c(c) of the Act, the trading of commodity options is permitted only in accordance with Commission regulations.[13] Part 33 of the

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9 7 USC 2(i).

10 7 USC 1a(3).

11 7 USC 6(a), 6c(b), and 6c(c).

12 7 USC 6(a). This prohibition does not apply to contracts made on or subject to the rules of a board of trade, exchange, or market located outside of the United States, its territories, or possessions.

13 7 USC 6c(b) and 6c(c). Section 4c(b) provides, *inter alia:*

> No person shall offer to enter into, enter into or confirm the execution of, any transaction involving any commodity regulated under this Act which is of the character of, or is commonly known

regulations prohibits persons from entering into, offering to enter into, or executing any commodity option transaction unless the transaction occurs on a contract market designated by the Commission to trade commodity options, subject to certain exceptions set forth elsewhere in Commission rules.[14]

The Futures Trading Practices Act of 1992 ("1992 Act") added subsections (c) and (d) to Section 4 of the CEA.[15] Section 4(c)(1) authorizes the Commission, by rule, regulation, or order, to exempt any agreement, contract or transaction, or class thereof, from the exchange-trading requirement of Section 4(a) or any other requirement of the Act other than Section 2(a)(1)(B).[16] The Commission is authorized to grant an exemption either: (i) on its own

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> to the trade as, an 'option' . . . contrary to any rule, regulation or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe.

Section 4c(c) directs the Commission to issue regulations that, *inter alia*, "permit the trading of such commodity options under such terms and conditions that the Commission from time to time may prescribe."

[14] 17 CFR Part 33.

[15] Pub. L. No. 102-546 (1992), 106 Stat. 3590, 3629.

[16] Section 4(c) provides that:

> In order to promote responsible economic or financial innovation and fair competition, the Commission by rule, regulation, or order, after notice and opportunity for hearing may (on its own initiative or on application of any person, including any board of trade designated as a contract market for transactions for future delivery in any commodity under section 5 of this Act) exempt any agreement, contract, or transaction (or class thereof) that is otherwise subject to subsection (a) (including any person or class of persons offering, entering into, rendering advice or rendering other services with respect to, the agreement, contract or transaction), either unconditionally or on stated terms or conditions or for stated periods and or from any other provision of the Act

initiative or on the application of any person; (ii) retroactively or prospectively; and (iii) unconditionally or on stated terms or conditions.[17]

The Commission may grant an exemption from the exchange trading requirement of Section 4(a) or any other requirement of the Act other than Section 2(a)(1)(B) "to promote responsible economic or financial innovation and fair competition" if it determines that "the exemption would be consistent with the public interest."[18] Prior to issuing an exemption under Section 4(c) from the exchange trading requirement of Section 4(a), the Commission must find that: (i) the exchange trading requirement "should not be applied to the agreement, contract, or transaction for which the exemption is sought and that the exemption would be consistent with the public interest and the purposes of [the] Act;" (ii) the exempted transaction "will be entered into solely between the 'appropriate persons'" delineated in Section 4(c)(3);[19] and (iii) the

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> (except section 2(a)(1)(B)), if the Commission determines that the exemption would be consistent with the public interest.

17 7 USC 6(c)(1).

18 *Id.*

19 The Act defines the term "appropriate person" to include:

> (A) A bank or trust company (acting in an individual or fiduciary capacity).
> (B) A savings association.
> (C) An insurance company.
> (D) An investment company subject to regulation under the Investment Company Act of 1940 (15 USC 80a-1 et seq.).
> (E) A commodity pool formed or operated by a person subject to regulation under [the] Act.
> (F) A corporation, partnership, proprietorship, organization, trust, or other business entity with a net worth exceeding $1,000,000 or total assets exceeding $5,000,000, or the obligations of which under the agreement, contract or transaction are guaranteed or otherwise supported by a letter of credit or keepwell; support or other agreement by any such entity or by an entity

agreement, contract, or transaction in question "will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under [the] Act."[20]

> referred to in subparagraph (A), (B), (C), (H), (I), or (K) of this paragraph.
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> (G) An employee benefit plan with assets exceeding $1,000,000, or whose investment decisions are made by a bank, trust company, insurance company, investment adviser registered under the Investment Advisers Act of 1940 (15 USC 80b-1 et seq.), or a commodity trading advisor subject to regulation under the Act.
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> (H) Any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing.
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> (I) A broker-dealer subject to regulation under the Securities Exchange Act of 1934 (15 USC 78a et seq.) acting on its own behalf or on behalf of another appropriate person.
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> (J) A futures commission merchant, floor broker, or floor trader subject to regulation under [the] Act acting on its own behalf or on behalf of another appropriate person.
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> (K) Such other persons that the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections. 7 USC 6(c)(3).

[20] Specifically, Section 4(c) states:

> The Commission shall not grant any exemption under [Section 4(c)] from any of the requirements of subsection (a) [the exchange trading requirement] unless the Commission determines that - -
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> (A) the requirement should not be applied to the agreement, contract, or transaction for which the exemption is sought and that the exemption would be consistent with the public interest and purposes of this Act; and
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> (B) the agreement, contract, or transactions –
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> (i) will be entered into solely between appropriate persons; and
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> (ii) will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under this Act.

Section 4(c)(5) of the Act authorized the Commission "promptly" to exercise the exemptive authority granted in Section 4(c)(1) by providing an exemption for swap agreements that are not part of a fungible class of agreements that are standardized as to their material economic terms.[21] The Commission did so by adopting Part 35 of the Commission's regulations in January 1993. These rules exempt swap agreements satisfying specified criteria and any person who offers, enters into, or renders advice or other services with respect to such transactions from all provisions of the Act and the Commission's regulations except for Sections 2(a)(1)(B), 4b and 4*o*, Rule 32.9, and the antimanipulation provisions in Sections 6(c) and 9(a)(2).[22] The Part 35 swaps exemption became effective retroactively as of October 23, 1974, the date of the enactment of the Commodity Futures Trading Commission Act of 1974.

To be eligible for exemptive treatment under Part 35, a transaction must: (i) be a "swap agreement" as defined in Rule 35.1(b)(1);[23] (ii) be entered into solely between "eligible swap

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21 Section 4(c)(5)(B) states, in part, that the Commission may

> [P]romptly following the enactment of this subsection, or upon application by any person, exercise the exemptive authority granted under paragraph (1) . . . with respect to classes of swap agreements . . . that are not part of a fungible class of agreements that are standardized as to their material economic terms, to the extent that such agreements may be regarded as subject to the provisions of this Act.

22 17 CFR Part 35. In enacting the swaps exemption, the Commission also acted pursuant to its plenary authority to regulate commodity options under Section 4c(b) of the CEA with respect to swap agreements that are commodity options. *Id.* at 5589.

23 Rule 35.1(b)(1) defines a "swap agreement" as:

> (i) An agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement,

participants" as defined in Rule 35.1(b)(2);[24] (iii) not be part of a fungible class of agreements that are standardized as to their material economic terms;[25] (iv) include the creditworthiness of a party having an obligation under the agreement as a material consideration in entering into or determining the terms of the swap agreement; and (v) not be entered into and traded on or through a multilateral transaction execution facility. These criteria were designed to ensure that the exempted swap agreements met the requirements set forth by Congress in Section 4(c) of the CEA and "to promote domestic and international market stability, reduce market and liquidity

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currency option, any other similar agreement (including an option to enter into any of the foregoing);

(ii) Any combination of the foregoing; or

(iii) A master agreement for any of the foregoing together with all supplements thereto. 17 CFR 35.1(b)(1).

[24] 17 CFR 35.1(b)(2). The definition of "eligible swap participants" in Part 35 was patterned after the definition of "appropriate persons" in Section 4(c) of the Act with certain adjustments to ensure that both foreign and United States entities could qualify for treatment as eligible swap participants and to establish minimal financial requirements for some participants. *Exemption for Certain Swap Agreements*, 58 FR 5587, 5589 (Jan. 22, 1993). This approach is consistent with Congressional intent that the Commission may limit the terms of an exemption granted pursuant to Section 4(c) to some, but not all, of the listed categories of appropriate persons. H.R. Rep. No. 978, 102d Cong., 2nd Sess. 79 (1992); 58 FR 5587 at 5589. The determination as to whether a counterparty qualifies as an eligible swap participant must be made at the time the counterparties enter into the swap agreement, but it is sufficient that a party have a reasonable basis to believe that the other party is an eligible swap participant at such time. 17 CFR 35.2; 58 FR 5587 at 5589.

[25] The phrase "material economic terms" was intended "to encompass terms that define the rights and obligations of the parties under the swap agreement and that, as a result, may affect the value of the transaction." 58 FR 5587 at 5590. This condition was designed to ensure "that the exemption does not encompass the establishment of a market in swaps agreements, the terms of which are fixed and are not subject to negotiation, that functions essentially in the same manner as an exchange but for the bilateral execution of transactions." *Id.*

risks in financial markets, including those markets (such as futures exchanges) linked to swap markets and eliminate a potential source of systemic risk."[26]

The Part 35 swaps exemption does not extend to transactions that are subject to a clearing system, such as SwapClear, where the credit risk of individual counterparties to each other is mitigated.[27] The Commission excluded centralized swaps clearing facilities from the Part 35 rules because "such mechanisms [were] not yet in existence, and [might] take many forms and raise different regulatory concerns depending upon their structure or participants or whether another regulatory regime is applicable" and because the Commission believed that "the design of swaps clearing facilities and the services that such facilities will offer should be driven by the needs and desires of swaps market participants."[28] The Commission stated that "a clearing house system for swap agreements could be beneficial to participants and the public generally."[29] Accordingly, the Commission stated that it would "consider the terms and conditions of [an] exemption for swaps clearing houses in the context of specific proposals from exchanges, other regulators and others."[30]

On May 12, 1998, the CFTC published a *Concept Release on OTC Derivatives* ("OTC Concept Release").[31] Therein, the Commission generally recognized that "the OTC derivatives market [had] grown dramatically in both volume and variety of products offered" since the

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26 *Id.* at 5588.

27 *See id.* at 5591.

28 *Id.* at 5591, n.30.

29 *Id.*

30 *Id.*

31 63 FR 26114.

Commission's last major regulatory action involving such products.[32] The Commission specifically observed that the swaps exemption provided by Part 35 of the Commission's regulations reflects "the circumstances in the relevant market at the time of their adoption" and that the Commission should review the exemption "in light of current market conditions."[33] The increased "interest in developing clearing mechanisms for swaps and other OTC derivatives" was among the recent market changes explicitly noted by the Commission.[34] The Commission stated that it believed that such efforts had reached a stage where it was necessary "to consider and to formulate a program for the appropriate oversight and exemption of swaps clearing."[35] Accordingly, it requested comment on the extent to which the Commission should continue to require that the creditworthiness of a counterparty be a material consideration for relief under the Part 35 rules.[36] The Commission also requested comment on the type of functions that an OTC derivatives clearing facility would perform, the products it would clear, the standards it would impose upon participants, and the risk management tools it would employ.[37]

As discussed in the OTC Concept Release and in Section VI.B below, a swaps clearing operation may reduce counterparty credit risk and the transaction and administrative costs associated with the swaps market while increasing liquidity and price transparency in that

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32 *Id.*

33 *Id.* at 26120.

34 *Id.* at 26122.

35 *Id.*

36 *Id.* at 26120.

37 *Id.* at 26122-23.

market.[38] Accordingly, the Commission is approving the LCH Petition, pursuant to Section 4(c) of the Act, subject to the terms and conditions contained in the Commission's order. As set forth in Section VI below, the Commission believes that the representations made in the LCH Petition, as supplemented by its counsel, support the findings required by that provision of the Act.

The Commission has reviewed the SwapClear operation as presented in the LCH Petition and has decided to extend exemptive relief only to those transactions and market participants set forth in its order. Because Section 4(c) expressly authorizes the Commission to furnish the exemptive relief described therein by order, as well as by rule or regulation, the Commission believes that there is no legal impediment to providing individualized relief to LCH for SwapClear.

The Commission has chosen this approach for several reasons. First, LCH, SwapClear, and SwapClear participants will be subject to a comprehensive regulatory regime in the United Kingdom, including oversight by the Financial Services Authority ("FSA"). In adopting the Part 35 exemption, the Commission stated that it was "mindful of the costs of duplicative regulation" and indicated that it would consider "the applicability of other regulatory regimes" in addressing petitions for further exemptive relief relating to swaps facilities.[39] It reiterated this intention in the OTC Concept Release.[40] The FSA, as the regulator in SwapClear's home jurisdiction, has primary responsibility for implementing regulatory requirements and enforcement procedures that are sufficient to protect against credit concentration and other risks associated with a swaps clearing facility that interposes a central counterparty to the transactions it clears and provides

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38 *Id.* at 26122.

39 58 FR 5587 at 5591, n. 30.

40 63 FR 26114 at 26123.

for payment netting across exchange-traded and OTC instruments.[41] Because the Commission is deferring to the applicable regulatory body in the United Kingdom in this case, the Commission is not presented with certain issues that would otherwise arise if a petition were submitted by a domestic clearing organization or by a foreign clearing organization subject to a less comprehensive regulatory structure. Accordingly, the Commission believes that the LCH Petition is not necessarily a basis from which to develop a regulatory framework for other swaps clearing facilities.

