

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

28 April 2011

Dear Ms. Murphy:

**Re: 17 CFR Part 240: "Clearing Agency Standards for Operation and Governance"**

The LCH.Clearnet Group ("LCH.Clearnet") is pleased to add further comment to the letters it has already submitted to the Securities and Exchange Commission ("Commission"). We continue to appreciate the careful thought and consideration that the Commission has given to the rulemaking process and the open manner in which it has consulted with market participants and other interested parties.

One of the primary goals of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") was to lower risk by requiring over-the-counter ("OTC") derivatives to be centrally cleared. LCH.Clearnet supports both the Dodd-Frank Act, and the policy goals underpinned by the Commission's Proposing Release and the statutory provisions contained in Section 763 of Title VII and in Section 805 of Title VIII of the Dodd-Frank Act.

Title VII of the Dodd-Frank Act added new provisions to the Securities Exchange Act of 1934 ("Exchange Act"), that require clearing agencies that clear security-based swaps ("security-based swap clearing agencies") to register with the Commission and, additionally, require the Commission to adopt rules with respect to security-based swap clearing agencies. Title VIII of the Dodd-Frank Act, meanwhile establishes an enhanced supervisory and risk control system for systemically important clearing agencies and other financial market utilities ("FMUs"). It provides that the Commission may prescribe regulations containing risk management standards, taking into consideration relevant international standards and existing prudential requirements, for any designated clearing entities it regulates.

The Group believes it is appropriate that the Commission should adopt rules and standards for security-based swap clearing agencies and important that the Commission establishes a process for the registration of security-based swap clearing agencies. The Group is also supportive of the requirement that systemically important clearing agencies and other financial market utilities be subject to enhanced supervisory and risk control systems.

LCH.Clearnet commends the Commission for its consideration of these provisions and believes that the proposed rules set forth in the Proposing Release will help establish a comprehensive regulatory framework to reduce risk, increase transparency and promote market integrity within the financial system.

The Group would, however, like to make a few observations on these important rules, and welcomes this opportunity to share these with the Commission. LCH.Clearnet sets forth its more detailed comments on the Commission's proposals overleaf.

**PART 240 General Rules and Regulations, Securities Exchange**

**§240.17Ad-22 Standards for Clearing Agencies**

(b) The proposed rules set out under Proposed Regulation § 240.17Ad-22 (b) set out the written policies and procedures that the clearing agency should establish, implement and maintain.

(b)(1) *Under § 240.17Ad-22 (b)(1) the Commission sets out the frequency with which the clearing agency should measure its credit exposures to its participants. The SEC requires that the clearing agency should measure its credit exposures to its participants at least once a day and limit its exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the clearing agency would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.*

The Group would respectfully submit that this requirement ought to be stricter. In order to discharge its responsibilities, we believe that the clearing agency should be required to measure its credit exposures “several times each business day”, and that the clearing agency should be obliged to recalculate (and potentially call) Initial and Variation Margin requirements for each participant and their clients more than once each business day.

(b)(2) *Under § 240.17Ad-22 (b)(2) the Commission sets forth standards by which the clearing agency should set margins to limit its credit exposures to its participants. The Commission requires that the clearing agency use margin requirements to limit its credit exposures to participants in normal market conditions and use risk-based models and parameters to set margin requirements and review them at least monthly.*

The Group upholds the Commission’s intent of ensuring adequate margining by the clearing agency and broadly agrees with the Commission’s proposal, we would however recommend that this sub-paragraph be moderately amended. We would respectfully suggest that the margin requirements must be sufficient to limit credit exposures to both the clearing agency’s participants and to the clients of the clearing agency’s participants.

(b)(3) *Under § 240.17Ad-22 (b)(3) the Commission defines the financial resources that the clearing agency should hold. The proposed rulemaking stipulates that the clearing agency should maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions; provided that a security-based swap clearing agency shall maintain sufficient financial resources to withstand, at a minimum, a default by the two participants to which it has the largest exposures in extreme but plausible market conditions.*

The Group believes that financial standards are of paramount importance for clearing agency stability and believes that it is entirely appropriate for the Commission to define these requirements. Notwithstanding this, the Group does have some concerns with the proposed requirements inasmuch as these set two standards for clearing agencies – higher standards for those clearing security-based swaps, and lower standards for those clearing other products. The Group appreciates that the Commission is seeking to ensure that security-based swap clearing agencies are sufficiently robust before introducing these products into clearing, however we would caution that the introduction of two different sets of financial standards for clearing agencies may either discourage clearing agencies from clearing security-based swap products, or discourage participants from joining those clearing agencies with higher standards. The introduction of this two-tier structure might thus have the unintended consequence of limiting the amount of security-based swaps introduced into clearing.