Second, the LCH Petition is the first of its kind. An individualized course will afford the Commission an opportunity to gain greater experience with swaps clearing operations prior to formulating and proposing more generalized exemptive relief. Finally, an individualized approach is consistent with the Commission's previously stated intention to review and to analyze petitions for swaps clearing operations on a case-by-case basis in the context of specific proposals.[42]

The Commission's decision to provide specific relief to LCH does not preclude the Commission from issuing exemptive relief to additional parties that submit petitions to the Commission at a later date. Nor does it prevent the Commission from granting exemptive relief of broader applicability should circumstances or experience warrant.

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41 In its OTC Concept Release, the Commission acknowledged that the benefits that might accrue from a swaps clearing service might come at the cost of increased credit concentration and its attendant risks. 63 FR 26114 at 26122. The Commission notes, however, that LCH represents that it has adopted several risk management procedures to address such risks. LCH's risk management program is discussed in Section III.B below.

42 58 FR 5587 at 5591.

III. LCH and SwapClear

A. LCH

LCH is a recognised clearing house ("RCH") under the United Kingdom's Financial Services Act 1986 ("FSAct") and is subject to the FSAct and other relevant laws, rules and regulations in the United Kingdom.[43] Under the FSAct, as supplemented by the Companies Act 1989 ("U.K. Companies Act"), a clearing house may be "recognised" if it appears to the FSA[44] that the clearing house, among other things: (i) has sufficient financial resources; (ii) has adequate arrangements and resources for the effective monitoring and enforcement of its rules; (iii) is able and willing to promote and maintain high standards of integrity and fair dealing and to cooperate by the sharing of information and otherwise, with the Secretary of State and any other authority, body or person having responsibility for the supervision or regulation of investment business or other financial services; and (iv) has default rules which enable action to be taken to close out a member's position in relation to all unsettled market contracts to which such member is a party, where that member appears to be unable to meet its obligation.[45]

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43 LCH Petition at 17-18.

44 The FSA is authorized to "recognise" clearing houses in the United Kingdom pursuant to FSAct (Delegation) Order 1987. *Id.* at 17, n. 33.

45 *Id. See also* FSAct Pt. 1, 39 (1986) (Eng.). According to LCH, the FSAct requires that persons who intend to engage in "investment business" in the United Kingdom be either "authorised" or "exempted" persons, as those terms are defined in the FSAct. RCHs qualify as "exempted persons" and, thus, are exempt from the authorisation requirement and the conduct of business rules for the activities associated with their recognition status, as long as they continue to satisfy the recognition criteria. These criteria were established to take into account an RCH's "special regulatory position within the financial system" and an RCH's expertise in the operation of such markets.

Subject to its continuing compliance with the RCH recognition requirements, LCH is permitted to clear both exchange-traded and OTC instruments.[46] LCH currently performs clearing and settlement functions for futures and option contracts traded on the London International Financial Futures and Options Exchange ("LIFFE"), the London Metal Exchange, and the International Petroleum Exchange and for United Kingdom equity transactions effected on Tradepoint, an electronic stock exchange.[47] LCH states that it cleared and settled 279 million exchange-traded futures and option contracts in 1997.

As discussed more particularly in Section IV.A below, LCH, as an RCH, is subject to direct regulatory oversight by the FSA and is subject to reporting, recordkeeping, and other regulatory obligations.[48] Among other things, the FSA monitors LCH's continuing compliance with the RCH qualifying criteria and its own annual statement of objectives and requires that LCH furnish the FSA with information regarding its governance, personnel, members, business entities, and rule changes.[49]

B. SwapClear

SwapClear is a newly-developed LCH operation that will provide multilateral clearing, settlement, and payment netting services to qualified participants for forward rate agreements ("FRAs") and interest rate swap agreements that satisfy SwapClear's product eligibility

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46 LCH Petition at 17.

47 *Id.*

48 *Id.* at 18. *See also* FSAct Pt. I, 39 (1986) (Eng.).

49 Letter from Jane Lowe, FSA, to Michael Greenberger, Director, Division of Trading and Markets, CFTC (Nov. 17, 1998) (on file with the Division of Trading and Markets, CFTC) at 4.

criteria.[50] SwapClear is neither a separately organized corporation nor an affiliated entity or branch of LCH. As an extension of an RCH's activities, SwapClear will be subject to the regulatory authority of the FSA and to applicable United Kingdom law.[51] SwapClear is scheduled to commence operation in the summer of 1999.[52]

1. Participants

LCH will restrict participation in SwapClear to those persons who are eligible for designation by LCH as SwapClear Dealers ("SDs")[53] and/or SwapClear Clearing Members

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50 LCH Petition at 1-2.

51 *Id.* at 38.

52 *Id.* at 2.

53 To qualify as an SD, an entity must be: (i) an institution that enters into transactions that are equivalent to the swap agreements cleared through SwapClear as a dealer in the "wholesale market" in the United Kingdom or its equivalent elsewhere; (ii) at all times such person is carrying on "investment business" in the United Kingdom, as that term defined in the FSAct, either: (a) an authorised or exempted person under the FSAct or (b) a "European investment firm" as that term is defined in the United Kingdom's Investment Services Regulations 1995 ("U.K. Investment Services Regulations"); (iii) of investment grade caliber (*i.e.*, an entity having a Standard and Poor's credit rating of BBB or better) or a fully guaranteed subsidiary of an investment grade parent; (iv) use the Society for International Financial Telecommunications communications network ("SWIFT") (SWIFT is a bank-owned cooperative which operates a network that processes and transmits financial messages among its users worldwide); and (v) either a swaps clearing member ("SCM") or an entity that has a clearing arrangement with an SCM. *Id.* at 13-14, 23. *See also* Letter from Michael M. Philipp, Katten Muchin & Zavis, counsel to LCH, to Jocelyn B. Barone, Staff Attorney, Division of Trading and Markets, CFTC 1 (Nov. 10, 1998) (on file with the Division of Trading and Markets, CFTC).

LCH will usually regard transactions as being in the wholesale market where, for example, the institution enters into such transactions as a "listed institution" under Section 43 of the FSAct or otherwise meets the eligibility criteria for such listing. LCH Petition at 13, n. 28. If the institution is not undertaking such transactions in the United Kingdom, LCH will usually regard the transactions as being in the wholesale market if the eligibility criteria for Section 43 listing would be met by the institution if it were undertaking such transactions in the United Kingdom. *Id.* LCH will not usually regard

("SCMs").[54] A swap agreement will not be eligible for clearing through SwapClear unless both counterparties to the transaction have been approved as SDs and the SDs submit transactions to SwapClear for clearing through a qualified SCM.[55] End-users and members of the general public will not be permitted to participate.[56]

LCH designed the SD and SCM eligibility criteria to ensure that SwapClear participants[57] possess the financial and operational capability and experience to deal in swap agreements and the sophistication to understand and to manage the risks of such transactions.[58] Its admission

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the wholesale market dealer criterion as being satisfied where the institution is generally regarded as a customer or end-user of the interbank wholesale market. *Id.* at 13.

54 *Id.* at 8-9 and 12-13. To qualify as an SCM, an entity must: (i) at all times such person is carrying on "investment business" in the United Kingdom, as that term is defined in the FSAct, be either: (a) an authorised or exempt person under the FSAct or (b) a "European investment firm," as that term is defined in the U.K. Investment Services Regulations; (ii) be an LCH shareholder; (iii) contribute a minimum of £2 million to LCH's Default Fund; (iv) submit regular financial reports to LCH; (v) maintain a back-office with adequate systems and records and a staff with expertise in the swaps market; and (vi) satisfy minimum financial resource requirements. *Id.* at 12-13.

An SCM's financial requirements will be satisfied if an SCM: (i) is an SD; (ii) has a parent who is an SD and who provides a guaranty of the SCM's liabilities to LCH; or (iii) has financial resources of £250 million. *Id.* An SCM's financial resources will be calculated by subtracting its current liabilities from its current assets. *Id.* at 13, n.27. For purposes of this calculation, intangible fixed assets, investments in subsidiaries or other group companies, other long term assets, shares in LCH, and the value of exchange memberships will not be included as current assets. *Id.* LCH has indicated that long term assets include debts or debits that will be due in more than twelve months.

55 LCH Petition at 8-9, 12-13, and 23. An SCM may also act as an SD if it satisfies LCH's SD admission standards. *Id.* at 9.

56 *Id.* at 22-23 and 35.

57 SDs and SCMs are referred to collectively throughout this release as "SwapClear participants."

58 *Id.* at 13-14, 28, and Appendix I, A-1.

standards will limit participation in SwapClear to persons whose qualifications exceed those of the "appropriate persons" set forth in Section 4(c) of the Act and the "eligible swap participants" delineated in Rule 35.1.[59] LCH represents that its participant eligibility standards will be publicly disclosed and that it will provide access to SwapClear's services to all qualified SDs and SCMs on equal terms.[60]

LCH further represents that its Risk Management Department will monitor the compliance of SDs and SCMs with SwapClear's admission standards on an ongoing basis[61] and that all SDs and SCMs will be bound by LCH rules, regulations, and procedures (collectively, "LCH Rules").[62] Any SD who fails to comply with LCH Rules will no longer satisfy SwapClear's participant eligibility criteria. An SCM's failure to comply with LCH Rules will constitute an event of default by the SCM.[63] LCH will establish formal limits on its intraday credit exposure to each SCM.[64] SCMs will be notified of their respective credit limits.[65]

2. Products

Only those swap agreements whose terms comply with certain product eligibility

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59 *Id.* at 23 and 42.

60 *Id.* at 12, 23, and 29.

61 *Id.* at 12-13 and 23.

62 *Id.* at 37. LCH represents that all SwapClear participants will receive a copy of LCH's regulations and default rules. *Id.* at 28.

63 *Id.* at 37.

64 *Id.* at 28 and Appendix I, A-1. LCH has indicated that intraday credit limits will be established on a "net" basis.

65 *Id.* at 16 and Appendix I, A-1.

requirements will be accepted for registration and clearing by SwapClear. The product eligibility criteria were designed to ensure that there is sufficient market liquidity in the swap agreements that are cleared through SwapClear to allow LCH to calculate daily mark-to-market prices accurately and to enter into replacement transactions in the event of an SCM's default.[66] Initially, the SwapClear operation will be restricted to clearing FRAs[67] and interest rate swap agreements[68] that contain specified characteristics. To be eligible for clearing by SwapClear, an interest rate swap transaction must: (i) be fixed versus floating rate in a single currency;[69] (ii) be in acceptable currencies;[70] (iii) use acceptable floating rate indices;[71] (iv) be for a maturity of up to ten years;[72] and (v) have a constant notional principal amount throughout the term of the

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66 *Id.* at 14.

67 The LCH Petition defines an FRA as "a privately negotiated contract in which two counterparties agree on the interest rate to be paid on a notional amount of a specified currency, of specified maturity, at a specific future time." *Id.* at 1. The principal is not exchanged. Rather, "the difference between the contracted rate and the prevailing rate is settled in cash." *Id.* FRAs may be for any gap period up to one year and will be settled on a discounted basis. *Id.* at 14.

68 The LCH Petition defines an interest rate swap agreement as "a privately negotiated agreement between counterparties to make periodic payments to each other for a specified period" where "[o]ne party makes payments based on a fixed interest rate, while the counterparty makes payments on a variable (*e.g.*, floating) rate. The contractual payments are based on a notional amount that is not actually exchanged." *Id.* at 1.

69 *Id.* at 14.

70 SwapClear will accept FRAs and interest rate swaps that have been transacted in United States Dollars, Japanese Yen, Euros, British Pounds, and if there is sufficient participation in SwapClear by Canadian Dollar market-makers, Canadian Dollars. *Id.*

71 Currently, SwapClear will accept transactions using the following floating rate indices: LIBOR, PIBOR, and EURIBOR. *Id.* at 15. LCH is contemplating expanding the list of acceptable indices to include Commercial Paper, Fed Funds, and Constant Maturity Treasuries. *Id.*

72 *Id.* at 14.

agreement, with no reset in arrears.[73] An FRA must also be transacted in acceptable currencies and use an acceptable floating rate to be eligible for clearing through SwapClear.[74] LCH will impose a minimum acceptable notional amount of one unit of currency on eligible FRAs and interest rate swaps, but will not impose a maximum notional amount.[75] SDs will be permitted to use forward starts,[76] stub periods,[77] and mismatched fixed/floating dates.[78] LCH anticipates broadening the classes of transactions acceptable for clearing through SwapClear in the future, but represents that it will only register and clear those transactions within the definition of a "swap agreement" as set forth in Part 35 of the Commission rules.[79]

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73 *Id.* During the life of a swap agreement, the floating rate is "reset" at an agreed frequency (*e.g.*, 6 months). In the case of swap agreements traded on the interbank market, this is typically done in advance. A swap agreement has "reset in arrears" where the rate is applied at the end of the prevailing period with payment being made on the period end date. Letter from Michael M. Philipp, Katten Muchin & Zavis, counsel to LCH, to Jocelyn B. Barone, Staff Attorney, Division of Trading and Markets, CFTC 1 (Nov. 13, 1998) (on file with the Division of Trading and Markets, CFTC).

74 LCH Petition at 14-15.

75 *Id.* at 15.

76 LCH defines a "forward start" as a swap agreement that starts at an agreed date in the future. Letter from Michael M. Philipp, Katten Muchin & Zavis, counsel to LCH, to Jocelyn B. Barone, Staff Attorney, Division of Trading and Markets, CFTC 1 (Nov. 13, 1998) (on file with the Division of Trading and Markets, CFTC).

77 LCH explains that a swap agreement contains a "stub period" when either the time period between the start of the swap agreement and the first reset or the time period between the last reset and the end of a swap agreement is not a commonly quoted interval (*i.e.*, 2.5 months, rather than 3 months). *Id.*

78 LCH Petition at 15.

79 *Id.*

Some of the material economic terms of transactions eligible to be cleared by SwapClear will be subject to private negotiation between SDs.[80] LCH will neither establish nor impose any requirement (other than those described above) that the swap agreements contain standard contract specifications, nor will it provide any facility for arranging or executing swap agreements.[81] LCH will not obligate an SD to submit swap agreements to LCH for registration and clearing, will not mandate that an SD submit a swap transaction for registration and clearing within a specified period of time after the trade date, and will not require that a swap agreement be at current market prices when submitted for registration.[82] Swap agreements that are ineligible for registration on the trade date may be submitted for clearing on a later date, if they subsequently become eligible.[83] No swap agreement to be cleared through SwapClear will be traded on a multilateral transaction execution facility.[84]

3. Clearing Procedures

Confirmations of swap agreements between SDs to be submitted for clearing through

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80 *Id.* at 14, 22, and 42. Within the parameters set by LCH, the SD may negotiate the notional amount, trade date, effective date, fixed rate, fixed rate payer, fixed rate payment dates, floating rate, floating rate payer, floating rate payment dates, reset dates, termination date, and business day convention, as defined in ISDA's 1991 definitions. *Id.* at 14.

81 *Id.* at 9 and 14.

82 *Id.*

83 *Id.* at 14. For example, a swap agreement with a fifteen year maturity initially would not satisfy SwapClear's product eligibility criteria because such criteria do not allow for transactions with maturities in excess of ten years. However, such a transaction would become eligible for registration after five years. *Id.*

84 *Id.* at 22.

SwapClear will be exchanged and matched through Accord,[85] Londex,[86] or another operationally compatible matching system.[87] After the agreement has been confirmed, the relevant details of the transaction will be transmitted to SwapClear.[88] SDs will be required to submit transactions to SwapClear for clearing through a registered SCM.[89] Upon submission, SwapClear will verify that: (i) both original counterparty SDs satisfy LCH's participant eligibility criteria and are in good standing with LCH; (ii) the swap agreement satisfies SwapClear's product eligibility requirements; and (iii) the transaction does not exceed the SCMs' respective intra-day credit limits with LCH.[90] If these criteria are satisfied, LCH will register the swap agreement and confirm the transaction to the SDs and their respective SCMs.[91] If a transaction does not satisfy these criteria, or LCH otherwise rejects the trade, the SwapClear system will send a rejection message to each original SD counterparty.[92] In the latter case, the transaction between the original SD counterparties will remain in existence and will remain subject to the relevant master

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85 Accord is a service offered to the users of SWIFT that facilitates the matching of transaction confirmations. *Id.* at 9, n. 24.

86 Londex is an OTC confirmation matching system that is currently being developed by SNS Systems, Inc. *Id.* at 9, n. 25.

87 *Id.* at 9. SDs will maintain responsibility for ensuring that the trade details of all swap agreements submitted to SwapClear for registration and clearing match. *Id.*

88 *Id.*

89 *Id.* at 8-9.

90 *Id.* at 8-9 and Appendix I, A-1.

91 *Id.* at 9.

92 *Id.* at Appendix I, A-2.

agreement between them, but the transaction will not be cleared through SwapClear.[93] Between the time a transaction is effected and the time it takes the SDs to match and present the details of the transaction for registration, the parties will keep the transactions on their own books and will be subject to full counterparty credit risk.[94]

LCH will register swap agreements for clearing only in the names of the SCMs, and the SCMs will be required to deal with LCH as principals.[95] Each SCM will be fully liable to LCH for ensuring performance with respect to each swap agreement registered in its name.[96] When LCH registers a swap agreement, it automatically will send a message to the applicable SCMs via SWIFT[97] confirming that their transaction has been registered. At the time of registration, the original, bilateral transaction between the SDs will be replaced with four new swap agreements: one between each SD and its SCM, contracting as principals, and one between each SCM and LCH, contracting as principals.[98] LCH will become the central counterparty with respect to all swap agreements to be cleared through SwapClear and, as such, will be responsible

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93 *Id.*

94 *Id.* at 9.

95 *Id.* at 12.

96 *Id.*

97 Because all SDs must be SWIFT users to acquire and maintain their SD designation, SCMs that also qualify as SDs necessarily will have access to the SWIFT network. LCH anticipates that most other SCMs will utilize the SWIFT system in order to obtain automatic confirmation. However, an SCM who is not SWIFT user will be able to access, through LCH, a real time listing of the registered trades for that SCM's customers.

98 *Id.* at 10 and Appendix I, A-2.

to the SCMs for the performance of the obligations thereunder.[99] The SCMs, in turn, will be responsible for performance to their respective SDs and to LCH.[100] The new contracts between the SDs and the SCMs will contain the same terms to which the original counterparties agreed.[101] The new contracts between LCH and each SCM will contain the same terms as the contracts they replaced, but will also contain LCH's standard contract terms (*e.g.*, margin payment requirements, rules regarding what constitutes acceptable collateral, and choice of law provisions).[102]

Immediately upon registration of a swap agreement, LCH will net the payment amounts due to or from each SCM under the terms of all of the swap transactions registered in the SCM's name for the same value date and in the same currency.[103] In addition, LCH will net these payments with other payments due to or from the SCM as a result of any exchange-traded instruments that it clears with LCH on each payment date.[104] This will result in a net single pay or receive amount per currency per day between LCH and each SCM.[105] SwapClear will determine all reset rates and calculate reset amounts.[106] Upon each payment date, the amount

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99 *Id.* at 10.

100 *Id.*

101 *Id.* at Appendix I, A-1-A-2.

102 *Id.*

103 *Id.* at 10 and Appendix I, A-2. These payments may include margin payments, fees, interest, settlement payments, and other payments associated with the SCM's LCH-cleared transactions. *Id.* at Appendix I, A-2.

104 *Id.* at 10 and Appendix I, A-2.

105 *Id.* at 10.

106 *Id.*

payable or receivable in each currency will be settled by means of LCH's Protected Payment System ("PPS").[107]

4. Treatment of Client Funds

LCH represents that United Kingdom law would permit LCH to commingle segregated client funds relating to an SCM's exchange-traded business in the United Kingdom and client funds relating to an SCM's SwapClear business.[108] However, LCH represents further that it anticipates that LCH clearing members who are also SCMs will carry their non-proprietary futures positions and associated margin funds in their "client" account at LCH, but likely will carry their non-proprietary SwapClear positions and associated margin funds in their "house" account at LCH.[109] Accordingly, LCH believes that United States persons who do not engage in SwapClear transactions, but who clear their exchange-traded futures through the "client" account of a member of LCH who is also an SCM are unlikely to be exposed to a greater likelihood of

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107 *Id.* LCH requires SCMs to maintain accounts for each currency type with at least one of the twenty-three banks it uses under its PPS. *Id.* at Appendix I, A-4. Settlement takes place via book entry transfer between the accounts of the SCM and LCH. *Id.*

108 Letter from Michael M. Philipp, Katten Muchin & Zavis, counsel to LCH, to Jocelyn B. Barone, Staff Attorney, Division of Trading and Markets, CFTC 2 (Feb. 9, 1999) (on file with the Division of Trading and Markets, CFTC).

109 Letter from Michael M. Philipp, Katten Muchin & Zavis, counsel to LCH, to Jocelyn B. Barone, Staff Attorney, Division of Trading and Markets, CFTC (Mar. 2, 1999) (on file with the Division of Trading and Markets, CFTC). LCH's expectation that SCMs will carry their respective SwapClear positions in their "house" account is based upon three assumptions. First, LCH believes that most SDs will submit swap transactions for clearing through an affiliated SCM. Second, LCH anticipates that most SCMs will not be required under relevant United Kingdom law to segregate an SD's SwapClear-related funds into a "client" account and will not, in fact, do so. Third, to the extent that the segregation requirement would otherwise apply, relevant United Kingdom law permits most SDs to "opt out" of that requirement and to consent to the placement of their funds in the SCM's "house" account.

loss in the event of a default by a SwapClear participant than would exist prior to the implementation of a SwapClear facility.

5. Risk Management Procedures

LCH represents that it will employ several risk management tools to control the risks arising from its acting as a central counterparty for swap transactions that are registered and cleared through SwapClear.[110] In addition to the mechanisms already discussed - participant admission standards and payment netting arrangements - these risk management tools include participant reporting requirements, initial margin requirements, daily marking-to-market of all positions, variation margin requirements, intraday credit limits, back-up financial resources, and stress testing.

LCH also will impose both routine and event-based reporting requirements upon SwapClear participants.[111] For example, SCMs will be required to submit regular financial statements and audited accounts to LCH. SCMs and SDs will have an ongoing duty to notify LCH if they cease to satisfy any of the SwapClear participant eligibility criteria and will be

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110 LCH Petition at 15-17 and Appendix I, A-1-A-8.

111 *Id.* at 16 and 37. The specific reporting requirements LCH will impose upon SwapClear participants will vary depending upon the type of SwapClear participant and the regulatory regime to which the participant is subject. Letter from Michael M. Philipp, Katten Muchin & Zavis, counsel to LCH, to Jocelyn B. Barone, Staff Attorney, Division of Trading and Markets, CFTC 1 (Nov. 20, 1998) (on file with the Division of Trading and Markets, CFTC). For instance, a SwapClear participant that is regulated as a bank will be required to provide LCH with a copy of its annual report and audited accounts; a participant that is regulated by the FSA or the Securities and Futures Authority ("SFA") will be required to provide copies of the monthly financial reports that it files with its respective regulator; a participant that is regulated by the CFTC or the SEC will be required to provide copies of the quarterly financial reports that it files with its respective regulator; and an unregulated participant will be required to provide quarterly financial reports, including the balance sheets and profit and loss statements prepared by the participant for its management's use. *Id.* at 37.

required to furnish LCH, upon request, with any information LCH deems necessary to determine their participant eligibility status if LCH reasonably doubts their continued eligibility.[112] SDs and SCMs will be required to notify LCH upon the occurrence of specified events relating to their status as a registrant or licensee; their authorization to conduct investment business in the United Kingdom; their insolvency, dissolution, or conviction of a financial crime; disciplinary or enforcement judgments involving them; and material changes in their business.[113] LCH will maintain records of SCM transactions for six years, and such records will be available to SwapClear participants and to their auditors upon request.[114]

To protect against potential adverse future market movements and the cost of liquidating the portfolio in the event of an SCM's default, LCH will require SCMs to post initial margin.[115] The initial margin required of SCMs will be established using a scenario-based margin methodology analogous to London SPAN®, the futures margining system currently in use at LCH.[116] In determining the definition and scale of the scenarios, LCH will use: (i) its experience in setting margin rates for LIFFE interest rate contracts; (ii) an analysis of historic, implied, and modeled term structure volatility; (iii) modeling of extreme events;[117] and (iv)

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112 *Id.* at 16.

113 *Id.*

114 *Id.* at 37. LCH is also subject to certain reporting and recordkeeping regulations imposed by the FSA. These requirements are discussed in Section IV.

115 *Id.* at 16 and Appendix I, A-1 and A-3.

116 *Id.* at Appendix I, A-3. SwapClear's margin methodology is subject to approval by the FSA. *Id.*

117 The LCH Petition cites the United Kingdom leaving the ERM in 1992 and the bond crisis in February of 1994 as examples of such events. *Id.*

conservative assumptions regarding the time necessary to close out.[118] The amount of initial margin required of any SCM will be affected by the market volatility of the SCM's portfolio, the liquidity of the instruments in the portfolio, and the relative size of the portfolio.[119] LCH will distribute its margin model to SCMs and will publish its margin parameters.[120] In its discretion, LCH's Risk Management Department may require an SCM to post initial margin in excess of that calculated using its margin methodology.[121] LCH will accept initial margin in the form of: (i) cash; (ii) securities of the following types -- United Kingdom gilts and treasury bills, United States government bills, notes, and bonds, German government bonds, French, Dutch, Italian, and Spanish government bonds and treasury bills, and certain certificates of deposit; and (iii) bank guarantees, in a form determined by LCH.[122]

To prevent losses from accumulating in the system, LCH will mark-to-market all

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118 *Id.* LCH's yield curve scenarios used in calculating SwapClear initial margin requirements assume a time to close out of five days, although LCH would seek to offset the positions of a defaulting SCM by liquidating, hedging, or transferring such positions in a shorter period of time. Letter from Michael M. Philipp, Esquire, Katten Muchin & Zavis, counsel to LCH, to Jocelyn B. Barone, Staff Attorney, Division of Trading and Markets, CFTC 1 (Mar. 3, 1998) (on file with the Division of Trading and Markets, CFTC).