The Group further understands that the Commission is required to progress with its rulemakings in advance of the finalization of similar work being undertaken by international standard-setters<sup>1</sup>. Notwithstanding this, we would encourage the Commission to ensure that its final rulemakings in this area are aligned to the closest extent possible with international standards and rules being promulgated elsewhere and applaud the Commission's ongoing efforts in this regard.

- (b)(4) *Under § 240.17Ad-22 (b)(4) the Commission sets forth the standards by which the clearing agency should validate its margin models. The Commission requires that the clearing agency should provide for an annual model validation consisting of evaluating the performance of its margin models and the related parameters and assumptions associated with such models by a qualified person who does not perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs these functions.*

The Group concurs with this provision.

- (b)(5)-(7) *Under § 240.17Ad-22 (b)(5)-(7) the Commission sets out the requirements for membership at a clearing agency that clears Security-Based Swaps. These rules stipulate that the clearing agency must: (5) provide the opportunity for a person that does not perform any dealer or security-based swap dealer services to obtain membership at the clearing agency to clear securities for itself or on behalf of other persons; (6) have membership standards that do not require that participants maintain a portfolio of any minimum size or that participants maintain a minimum transaction volume; and (7) provide a person that maintains net capital equal to or greater than \$50 million should have the ability to obtain membership at the clearing agency, with any net capital requirements being scalable so that they are proportional to the risks posed by the participant's activities to the clearing agency. The clearing agency may however provide for a higher net capital requirement as a condition for membership at the clearing agency if the clearing agency demonstrates to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures and the Commission approves the higher net capital requirement as part of a rule filing or clearing agency registration application.*

The Group upholds the Commission's intent of ensuring broad participation in and open access to clearing agencies. We further believe that the Commission's proposal that participation requirements be set on a "scalable" basis such that the clearing agency may elect to place limits on its potential exposure to participants is entirely appropriate. Membership standards that link the nature and degree of participation with the risks posed by the potential participant, and ensure proportionate risk responsibility should facilitate sound risk management practices whilst affording entry to a wide group of participants.

Notwithstanding this the Group would respectfully observe that the first responsibility of the clearing agency is to ensure the integrity of the clearing agency, its guarantee fund and the protection of its participants and their clients. In a default situation, the integrity of the clearing agency is wholly reliant on an effective and efficient default management process. In the case of security-based swaps, such a default management process may depend on participants' assuming risk underwriting and or default management responsibilities. Indeed, as the Commission acknowledges in its preamble to this rulemaking, extremely illiquid security-based

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<sup>1</sup> *Principles for financial market infrastructures*, Consultative Report from the Committee on Payment and Settlement Systems, Technical Committee of the International Organization of Securities Commissions ("CPSS-IOSCO") March 2011.

swap products can be difficult to clear under a conventional CCP clearing model.<sup>2</sup> For this reason we would respectfully urge the Commission permit clearing agencies to impose such requirements on and set such rules for participants clearing security-based swaps. In furnishing security-based swaps clearing agencies with the latitude to impose such requirements, the Commission will enable such clearing agencies to fulfill the requirements set out in the Dodd-Frank Act and ensure that more security-based swaps are introduced into clearing.

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LCH.Clearnet looks forward to extending its clearing services further into the U.S. marketplace, thereby offering the safeguards of its proven structures to a wider audience. It believes that, subject to the above modifications, the Proposing Release will help establish a comprehensive regulatory framework to reduce risk, increase transparency and promote market integrity within the financial system.

We recognize the hard work undertaken by the Commission in order to develop these proposed rules and applaud the Commission's open and thoughtful approach to this task as well as its ongoing efforts to work toward global harmonization in these regards. The Group appreciates the opportunity to comment on these important issues, and would be pleased to enter into a further dialogue with the Commission and its staff on the matters raised in this letter.

Please do not hesitate to contact Simon Wheatley at +44 (0)20 7426 7622 regarding any questions raised by this letter, or to discuss these comments in greater detail.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Ian Axe', written in a cursive style.

Ian Axe  
Chief Executive Officer

<sup>2</sup> <http://www.gpo.gov/fdsys/pkg/FR-2011-03-16/pdf/2011-5182.pdf>