119 LCH Petition at Appendix I, A-3.

120 *Id.*

121 *Id.* LCH represents that its governance structure reserves margin rate setting to LCH's Chief Executive to ensure LCH's decisions regarding margin are made independently and to avoid conflicts of interest. *Id.* at 28. LCH has indicated that neither the Chief Executive nor members of his staff will be associated with SwapClear participants.

122 *Id.* at Appendix I, A-4. Bank guarantees from an SCM or from an SCM's parent company would not be accepted. LCH is currently considering whether to extend its arrangements to include Euroclear's Collateral Management Service in order to facilitate the provision of additional margin cover after transfers are no longer possible through the United Kingdom banking system. *Id.*

SwapClear positions on a daily basis and will require SCMs to pay any change in the value of those positions from the previous day's value in cash as variation margin.[123] LCH will establish a zero-coupon yield curve in each currency on each day and calculate mark-to-market values of the swap agreements cleared through SwapClear to facilitate the collection of the appropriate amount of variation margin.[124]

As discussed above, SCMs will be subject to intraday credit limits set by LCH.[125] LCH intends to monitor its exposure to each SCM throughout the day and to call for additional margin cover in advance of the SCM's exceeding its credit limit.[126] LCH will reject transactions involving an SCM that has reached its limit unless additional margin is provided.[127] LCH also has extensive emergency intervention powers under its regulations to impose liquidation orders when an SCM exceeds its credit limit.[128]

LCH asserts that it will ensure that SwapClear will have access to financial resources of sufficient size and liquidity to satisfy its settlement obligations.[129] As of the date of the LCH

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123 *Id.* at 16, 28, and Appendix I, A-3.

124 *Id.* at 16 and Appendix I, A-1-A-2. One feature of SwapClear's margining process that distinguishes it from an exchange margining procedure is that SwapClear sets no separate maintenance margin level. Daily margin flows must meet initial margin requirements, so that all margin payments are essentially "variation margin" because there is no daily settlement or mark-to-market flows that adjust margin accounts above the maintenance level, but below the initial margin level.

125 *Id.* at 16 and Appendix I, A-1.

126 *Id.* at Appendix I, A-1.

127 *Id.* at 9, 16, and Appendix I, A-1.

128 *Id.* at Appendix I, A-1.

129 *Id.* at 16 and Appendix I, A-4.

Petition, LCH had cash margin cover for its futures and option business in excess of £2 billion.[130] LCH represents that these funds are held on short-term deposit with acceptable bank depositories, as determined by minimum credit rating criteria and limits according to credit rating and shareholder funds.[131] Should additional funds be needed, LCH maintains bank lines of credit in the amount of £40.5 million and $10 million.[132] LCH also maintains a Default Fund ("DF") to cover situations where the costs to LCH of standing behind and closing out and/or transferring a defaulting member's positions exceed the margin collected by LCH from the defaulting member.[133] The DF currently consists of £150 million contributed by LCH's exchange clearing members.[134] The DF contributions are in the form of cash-backed indemnities, with LCH holding the cash.[135] Upon commencement of the SwapClear operation, LCH intends to increase the DF by an additional £100 million to be contributed by SCMs.[136] It is likely that each SCM initially will contribute to the DF at a minimum flat rate of £2 million.[137]

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130 *Id.* at Appendix I, A-4.

131 *Id.*

132 *Id.* LCH does not believe that it will be necessary to establish additional credit lines with respect to its SwapClear business. LCH asserts that it does not need to maintain the large credit lines held by clearing houses whose initial margin cover principally takes the form of securities because LCH's margin cover is highly liquid. *Id.*

133 *Id.*

134 *Id.*

135 *Id.*

136 *Id.* at Appendix I, A-5.

137 *Id.*

As registered positions increase, LCH intends to implement risk-based contributions.[138] The adequacy of the SCMs' additional £100 million contribution to the DF and the aggregate size of the DF will be reassessed once SwapClear becomes operational on the basis of actual exposures and stress test results.[139]

LCH currently conducts internal stress tests on the initial margin cover it holds from each member on a daily basis to assess the adequacy of its daily funding level in the event a member default coincides with extreme market movements.[140] The stress tests employ, for all contracts, extreme historical price movements recorded in the exchange markets cleared by LCH.[141] LCH examines the results of the stress testing daily and reports the results on a quarterly basis to the Risk Committee of LCH's Board so that the Risk Committee may make recommendations to the Board if the ongoing adequacy of the DF is placed in doubt.[142] LCH also makes the results of the stress testing available to the FSA.[143]

6. Default Rules and Procedures

SCMs will be subject to LCH's default rules.[144] LCH is authorized by these rules to

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138 *Id.*

139 *Id.* Both the transitional DF increase of £100 million and LCH's approach to measuring the adequacy of the DF and making necessary adjustments to it are subject to further refinement and discussion with the FSA. Changes to the rules governing the DF are also subject to approval by LCH's membership. *Id.*

140 *Id* at Appendix I, A-4-A-5.

141 *Id.* at 28 and Appendix I, A-4.

142 *Id.* at Appendix I, A-4-A-5.

143 *Id.* at Appendix I, A-5.

144 *Id.* at Appendix I, A-2.

declare an SCM in default in a number of circumstances, including: (i) the failure of the SCM to satisfy its payment obligations on time or the likelihood that it will have difficulty in doing so; (ii) the insolvency of the SCM or a related company; and (iii) certain regulatory action.[145] LCH will have the discretion to take a variety of actions with respect to a defaulting SCM's transactions, including: (i) closing out the transactions; (ii) entering into replacement transactions;[146] (iii) setting off any losses that result from the SCM's default against its gains; (iv) applying margin held against any net loss;[147] and (iv) if the margin held by LCH is insufficient to cover the net loss, applying additional resources against the net loss in accordance with its default rules.[148] Additional resources would be applied in the following order: (i) the defaulting SCM's DF contribution; (ii) any pre-tax, pre-rebate earnings LCH has generated in the financial year in which the default occurs as a loss borne by LCH for its own account, up to a maximum of £10 million per financial year; (iii) LCH's insurance backing or analogous arrangements; (iv) the DF contributions of non-defaulting members;[149] and (v) LCH's own

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145 *Id.* at Appendix I, A-5. Regulatory actions that might constitute an event of default include: i) the SCM is in breach of the terms of membership of a regulatory body, is refused an application for membership in a regulatory body or is suspended or expelled from membership in a regulatory body; ii) the SCM is in breach of the rules of a regulatory body to which it is subject; iii) the SCM's authorisation by a regulatory body is suspended or withdrawn; or iv) a regulatory body takes or threatens to take action against or in respect of the SCM under any statutory provision or process of law. LCH Default Rules.

146 The replacement costs would be part of the loss that LCH could claim from the defaulting SCM. LCH Petition at Appendix I, A-6.

147 LCH would return any surplus margin to the defaulting SCM's administrator or liquidator or to the defaulting SCM itself, as appropriate. *Id.*

148 *Id.* at Appendix I, A-5-A-6.

149 LCH's default rules permit LCH to use a non-defaulter's DF contribution unless insurance is available. Letter from Michael M. Philipp, Katten Muchin & Zavis, counsel

capital.[150]

7. Operational Safeguards

LCH will implement certain safeguards to ensure the reliability and security of its operations.[151] Specifically, LCH will internally test and will participate in third party testing of the systems upon which it relies (*e.g.*, CGO II, CREST, and SWIFT).[152] LCH will also maintain comprehensive back-up and business recovery facilities.[153] In addition, LCH has implemented a comprehensive year 2000 ("Y2K") program to avoid disruptions that could be caused by the use of computer technology that is not Y2K compliant.[154]

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to LCH, to Jocelyn B. Barone, Staff Attorney, Division of Trading and Markets, CFTC 1 (Nov. 19, 1998) (on file with the Division of Trading and Markets, CFTC). The terms of LCH's insurance contract provide for coverage for default losses totaling in excess of £150 million over a rolling three year period rather than a loss incurred on any individual default. *Id.* To the extent that LCH has used any of its profits, or if there has been a previous call on the DF after which LCH has required members to "top-up" the DF, the insurance may be available before all of the DF has been depleted. *Id.*

150 LCH Petition at Appendix I, A-5-A-6; LCH Default Fund Rules; and Letter from Michael M. Philipp, Katten Muchin & Zavis, counsel to LCH, to Jocelyn B. Barone, Staff Attorney, Division of Trading and Markets, CFTC 1 (Nov. 19, 1998) (on file with the Division of Trading and Markets, CFTC). Such procedures would not preclude LCH from pursuing contractual and other legal remedies against the SCM in the event of a default.

151 LCH Petition at 16, 28, and Appendix I, A-1 and A-7.

152 *Id.* at Appendix I, A-8.

153 *Id.* at Appendix I, A-1 and A-7.

154 *Id.*

IV. Regulatory Oversight in the United Kingdom and Information-Sharing Between Regulators

A. Applicable Regulations in the United Kingdom

LCH, SwapClear, and SwapClear participants are subject to a comprehensive regulatory regime in the United Kingdom. The Commission reviewed the United Kingdom's regulatory framework in connection with a petition submitted by the FSA's predecessor in interest, the Securities and Investment Board ("SIB"), that requested an exemption from the application of certain Commission foreign futures and options rules pursuant to Rule 30.10 ("SIB Petition").[155] The SIB Petition requested exemptive relief on the grounds that the applicable regulatory and self-regulatory framework in the United Kingdom was comparable to that imposed by the CEA and the Commission's regulations. By an order that became effective on July 19, 1989,[156] the Commission granted the SIB Petition, stating that the Commission had concluded that the standards for relief relevant to a determination that a particular regulatory program is "comparable" to that in the United States, as set forth in Commission rules, had "generally been satisfied" and that "compliance with applicable United Kingdom Law and SIB rules may be substituted for compliance with [certain] sections of the Act . . . ."[157]

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155 Appendix A to Rule 30.10 permits specified persons located outside of the United States and subject to a comparable regulatory structure in the jurisdiction in which they are located to petition the Commission for exemption from the application of certain Part 30 rules based upon substituted compliance with comparable regulatory requirements imposed by the foreign jurisdiction. 17 CFR 30.10. The Part 30 rules authorize the Commission to grant such an exemption if the action would not be otherwise contrary to the public interest or to the purposes for which the exemption is sought. *Id.*

156 *Foreign Futures and Option Transactions*, 54 FR 21599 (May 19, 1989).

157 *Id.* at 21600.

Pursuant to applicable United Kingdom law, LCH, as an RCH, is subject to oversight by the FSA. The FSA will monitor LCH's ongoing compliance with relevant regulatory requirements. In order to uphold its RCH status, LCH is required to maintain specified financial resources and to adhere to certain reporting and recordkeeping requirements. For example, LCH must furnish the FSA with the information set forth in the Financial Services Notification by Recognised Bodies Regulations 1996 ("Notification Regulations").[158] LCH must also provide the FSA with an annual regulatory plan that includes a statement of its objectives and annual

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158 FSAct, Section 39. Section 41 of the FSAct authorizes the FSA to promulgate regulations so that it may acquire the information necessary to carry out its supervisory and other regulatory functions.

Among other things, LCH is required to provide the FSA with information relating to its governance, personnel, business activities, members and changes to its rules. LCH Petition at 18; Letter from Jane Lowe, Financial Services Authority, to Michael Greenberger, Director, Division of Trading and Markets, CFTC (Nov. 17, 1998) (on file with the Division of Trading and Markets, CFTC) at 3. Governance and personnel information would include information relating to changes to its constitution, changes to key personnel, and events relating to key personnel (*e.g.*, the presentation of a petition for bankruptcy); a change in its independent arbitrator, ombudsman, or complaints investigator; or the dismissal of, or any disciplinary actions relating to, any of its officers or employees). *Id.* at 6-7. With respect to its business activities, LCH must provide the FSA with certain financial information (*e.g.*, annual audited reports and accounts and the quarterly and annual budgets) and notification of the following: a change in its auditors, fees, or charges; the presentation of a petition for winding up; the appointment of a receiver or liquidator; the making of a voluntary arrangement with creditors; the institution of legal proceedings against it; the delegation of regulatory functions of another body regulated by the FSA; the undertaking of any regulatory functions of another body regulated by the FSA; a change in the name of the persons to whom it provides clearing services; and admissions and deletions from its membership. *Id.* With respect to its members, LCH is required to advise the FSA of any disciplinary action it takes against a member or an employee of a member; persons appointed by another regulatory body to investigate the affairs of a member or its clearing services; evidence indicating that any person has been carrying on unauthorized investment business or has committed a criminal offense under the FSAct; and the open positions, margin liability, and cash and collateral balances of a defaulting member's accounts. *Id.*

targets against which LCH's performance may be judged.[159] The FSA monitors LCH's progress against its regulatory plan on an annual basis.[160]

Representatives of the FSA meet with senior clearing house risk managers and LCH's Chief Executive on a regular basis to discuss regulatory issues. The FSA also conducts various site projects, as necessary, in response to specific regulatory concerns.[161]

As an extension of LCH's activities as an RCH, the SwapClear operation will be subject to regulatory oversight by the FSA. The FSA anticipates requiring regular reporting regarding SwapClear, but has not determined definitively the specific reporting requirements that it will impose with respect to the SwapClear operation. The FSA expects to receive, among other things, product reporting (*e.g.*, the range in mark-to-market values of the FRAs and swap agreements it clears and information regarding counterparty positions); risk management reporting (*e.g.*, margining levels, changes in the credit standing of SCMs, LCH's counterparty exposure, and stress testing results); and exception reporting (*e.g.*, same day reporting on matters being reported regularly, where developments extend beyond predetermined levels).[162]

SwapClear participants will also be subject to regulation in the United Kingdom. SwapClear participants will be required to be authorised or exempt under the FSAct where

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159 LCH Petition at 18.

160 Letter from Jane Lowe, Financial Services Authority, to Michael Greenberger, Director, Division of Trading and Markets, CFTC (Nov. 17, 1998) (on file with the Division of Trading and Markets, CFTC) at 4.

161 *Id.* at 4-5. The FSA anticipates that the existing regulatory framework applicable to LCH will be substantially retained in the United Kingdom's Financial Services Reform Bill. *Id.* at 5.

162 *Id.* at 8.

entering into swap agreements cleared by SwapClear would constitute "investment business in the United Kingdom," as that phrase is defined in the FSAct.[163]

B. Information-Sharing Between the CFTC and the FSA

The FSA and the CFTC have reached an understanding concerning the form and content of a Bilateral Side Letter ("Side Letter") to the *Memorandum of Understanding dated September 25, 1991 on the Mutual Assistance and Exchange of Information between the SEC, the CFTC, the United Kingdom's Department of Trade and Industry, HMT, and the FSA (formerly the Securities and Investments Board)*("US/UK MOU"). The Commission believes that an exchange of information concerning SwapClear should help provide LCH, the FSA, and the Commission with notice of potential problems arising from the operation of SwapClear or the activities of SDs and SCMs and thus permit regulatory or self-regulatory bodies to react to such conditions at an earlier stage.

V. Summary of Comments

Most of the commenters viewed the establishment of a swaps clearing operation as an important and positive development in the OTC derivatives market and affirmed that a clearing mechanism may provide significant benefits to swap market participants, including a reduction of the counterparty credit risk associated with swap transactions. However, the commenters' views diverged on the approach that the Commission should take in approving a swaps clearing operation and the appropriate timing of Commission action on the LCH Petition.

CBOT questioned the suitability of any Commission action on the LCH Petition prior to the completion of Commission consideration of the comments regarding swaps clearing

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163 *Id.* at 18.

organizations it solicited in the OTC Concept Release.[164] It further suggested that the Commission subject the LCH Petition itself to the concept release process consistent with its recent treatment of similar market initiatives.[165] The Commission notes that there is no legal requirement for the Commission to issue a concept release prior to granting an exemption pursuant to the authority provided by that provision. Furthermore, the Commission has had the benefit of the public comments submitted in response to the OTC Concept Release as well as the public comments submitted in response to its request for comment on the LCH Petition.

Both CBOT and NYMEX recommended that, in lieu of granting piecemeal exemptions, the Commission should adopt a generic regulatory framework that would permit the centralized clearing of swap agreements in accordance with standards that would apply equally to foreign and domestic clearing organizations. CBOT and NYMEX urged the Commission to defer action upon the LCH Petition until generally applicable rules could be proposed and published. NYMEX maintained that publishing proposed standards for broad prospective application would be more compatible with the Commission's prior practice in issuing Section 4(c) exemptions

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164 63 FR 26115.

165 CBOT cited the placement of the electronic computer terminals of foreign boards of trade in the United States for the purpose of trading products available through those boards of trade as an example of a recent market innovation that the Commission has subjected to the concept release process. *Concept Release on the Placement of a Foreign Board of Trade's Computer Terminals in the United States*, 63 FR 39779 (July 24, 1998). CBOT also cited the Commission's decision to postpone its deliberation of CBOT's proposal regarding the exchange of agricultural futures for OTC options and NYMEX's proposal to adopt a new rule that would permit an exchange of futures contracts for qualifying swap agreements ("EFS Transactions") until the Commission examined the issues raised in its *Concept Release on the Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market*, 63 FR 3708 (Jan. 28, 1998). The Commission notes that it has since approved NYMEX's EFS Transactions proposal, pursuant to the terms and conditions of a three year pilot program. *CFTC Approves [NYMEX's] Proposal to Permit EFS Transactions*, CFTC Press Release No. 4228-99 (Jan. 11, 1999).

than providing isolated relief to one applicant.[166] It also argued that a generalized rulemaking would provide the Commission with an opportunity to acquire and consider the perspectives of several segments of the derivatives markets and would provide a level of due process more appropriate to the contemplated degree of regulatory change.

As discussed above, the Commission is authorized to examine and assess petitions for exemptive relief pursuant to Section 4(c) of the Act on a case-by-case basis and to issue orders granting or denying such relief. It has elected to do so because (i) such an approach is consistent with its formerly-stated intention to evaluate proposals for swaps clearing operations in this way; (ii) this is the first such petition that has been submitted to the Commission; (iii) swaps clearing services are a novel addition to the OTC market and, thus, there is little experience upon which the Commission might draw in developing an exemption of general applicability; and (iv) SwapClear and SwapClear participants will be subject to extensive regulation abroad. The Commission also notes that the comment letters received by the Commission support the conclusion that the public was sufficiently informed of the LCH Petition to enable meaningful comment on the proposal.

NYMEX also recommended that the Commission use the minimum standards for netting systems recommended by the Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries, known as the "Lamfalussy Report," as a starting point in developing standards for a swaps clearing facility. NYMEX specifically proposed that the Commission establish qualifying criteria for participation in a swaps clearing operation that

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166 NYMEX cited the Commission's publication of the proposed order granting exemptive relief for certain contracts involving the deferred purchase or sale of energy products. *See Exemptions for Certain Contracts Involving Energy Products*, 58 FR 6250 (Jan. 27, 1998)(Proposed Order).

consider the financial integrity, commercial standing, and swaps transaction experience of the prospective participants.[167] It further suggested that the Commission require swaps clearing facilities to, *inter alia,* collect original and variation margin in cash or cash equivalents, mark-to-market and settle cleared swap agreements on a daily basis,[168] segregate customer funds from proprietary funds,[169] and maintain certain records of the essential terms of cleared swap transactions and of all exchanges of payments, including margin flows, associated with the such transactions. NYMEX also recommended that the Commission reserve the right periodically to review any exemption it provides pursuant to Section 4(c) of the Act and prospectively to modify or terminate the exemption as circumstances warrant. The Commission notes that NYMEX acknowledged that the LCH Petition incorporated many of the financial and operational safeguards suggested by NYMEX. For example, SwapClear's risk management features include

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167 NYMEX objected to SwapClear's admission standards as unnecessarily restrictive and anticompetitive because they would prohibit an entity that is not a swaps dealer in the interbank wholesale market from using SwapClear, regardless of the entity's size, financial integrity, or experience in swap transactions.

168 NYMEX recommended that the Commission accept the prices of Commission-approved contracts with sufficient levels of trading volume and open interest as safe and reliable sources of price data for use in marking swaps positions to market, but that it formulate standards for the use of alternative sources of price data as well. NYMEX suggested that such standards should take into account the reliability of the data sources, the frequency with which the data are disseminated, and the degree of acceptance of the data sources by market participants.

169 NYMEX contended that centralized swaps clearing operations would raise fiduciary concerns because they would collect and hold money from many parties. NYMEX conceded, however, that it would be appropriate to provide an exception to the segregation requirement where the customer knowingly and willingly opts out of the protection afforded by it. LCH represents that it will permit SCMs to establish separately designated "client" accounts that are separately margined, if they so desire, even though the United Kingdom Client Money Rules that generally require the segregation of proprietary and client funds will not apply to most SCMs.

participant reporting requirements, the collection of initial and variation margin, and daily marking-to-market of all positions.

CBOT and NYMEX also expressed concern regarding the competitive effects on the United States industry of approving the LCH Petition in the absence of generally applicable exemptive relief. CBOT explicitly noted that approving the LCH Petition absent generalized relief would enable a foreign entity to begin clearing swap agreements in the United States before a United States-based clearing organization would have an opportunity to develop a competing facility. These commenters contended that the likelihood that swap agreements cleared by LCH will directly compete with products traded on regulated domestic futures exchanges necessitates consistency both between the regulatory treatment of clearing facilities for swap agreements and clearing facilities for futures contracts and between foreign and domestic clearing operations. CBOT remarked, for example, that the terms of LCH-cleared swap agreements were likely to become standardized over time to qualify for clearing and indicated that this increasing standardization might facilitate secondary trading in swaps contracts among swap market participants, SDs, and SCMs, thereby creating a new and competitive futures-like market in swap transactions. To ensure even-handed regulation and fair competition between OTC markets and futures exchanges, NYMEX proposed that the Commission undertake a broad review of its current regulations and consider applying its Section 4(c) exemptive authority to exchange-traded instruments.

The Commission notes that its order expressly conditions the exemptive relief provided therein upon the requirement that the swap transactions to be cleared by SwapClear not be part of a fungible class of agreements that are standardized as to their material economic terms. The

Commission also notes that its approval of the LCH Petition does not preclude other entities that may wish to operate a swaps clearing facility from submitting a similar request for relief.

ISDA and SIA questioned the Commission's ability to exercise jurisdiction over LCH and the transactions to be cleared by SwapClear. In ISDA's view, individually negotiated swap transactions subject to clearing arrangements are excluded from the exemption of Part 35, but are not within the ambit of the CEA and the Commission's regulations. Accordingly, ISDA maintained that LCH was not required to submit a petition for exemptive relief under Section 4(c) of the CEA. ISDA asserted that Commission action on the LCH Petition should be restricted to: (i) stating that LCH does not require an exemption pursuant to Section 4(c) of the Act or (ii) issuing an exemption pursuant to Section 4(c) that specifies that the exemption should not be construed to imply that the exempted transactions are futures contracts under the CEA. SIA similarly urged the Commission to grant the requested exemptive relief only to the extent, and without any determination that, the swap transactions submitted for clearance by LCH constitute futures contracts or commodity options subject to the Commission's jurisdiction. The Commission notes that the order grants an exemption from the CEA only to the extent that the CEA is applicable to the instruments covered by SwapClear and that the Commission need not analyze each such instrument to determine that issue.

SIA further suggested that the Commission limit the scope of the transactions that are eligible for the requested exemptive relief to transactions that satisfy the requirements for an exemption under Part 35 of Commission rules, except for the requirement that the credit-worthiness of a party with an obligation under the transaction be a material consideration in entering into the swap transaction. The Commission notes that the exemptive relief provided by

the order is restricted to transactions and participants that satisfy such requirements as well as the other terms and conditions set forth in the order.

SIA also questioned the Commission's authority to oversee the operations of a clearing house such as LCH. Specifically, it asserted that the Commission may only regulate a clearing organization in the limited context of its oversight of the futures and option clearing activities of boards of trade designated as contract markets. SIA also argued that the Commission's assertion of jurisdiction over LCH would be inconsistent with Section 4(b) of the Act.[170] The Commission recognizes that LCH and SwapClear are subject to an extensive regulatory scheme in the United Kingdom and notes that it is not adopting any rules or regulations of the type prohibited by Section 4(b) of the CEA. Rather, the Commission is issuing an order as authorized by Section 4(c) of the Act to extend the exemption already granted in Part 35 of the Commission's Rules by permitting swaps clearing.

In sum, the Commission has carefully considered each of the comments and believes that the order is generally responsive to the commenters' concerns.

VI. Determinations Required for Exemption

Section 4(c) of the CEA authorizes the Commission, by rule, regulation, or order, to exempt any agreement, contract or transaction, or class thereof from the exchange trading requirement or Section 4(a) of the Act or any other requirement of the Act other than Section

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[170] Section 4(b) of the Act, *inter alia*, prohibits the Commission from adopting a rule or regulation that:

> (1) requires Commission approval of any contract, rule, regulation, or action of any foreign board of trade, exchange, or market or clearinghouse for such board of trade, exchange, or market, or (2) governs in any way any rule or contract term or action of any foreign board of trade, exchange, or market, or clearing house for such board of trade, exchange, or market. 7 USC 6(b).

2(a)(1)(B), if the Commission determines that the exemption would be consistent with the public interest. Furthermore, Section 4(c)(2) of the Act provides that the Commission may not grant an exemption from the exchange trading requirement of Section 4(a) of the Act unless the Commission finds that: (i) the exchange-trading requirement should not be applied to the agreement, contract, or transaction for which the exemption is requested and the exemption would be consistent with the public interest and the purposes of the Act; (ii) the exempted transaction will be entered into solely between "appropriate persons"; and (iii) the agreement, contract or transaction in question will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act.[171] For the reasons stated below, the Commission believes that issuing the exemptive relief as set forth in the order is consistent with those determinations.

A. Exchange-Trading Requirement

The Commission believes that the exchange trading requirement contained in Section 4(a) of the CEA should not be applied to swap transactions that satisfy the terms and conditions set forth in this order. First, the Commission has recognized that the OTC swaps market does not serve the same price discovery function[172] as the exchange-traded market because prices in the OTC swaps market are privately negotiated between individual market participants.[173] LCH represents that some of the material economic terms of the transactions to be cleared by

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171 7 USC 6(c)(2).

172 By this statement, the Commission does not intend to suggest that a price discovery process is absent from the OTC swaps market. It merely notes that the difference between the price discovery functions of the exchange and OTC markets may warrant diverse regulatory treatment.

173 Accordingly, participants in the OTC market may trade "off-market."

SwapClear will be bilaterally negotiated between the SDs. Accordingly, SwapClear will not likely perform a "primary price discovery function."[174]

In addition, when adopting the Part 35 rules,[175] the Commission found that it was not necessary to apply the exchange trading requirement to swap agreements satisfying the conditions of the exemption provided therein because "one of the prerequisites for the exemption [was] that the swaps agreement not be standardized like exchange products or entered into or traded on a [multilateral transaction execution facility]."[176] Allowing transactions to be cleared through SwapClear, under the conditions enumerated in the order, will not alter the validity of this determination. The swaps market currently exists outside the exchange trading forum pursuant to Part 35, and LCH represents that "[a]ll swap agreements cleared through SwapClear will continue to be individually negotiated transactions and will not be traded on a multilateral trade execution facility."[177]

The Commission has expressly excluded transactions that are part of a fungible class of agreements standardized as to their material economic terms or are traded on a multilateral transaction execution facility from the scope of the order. It has further restricted the exemptive relief to "swap agreements" that have been entered into by "eligible swap participants," as those

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174 LCH Petition at 22.

175 As discussed above, Part 35 of the Commission's regulations exempts specified persons who offer, enter into or render advice or services with respect to specified swap agreements from certain provisions of the CEA.

176 58 FR 5587 at 5592.

177 LCH Petition at 22.

terms are defined in Rule 35.1.[178] The order, therefore, does not significantly expand the class of transactions or class of participants already afforded exemptive relief pursuant to Part 35 of Commission rules because the transactions to be cleared by SwapClear satisfy all of the conditions for an exemption under those rules, with the exception of one. Because LCH will interpose itself as a counterparty to each transaction it clears, the requirement that the creditworthiness of the counterparties be a material consideration in entering into or determining the terms of the agreements is not satisfied. In adopting the Part 35 Rules, however, the Commission indicated its willingness to expand the exemption to include centralized swaps clearing facilities under appropriate conditions and stated that such a facility may prove beneficial to participants and the public.[179]

Based upon the above, the Commission determines that the exchange trading requirement of Section 4(a) of the CEA should not be applied to transactions meeting the terms and conditions of this order.

B. The Public Interest and the Purposes of the Act

When considering previous Section 4(c) exemptive actions, the Commission has measured the action's consistency with "the public interest and the purposes of the Act" against the "template of its over-all regulatory scheme" and the guidance set forth in the Conference

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178 Only the particular FRAs and interest rate swap agreements described in the LCH Petition are eligible for exemptive relief under the terms of the order granted herein. Accordingly, the exemption that would be provided would be applicable to fewer types of agreements than are covered by the Part 35 exemption.

179 58 FR 5587, 5591, n.30.

Report accompanying the 1992 Act.[180] In this respect, the Conference Report states that the term "public interest" as used in Section 4(c) is intended "to include the national public interests noted in the Act, the prevention of fraud and the preservation of the financial integrity of the markets, as well as the promotion of responsible economic or financial innovation and fair competition."[181] The Conference Report also states that the reference in Section 4(c) to the "purposes of the Act" is intended to "underscore [the Conferees'] expectation that the Commission will assess the impact of a proposed exemption on the maintenance of the integrity and soundness of markets and market participants."

As the Commission stated when it adopted the Part 35 swaps exemption, "swap agreements are important tools that are used by [market participants] to hedge or manage financial risk and accomplish other financial objectives."[182] The Commission believes that a centralized swaps clearing facility such as SwapClear may reduce the risks and costs of participation in the swap market and increase transparency in that market without increasing the risk of fraud or market manipulation.

1. Potential Benefits of SwapClear

The Commission believes that a properly managed and adequately capitalized or otherwise secured clearing facility that includes a performance guarantee by a central counterparty, the multilateral netting of payments, positions, and credit exposure, and the other

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180 *Exemption for Certain Contracts Involving Energy Products*, 58 FR 21286, 21292 (Apr. 20, 1993)(Final Order). *See also Regulation of Hybrid Instruments*, 58 FR 5580, 5582 (Jan. 22, 1993); 58 FR 5587 at 5592.

181 H.R. Rep. No. 978, *supra* n.24 at 78.

182 58 FR 5587, 5592.

innovative features offered by SwapClear may significantly benefit the OTC derivatives marketplace by diminishing certain risks and costs associated with that market.[183]

For example, by interposing a central counterparty to each swap transaction it clears and by offering LCH's performance guarantee, SwapClear effectively substitutes the credit of a highly capitalized clearing system as a whole for the credit of an individual counterparty, thereby mitigating counterparty credit risk. SwapClear's use of a multilateral payment netting system may lessen the risks associated with multiple, redundant settlement payments by potentially reducing the number and the amount of payments that must be made. SwapClear also offers a default procedure designed to permit positions to be closed out with limited impact on other, non-defaulting counterparties. In this way, the effects of a single member default will be isolated, and a chain reaction of consequential defaults by other market counterparties that may, in turn, cause widespread risk to the financial system may be prevented. Moreover, LCH's default rules take precedence over the rights of a liquidator or other insolvency office-holder under relevant insolvency law in the United Kingdom.[184]

The market innovations offered by SwapClear may also reduce the costs of participation in the swaps market. For example, the multilateral clearing offered by SwapClear may reduce the costs of negotiating credit provisions and monitoring the financial condition of multiple counterparties. Multilateral payment netting may reduce the costs of providing margin, collateralizing payment obligations, and transferring several repetitive settlement payments to

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183 Similarly, the Bank for International Settlements concluded that a clearing house for OTC derivatives has the potential to mitigate counterparty risk and to reduce systemic risk if the clearing house manages risk effectively. *See*, Bank for International Settlements, *OTC Derivatives: Settlement Procedures and Counterparty Risk Management* 36 (Sept. 1998).

184 LCH Petition at Appendix I, A-2 and A-6-A-7.

multiple counterparties. By decreasing these costs, SwapClear may enable swaps market participants to make more efficient use of their capital, collateral, and credit lines.

SwapClear may also benefit the swaps industry by increasing transparency in the marketplace. LCH will have knowledge of each SwapClear participant's transactions and will set daily credit limits to restrict this exposure accordingly. This may send a clear signal regarding the size and risk of a portion of a individual participant's proprietary trading. By requiring positions to be marked-to-market on a daily basis and by requiring variation margin, SwapClear may reduce a trader's ability to maintain large positions without alerting its senior management to the size or risk exposure of those positions. Finally, by granting this exemptive relief, the Commission clearly establishes the legality of SwapClear and the swap instruments to be cleared through it under the CEA insofar as they comply with the terms and conditions of the Commission's order.

2. Financial Safeguards

The Commission has previously indicated that the benefits that might result from the centralized clearing of OTC derivative transactions may come "at the cost of concentrating risk in the clearing organization."[185] Similarly, NYMEX asserted that the centralized clearing of swap agreements would entail concentration of financial and credit risks in one facility and that clearing members would not be privy to or be able to assess the risk being undertaken by the clearing entity. LCH has developed a risk management program designed to control the credit concentration risks associated with its SwapClear operation. SwapClear's risk management program includes the following: imposing admissions standards intended to restrict participation to financially and operationally sophisticated entities; requiring that SCMs post initial margin for

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185 63 FR 26114 at 26122.

each cleared transaction in an amount that has been calculated in accordance with a margin methodology that is fundamentally similar to that successfully in use at LCH with respect to its exchange-traded derivatives;[186] calculating the marked-to-market values of swap agreements on a daily basis; collecting variation margin, in cash, from SCMs each day; and establishing formal intra-day credit exposure limits for each SCM and calculating the effect of each new transaction on an SCM's credit exposure. LCH also has established clearly prescribed procedures governing a member's default and has substantial financial resources to protect it against the consequences of such a default. The adequacy of LCH's member-backed default fund will be tested in daily stress tests. This risk management plan, as detailed in Section III.B above, incorporates the criteria set forth in the Lamfalussy Report,[187] a report that the Commission has indicated may

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186 The differences between the margin methodology applicable to LCH's exchange-traded and OTC derivatives business may be attributed to the features which distinguish the trading and pricing of non-fungible from fungible derivatives. LCH has requested Freedom of Information Act Confidential Treatment of its margin methodologies pursuant to Rule 145.9. SCMs will have access to SwapClear's margin methodologies.

187 The Lamfalussy standards include:

1. Netting schemes should have a well-founded legal basis under all relevant jurisdictions;

2. Netting scheme participants should have a clear understanding of the impact of the particular scheme on each of the financial risks affected by the netting process;

3. Multilateral netting systems should have clearly-defined procedures for the management of credit risks and liquidity risks which specify the respective responsibilities of the netting provider and the participants. These procedures should also ensure that all parties have both the incentives and the capabilities to manage and contain each of the risks they bear and that limits are placed on the maximum level of credit exposure that can be produced by each participant;

4. Multilateral netting systems should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single net-debit position;

serve as an appropriate touchstone for reviewing a swaps clearing service.[188] NYMEX also recommended that the Commission look to this report for guidance in developing standards for a prudently-managed swaps clearing facility.

Payment netting may also reduce the amount of capital held in reserve by clearing members. Capital reserves act as a buffer against shocks to the market and price volatility. However, the introduction of centralized swaps clearing should result in a reduction in counterparty credit risk and participation costs and a concomitant reduction in the need for capital reserves to address those factors.

3. Potential for Fraud or Manipulation

The Commission does not believe that the LCH Petition raises any particular concerns with respect to fraud, nor did any commenter suggest that the SwapClear operation might increase the opportunity for fraud in the swaps market. LCH will only clear transactions that are entered into by large, sophisticated financial institutions which have dealt with each other on a bilateral basis and have the ability and the resources to judge the overall fairness of the price and contract terms for each transaction.[189] Nevertheless, in its order, the Commission has reserved its authority to act against fraud under the antifraud provisions of Section 4b and 4*o* of the CEA

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5. Multilateral netting systems should have objective and publicly-disclosed criteria for admission which permit fair and open access; and

6. All netting schemes should ensure the operational reliability of technical systems and the availability of back-up facilities capable of completing daily processing requirements. CFTC, *OTC Derivatives Report* 136-37 (Oct. 1993).

188 *Id.*

189 In fact, by calculating daily mark-to-market prices, LCH may decrease potential fraud by reducing the chances that a party, including a "rogue" employee, could mislead its counterparty or other person about the current value of a transaction.

and Rule 32.9. The Commission also believes that it will be able to obtain information needed to investigate any complaints of fraud that are within its jurisdiction involving SwapClear transactions or participants under the terms of the US/UK MOU and the Side Letter between the Commission and the FSA.

The Commission is also unaware of any concerns that use of the SwapClear operation will enable parties to manipulate prices more easily, and no such concerns were raised by the commenters. Swap transactions typically do not raise the same market manipulation concerns under the CEA as do certain exchange-traded contracts because swap prices are not generally widely disseminated or used by persons engaged in buying or selling the underlying commodities to determine prices. Nevertheless, the order granted herein will specifically reserve the Commission's authority under the Act to take action against market manipulation.[190] The Commission believes it will be able to acquire information needed to investigate any market

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[190] Manipulative activity involving the trading of OTC derivative instruments can have a detrimental impact on commerce in the United States for at least three basic reasons. First, like their exchange-traded counterparts, OTC derivative contracts allow end users to hedge against adverse commodity price fluctuations, changing currency and interest rates, and other marketplace uncertainties. As a consequence, OTC markets are playing an increasingly important role in risk management. If they are to continue to fulfill this vital function, OTC derivative instruments must not be subject to manipulation by unscrupulous traders. Second, the very nature of the participants in the OTC derivatives markets - major investment banks, publicly held companies, pension and hedge funds, and government agencies - dictates that the impact of any distortion in the price of OTC derivative instruments could be widespread, harming many more persons than just the aggrieved party to the contract. Given the enormous size of many derivative transactions in the OTC markets and the high degree of leverage often involved in those transactions, price manipulation could result in significant individual counterparty failures and even generate systemic risk. Finally, the interrelated nature of prices in many cash, futures, and OTC derivative markets makes it likely that price movements in one market will have a corresponding effect on prices in related markets. As a consequence, if the value of an OTC derivative instrument were, for example, based on the closing price of futures traded on a Commission-designated contract market, an unscrupulous trader could seek to enhance the value of his or her OTC derivatives position by attempting to manipulate the price of the relevant futures contract.

manipulation complaints that are within its jurisdiction involving SwapClear transactions and participants under the terms of the US/UK MOU and the Side Letter between the CFTC and the FSA.

Accordingly, the Commission determines that the exemptive relief granted by this order is consistent with the public interest and the purposes of the Act.

C. Appropriate Persons

The Commission must also determine that a transaction exempted under Section 4(c) of the Act will be entered into only by "appropriate persons." The term "appropriate person" is specifically limited to certain persons defined in the Act which are generally institutional investors but may include "such other persons that the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections."[191] The Conference Report states that "[d]etermining whether particular categories of participants are appropriate for particular instruments will be part of the Commission's responsibility to determine that a proposed exemption is consistent with the public interest."[192]

LCH will impose minimum financial and operational admissions criteria intended to ensure that all SDs and SCMs who participate in SwapClear will possess the financial sophistication and resources to understand and to withstand the risks of participation in the swaps market. While LCH represents that every SD and SCM will qualify as an "appropriate person," as that term is defined by the CEA,[193] LCH's eligibility standards will in fact result in all SwapClear participants exceeding that standard because all SwapClear participants will qualify

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191 7 U.S.C. 6(c)(3).

192 H.R. Rep. No. 978, *supra*, n. 24 at 79.

193 LCH Petition at 23.

as "eligible swap participants" as that term is defined in Commission regulations.[194] The Commission believes that the "appropriate person" requirement of Section 4(c) is met by LCH's admission criteria.

LCH will monitor compliance with its participant qualifications on an ongoing basis. To ensure that participation is so limited, the Commission's order explicitly limits the relief provided to transactions in which both the original counterparties and the clearing SCMs are "eligible swap participants" as defined in Part 35 of the Commission's regulations.[195]

Thus, the Commission determines that the transactions granted relief pursuant to this order will be entered into solely by appropriate persons.

D. Adverse Effects on Regulatory or Self-Regulatory Duties

In determining that an exemption granted under Section 4(c) of the Act will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties, the Conference Report states that the Commission "should consider the potential impact of the new product on such regulatory concerns as market surveillance, financial integrity of participants, protection of customers, and trade practice enforcement."[196] However, the Conference Report also states that "this provision [is not intended] to allow an exchange or any other existing market to oppose the exemption of a new

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194 17 CFR 35.1.

195 Since the Part 35 swaps exemption was adopted pursuant to Section 4(c) of the Act, persons who are "eligible swap participants" have already been determined by the Commission to be "appropriate persons" as defined in the CEA. *See* 58 FR 5587 at 5589 (the Part 35 adopting release's discussion of "eligible swap participants").

196 H.R. Rep. No. 978, *supra* n.24 at 79.

product solely on grounds that it may compete with or draw market share away from that existing market."[197]

As discussed above, the Commission has recognized that regulatory protections related to price discovery, financial integrity, and customer protection may differ between OTC swaps markets and exchange markets because the OTC swap transactions in most markets do not appear to perform the same price discovery function as exchange-traded markets since the prices of OTC instruments are subject to private, bilateral negotiation and because OTC swap transactions are generally conducted on a principal-to-principal basis between financially sophisticated counterparties. For example, in adopting its Part 35 swap exemption, the Commission determined that regulatory concerns regarding financial integrity and customer protection were addressed in large part by the requirement that exempt transactions be carried out by eligible swap participants.[198] The Commission has included compliance with this requirement as a condition of the exemption provided by the order. At the same time, LCH's eligibility requirements for SDs and SCMs limit participation in SwapClear to a still smaller

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197 *Id.*

198 58 FR 5587 at 5592. In this respect, the Commission also noted that, in order to qualify for the Part 35 swaps exemption, the creditworthiness of the counterparty must be a material consideration in entering into the exempt transaction. The Commission concluded that the Part 35 criteria as a whole would preclude anonymous transactions and ensure that qualifying swap transactions would be limited to persons who are sophisticated or financially able to bear the risks associated with those transactions. *Id.* While swaps clearing effectively eliminates counterparty creditworthiness as a material consideration in entering into a swap transaction, LCH's admission criteria ensure that parties eligible to use SwapClear will be sophisticated and financially able to bear the risks of the underlying swap transaction, and LCH's risk management procedures and default reserve ensure that LCH will be a highly creditworthy central counterparty to the cleared transactions. In addition, each SD in any LCH-cleared transaction will know its counterparty and its SCM (and LCH will know both the SDs and SCMs involved) so that transactions cleared through SwapClear will not be anonymous at the point where the parties enter into the transaction.

subset of institutions that should possess the financial sophistication and resources to engage in and bear the risks associated with the transactions in question.

The types of swaps transactions that LCH proposes to clear are already being executed in the OTC derivatives market. The approval of LCH's Petition will potentially reduce certain risks now associated with OTC swaps transactions and add to the soundness and transparency of the OTC swaps market.

Moreover, it is widely acknowledged that the exchange-traded futures and OTC swaps markets are linked, with swaps market participants using certain exchange-traded futures as hedging vehicles. Developments that add to the soundness of the swaps market will also potentially add to the financial security and soundness displayed by the exchange-traded futures markets. In addition, the Side Letter between the FSA and the CFTC will enable the Commission to acquire information regarding LCH, SwapClear, SCMs, and SDs that may allow it to learn of and to respond to financial, operational, and other problems that may negatively affect United States contract markets and market participants on a more timely basis. Finally, no commenter indicated that any self-regulatory organization's ability to fulfill its obligations would be adversely affected by Commission approval of SwapClear.

Accordingly, the Commission determines that issuance of this order will not have a material adverse affect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act.

VII. Explanation of the Order

The order grants an exemption from most provisions of the CEA and the Commission's regulations with respect to any swap agreement submitted for clearing through SwapClear and any person offering, entering into, or rendering advice or other services with respect to such

agreements, subject to certain terms and conditions set forth therein. The exemption extends to all provisions of the Act and Commission regulations except for Sections 2(a)(1)(B), 4b and 4*o* of the Act, Rule 32.9, and the provisions of Sections 6(c) and 9(a)(2) of the Act to the extent that these provisions prohibit manipulation of the market price of any commodity in interstate commerce or for future delivery on or subject to the rules of any contract market. Exemptive relief provided by the order will not become effective until the FSA and the CFTC have executed the Side Letter, and the Commission has received confirmation that the FSA has completed its review of SwapClear and has granted LCH approval to commence SwapClear operations.

The Commission notes that the order specifically enumerates several aspects of SwapClear that it considers relevant to its decision to approve the LCH Petition, regarding SwapClear's admissions criteria, product eligibility requirements, margining system, and other risk management procedures; the applicable regulatory regime; and the reporting, recordkeeping, and information-sharing arrangements. These factors are illustrative of those elements of a swaps clearing operation that the Commission deems pertinent to a request for exemptive relief. The Commission will examine all future petitions based on the circumstances presented.

The Commission has limited the exemptive relief by imposing certain conditions. Section 4(c) of the Act expressly empowers the Commission to issue exemptions subject to terms and conditions. The Commission has included these restrictions to ensure that the participant base, products, and activities of SwapClear are not expanded without Commission consideration of whether the exemption should be so extended. If any of the conditions set forth in the order is not satisfied when a transaction is submitted for clearing through LCH (*e.g.*, LCH is no longer an RCH or the swap agreement is not of the type set forth in the order), the transaction will fall outside the exemption.

The exemptive relief is restricted to those FRAs and interest rate swap agreements described in the LCH Petition that fall within the definition of "swap agreements" as set forth in Rule 35.1(b)(1). The Commission intends that the order will provide LCH with flexibility to expand its product eligibility criteria to include, for example, interest rate swaps using currencies, floating rate indices, or maturity dates other than those that will be immediately available. However, the Commission recognizes that transactions other than FRAs and interest rate swap agreements that qualify as "swap agreements" under the Commission's rules may raise additional regulatory concerns. Accordingly, it is declining to extend relief to instruments other than those set forth in the order.

In addition, the exemptive relief extends only to those agreements that would already be entitled to exemption under Part 35 of the Commission's regulations except for the fact that they are subject to clearing. Thus, the agreements must have been entered into by "eligible swap participants" as that term is defined in Rule 35.1(b)(2). This stricture is intended to ensure that participation is limited to the "appropriate persons" pursuant to Section 4(c) of the Act and, more particularly, to those persons possessing the financial sophistication, experience, and resources sufficient for participation in the swaps market.

The Commission is further restricting its relief to non-fungible transactions the material economic terms of which have been individually negotiated and which have not been traded on or through a multilateral transaction execution facility. Once SwapClear receives FSA's regulatory approval, this order contemplates that parties will be allowed to submit to SwapClear previously transacted swap agreements and still claim the relief granted herein as long as such transactions met the terms and conditions of Part 35 at the time that they were first entered into.

Finally, the order expressly conditions the exemptive relief provided upon the requirement that LCH be an RCH with respect to SwapClear at the time the swap agreement for which exemptive relief is sought is submitted for clearing to LCH. This condition is being imposed because the Commission has deferred, in large part, to the FSA's regulation of LCH as an RCH. Thus, parties could not claim the exemption for transactions that were submitted for clearing at a time when LCH did not have RCH status. Swap agreements submitted to SwapClear prior to LCH's loss of status as an RCH would not be affected, however, as long as all other conditions set forth in this order were satisfied,.

The Commission recognizes that it may be appropriate to review, revise, or revoke the exemptive relief provided should circumstances or further experience with swaps clearing warrant, and it expressly reserves the power to take such action. The Commission reviewed LCH's request for exemptive relief in its totality with due regard for all representations made in support thereof. Because a change in any one of these representations, in whole or in part, may have led the Commission to reach a different conclusion, the Commission believes it must reserve the right to review, modify and/or revoke its order if it discovers that a material fact or circumstance regarding LCH or SwapClear has been misrepresented, has been found to be untrue, or has ceased to be true. As to the representations outlined in the order, the Commission believes that LCH possesses an affirmative obligation to notify the Commission in the event it discovers that such information is misleading or untrue. The Commission believes that the reservation of its right to modify or revoke the order will provide an incentive to all parties who may submit petitions for exemptive relief to the Commission to furnish complete and accurate information in support of their respective requests.

The activities of LCH and SwapClear are subject to a comprehensive regulatory regime in the United Kingdom, including capital, reporting, and other regulatory requirements designed to ensure their financial and operational integrity and to ensure that the FSA would receive timely notice of any financial or operational difficulties involving them. In the event that LCH and/or SwapClear are not so regulated or in the event that the FSA or any other relevant authority in the United Kingdom no longer authorizes the operation of SwapClear, the exemptive relief requested may not be appropriate. Accordingly, the order provides that the Commission may modify or revoke the order should either of those events occur.

The Commission believes that an adequate exchange of information between it and the FSA concerning SwapClear and its operations is important to the CFTC's ability to fulfill its domestic regulatory functions. Accordingly, the Commission is reserving the right to revise or revoke the exemption should it be unable to acquire the information it views as necessary to enforce the order, to provide adequate protection to United States contract markets or United States market participants, or otherwise to carry out its regulatory functions.

Finally, LCH has agreed to file a valid, effective, and binding appointment of an agent in the United States for purposes of accepting delivery and service of communications issued by or on behalf of the CFTC, the United States Department of Justice, any self-regulatory organization, or any SwapClear participant. Such communications include any summons, complaint, order, subpoena, request for information, or notice, as well as any other written document or correspondence. As the Commission believes that such an agency arrangement is essential to proper communications between LCH and agencies of the United States or United States participants, it is specifically reserving the right to revise or to revoke the order should such an arrangement become ineffective or cease to exist.

The Commission notes that any revision or revocation of its order will apply prospectively only and will not affect the legal certainty of any swap transaction entered into prior to the revision or revocation.

IX. Conclusion

As demonstrated above, the Commission believes that its order is supported by the appropriate determinations made in accordance with the standards set forth in Section 4(c) of the Act for granting exemptions and that a centralized swap clearing operation such as SwapClear may provide substantial benefits to the OTC derivatives industry.

ORDER GRANTING RELIEF:

Order of the Commodity Futures Trading Commission Pursuant to Section 4(c) of the Commodity Exchange Act Exempting Certain Swap Agreements to be Cleared Through the London Clearing House Limited's SwapClear Operation and Certain Persons Who Engage in Specified Activities With Respect to Such Transactions From Specified Provisions of the CEA.

By a petition dated June 15, 1998, the London Clearing House Limited ("LCH") requested that the Commodity Futures Trading Commission ("CFTC" or "Commission") grant an exemption pursuant to Section 4(c) of the Commodity Exchange Act ("CEA" or "Act") to qualified persons using SwapClear, LCH's proposed service for the centralized clearing of certain swap transactions ("LCH Petition"). The LCH Petition requested that the Commission exempt such persons from all provisions of the CEA and the Commission's regulations except for Sections 2(a)(1)(B), 4b, and 4*o* of the Act, the provisions of Sections 6(c) and 9(a)(2) of the Act to the extent that such provisions prohibit the manipulation of the market price of any

commodity in interstate commerce or for future delivery on or subject to the rules of any contract market, and Rule 32.9.

LCH Representations

LCH has made a number of representations in support of its Petition. The Commission has relied upon these representations in its evaluation of the LCH Petition and in its decision to grant the exemptive relief provided by this order. LCH's representations include, but are not limited to, the following:

1) LCH is a recognized clearing house ("RCH") under the laws of the United Kingdom and is authorized under United Kingdom law to clear over-the-counter instruments. In order to obtain recognition as a clearing house, LCH was required to demonstrate to the appropriate regulatory authorities in the United Kingdom that it had, among other things:
   a) sufficient financial resources to carry out its business as a clearing house;
   b) adequate arrangements and resources for the effective monitoring and enforcement of compliance with its rules;
   c) an ability and willingness to share information with its regulators; and
   d) default rules that enable action to be taken to close out a member's position in relation to all unsettled contracts to which such member is a party where a member appears unable to meet its obligations to the clearing house.
2) As an RCH, LCH is subject to direct regulatory oversight by the Financial Services Authority ("FSA") and is subject to reporting, recordkeeping, and other regulatory requirements.
3) Among other things, LCH is required to provide the FSA with an annual regulatory plan that includes a statement of objectives and targets. LCH is also required to provide the FSA with

information relating to its governance, personnel, and business activities and changes in its rules. The information that LCH must provide to the FSA includes information relating to:

a) its annual audited reports and accounts;

b) its quarterly and annual budgets;

c) the presentation of a petition for winding up, the appointment of a receiver or liquidator, or the making of a voluntary arrangement with creditors;

d) the institution of any legal proceedings against it;

e) changes in its constitution, fees and charges, key personnel, independent arbitrator, ombudsman, complaints investigator, auditors, and persons to whom it provides clearing services;

f) the presentation of a petition for bankruptcy by any of its key personnel;

g) the dismissal of or any disciplinary actions taken against or relating to any of its officers or employees;

h) admissions or deletions from membership;

i) any disciplinary action taken against a member or an employee of a member;

j) persons appointed by another regulatory body to investigate the affairs of a member or its clearing services;

k) evidence indicating any person has been carrying on unauthorized investment business or has committed a criminal offense under the Financial Services Act ("FSAct"); and

l) the open positions, margin liability, and cash and collateral balances of a defaulting member's account.

4) The FSA will continually monitor LCH's compliance with its annual regulatory plan and other regulatory requirements.

5) As an extension of LCH's activities as an RCH, the SwapClear operation will be subject to regulation and oversight by the FSA, and LCH will be required to provide the FSA with certain information regarding its SwapClear operation.

6) Among other things, LCH will be required to provide the FSA with information concerning:

   a) the range in mark-to-market values of the swap agreements it clears;

   b) counterparty positions;

   c) counterparty margining levels;

   d) changes in the credit standing of SwapClear Clearing Members ("SCMs");

   e) LCH's counterparty exposure; and

   f) the results of stress testing.

7) Only transactions entered into by persons who have been approved by LCH as SwapClear Dealers ("SDs") will be eligible for clearing through SwapClear. To qualify for designation as an SD under LCH Rules, a person must:

   a) be a financial institution that is active in the wholesale market for the type of forward rate agreements and interest rate swap agreements to be cleared by SwapClear;

   b) at all times such person is carrying on "investment business" in the United Kingdom, as that term defined in the FSAct, be either:

      i) an authorized or exempted person under the FSAct or

      ii) a "European investment firm" as that term is defined in the United Kingdom's Investment Services Regulations 1995 ("U.K. Investment Services Regulations");

   c) be of investment grade caliber or be guaranteed by an investment grade parent; and

   d) satisfy certain operational standards.

8) LCH will require that all agreements to be cleared through SwapClear be submitted through a person that has been approved by LCH as an SCM. Accordingly, an SD must have a clearing arrangement in place with a SCM or be approved as an SCM itself before it will be permitted to participate in SwapClear. To qualify for designation as an SCM, a person must:

   a) be an LCH shareholder;

   b) at all times such person is carrying on "investment business" in the United Kingdom, as that term is defined in the FSAct, be either:

      i) an authorized or exempt person under the FSAct or

      ii) a "European investment firm," as that term is defined in the U.K. Investment Services Regulations;

   c) satisfy minimum financial requirements;

   d) contribute to LCH's Default Fund ("DF");

   e) submit regular financial reports to LCH; and

   f) satisfy specified operational and staffing standards.

9) LCH will not permit end-users or members of the general public who do not satisfy LCH's criteria for designation as an SD or SCM to participate in SwapClear.

10) LCH will monitor the compliance of SDs and SCMs with SwapClear's admission standards on an ongoing basis.

11) All SDs and SCMs will be bound by LCH rules, regulations, and requirements (collectively, "LCH Rules").

12) LCH will permit only forward rate agreements and interest rate swap agreements that satisfy the product eligibility standards set forth in the LCH Petition to be cleared by SwapClear.

13) Material economic terms of all transactions to be cleared by SwapClear will be bilaterally negotiated between SDs.

14) LCH will not provide counterparties with any form of transaction execution facility.

15) LCH will register agreements for clearing only after it has verified that:

a) both counterparties satisfy LCH's participant eligibility criteria;

b) that the agreement satisfies SwapClear's product eligibility requirements; and

c) the transactions will not exceed the submitting SCM's respective intra-day credit limit.

16) LCH will register all agreements to be cleared by SwapClear in the name of an SCM, and the SCM will be fully liable for ensuring performance to LCH with respect to each swap agreement registered in its name. An SD may clear an agreement for itself if it has also received approval from the LCH to act as an SCM.

17) Where the SCM is not the same party as the SD, back-to-back transactions will also arise between the SD and the SCM. In these cases, upon registration of those agreements for clearing by LCH, the original bilateral forward rate agreements or interest rate swap agreements between the SDs will be replaced by four new transactions: one between each SD and its SCM, contracting as principals, and one between each SCM and LCH, contracting as principals.

18) LCH will become the central counterparty with respect to all swap agreements to be cleared through SwapClear and, as such, will be responsible to the SCMs for the performance of the obligations thereunder.

19) LCH represents that United Kingdom law would permit LCH to commingle segregated client funds relating to an SCM's exchange-traded business in the United Kingdom and client funds relating to an SCM's SwapClear business. However, LCH represents further that it

anticipates that LCH clearing members who are also SCMs will carry their non-proprietary futures positions and associated margin funds in their "client" account at LCH, but likely will carry their non-proprietary SwapClear positions and associated margin funds in their "house" account at LCH. Accordingly, LCH believes that United States persons who do not engage in SwapClear transactions, but who clear their exchange-traded futures through the "client" account of a member of LCH who is also an SCM are unlikely to be exposed to a greater likelihood of loss in the event of a default by a SwapClear participant than would exist prior to the implementation of a SwapClear facility.

20) LCH will implement certain risk management mechanisms and procedures to control the risks arising from its role as central counterparty to all agreements cleared through SwapClear. LCH's risk management program will include:

a) A requirement that the terms of a swap agreement be confirmed by the original counterparties before the agreement will be accepted for clearing by SwapClear.

b) A requirement that SDs and SCMs submit certain information to LCH including information relating to:

i) their ongoing ability to satisfy SwapClear's participant eligibility criteria;

ii) their status as a licensee;

iii) their authority to conduct investment business in the United Kingdom;

iv) their solvency;

v) their dissolution;

vi) their conviction of a crime;

vii) disciplinary or enforcement judgment involving them; and

viii) material changes to their business.

c) The establishment of intra-day limits on credit exposure with respect to each SCM. LCH will monitor its credit exposure to each SCM on an ongoing basis and will be able to reject any transaction for registration or impose liquidation orders with respect to transactions that exceed assigned credit limits.

d) The establishment of initial margin requirements to cover adverse market movements and the cost of liquidating positions in the event of a default by an SCM. Subject to the approval of the FSA, the initial margin requirements will be set using a scenario-based method analogous to London SPAN®. LCH will accept margin only in cash, bank guarantees, and specified government securities. LCH will retain the discretion to require a SwapClear participant to post initial margin in excess of that calculated using its margin methodology.

e) The calculation of mark-to-market values for all cleared agreements on a daily basis and a requirement that SCMs pay variation margin equivalent to any change in the value of an SCM's position from the previous day, each day, in cash.

f) The maintenance of financial resources of sufficient size and liquidity to cover the cost of closing out or transferring a defaulting member's position where those costs exceed the initial margin collected by LCH from the defaulting member, including cash; lines of credit, a default fund to which each SCM must contribute, and the maintenance of an insurance policy to cover any shortfall in the default fund.

g) The maintenance of rules which permit LCH to declare an SCM in default in appropriate circumstances and to take appropriate, clearly-defined action in the event of an SCM default.

h) Daily stress testing of the initial margin LCH holds from each member to ensure the adequacy of its daily funding level in the event of a member default and daily review of the stress testing results.

i) Internal and third party testing of the operational systems upon which LCH relies.

j) The maintenance of back-up and business recovery facilities to ensure the reliability and security of SwapClear's operations.

21) LCH will forward a copy of the annual report that it is required to file with the FSA to the CFTC upon submission of that document to the FSA.

22) LCH will provide a copy of the LCH Rules applicable to its SwapClear operation to the CFTC, prior to the onset of SwapClear's operations.

23) LCH will maintain a valid, effective, and binding agency agreement with a person located in the United States whereby it authorizes that person to act as its agent for purposes of accepting delivery and service of communications at all times during which this order is in effect. Such communications include any summons, complaint, order, subpoena, request for information, notice or any other written document or correspondence issued by or on behalf of the CFTC, the United States Department of Justice, any self-regulatory organization, or any SwapClear participant. LCH will provide immediate, written notice to the Commission of any change concerning the status of the party identified as the agent for the service of process or the effectiveness of any agreement with such party.

Terms and Conditions

Based upon the representations that have been made, the Commission has determined that granting the Petition for Exemption Pursuant to Section 4(c) of the Act dated June 15, 1998

submitted by LCH, subject to the terms and conditions below, would be consistent with the standards set forth in Section 4(c) of the CEA.

Accordingly, any swap agreement submitted for clearing to LCH through its swap clearing facility known as SwapClear is exempt from all provisions of the Act and any person or class of person offering, entering into, rendering advice or rendering other services, including clearing services, with respect to such agreement, is exempt for such activity from all provisions of the Act (except in each case, sections 2(a)(1)(B), 4b and 4*o* of the Act, and Rule 32.9 of the Commission's regulations, and the provisions of sections 6(c) and 9(a)(2) of the Act to the extent these provisions prohibit manipulation of the market price of any commodity in interstate commerce or for future delivery on or subject to the rules of any contract market), provided that each of the following terms and conditions is met:

1) The transaction would constitute a "swap agreement," as that term is defined in Section 35.1(b)(1) of the Commission's regulations, and the transaction is a forward rate agreement or interest rate swap agreement as defined in the LCH Petition.
2) The transaction has been entered into solely between "eligible swap participants," as that term is defined in Section 35.1(b)(2) of the Commission's regulations, which have been approved as SDs by LCH.
3) The transaction is not part of a fungible class of agreements that are standardized as to their material economic terms.
4) The transaction is not entered into and traded on or through a multilateral transaction execution facility.

5) At the time such agreement is submitted to LCH for registration by SwapClear, LCH is an RCH under the applicable laws of the United Kingdom with respect to the clearing services offered by SwapClear.

This order, and the exemption provided herein, shall not become effective until the FSA and the Commission have executed the Bilateral Side Letter to the *Memorandum of Understanding dated September 25, 1991 on the Mutual Assistance and Exchange of Information between the SEC, the CFTC, the United Kingdom's Department of Trade and Industry, HM Treasury, and the FSA (formerly the Securities and Investments Board)*, and the FSA has provided the Commission with written notification that it has reviewed the SwapClear operation and has approved the commencement of the SwapClear operation.

The Commission reserves the right to review and, prospectively, to modify and/or to revoke this order and the exemption contained therein, including the conditions imposed upon the exemptive relief, in certain circumstances, including, but not limited to, the following:

1) The Commission discovers that a material representation made by LCH or its counsel or representatives is materially misleading, is untrue, or has ceased to be true.
2) LCH ceases to satisfy the criteria for designation as an RCH under the applicable laws of the United Kingdom.
3) The FSA or any relevant authority in the United Kingdom no longer authorizes the operation of SwapClear.
4) LCH fails to maintain a valid, effective, and binding agreement appointing an agent in the United States for purposes of accepting delivery and service of communications, as defined above, issued by or on behalf of the CFTC, the United States Department of Justice, any self-regulatory organization, or any SwapClear participant.

5) The Commission determines that it is unable to obtain sufficient information including, but not limited to, information that the FSA and LCH have agreed to provide to the Commission or to which the Commission believes it is entitled to receive under the terms of the US/UK MOU, the Side Letter thereto or any other information-sharing arrangement.

6) Any revocation of this order or the exemption provided herein by the Commission would be prospective only and would not affect the status of any transaction entered into in reliance on this order prior to the revocation.

Issued in Washington, DC on March 23, 1999, by the Commission.

Jean A. Webb,

Secretary of the Commission