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**Via Electronic Submission**

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Re: Recovery Plan / Non-default Loss Allocation

To Whom It May Concern:

The Futures Industry Association, Inc. (“FIA”) appreciates the opportunity to provide LCH.Clearnet Limited (“LCH”) with the comments and recommendations set forth below in response to LCH’s Notice of Rulebook Change Consultation – Recovery Plan / Non-default Loss Allocation which contains a new Regulation 39(i) and a new Regulation 1 Solvency Threatening Treasury Default Loss (collectively, the “Proposed Rules”). The Proposed Rules propose to establish a mechanism whereby LCH would contribute €15 million of its own capital (“the LCH Contribution”) to cover in whole or in part certain investment losses that LCH may incur through its treasury management activities.<sup>1</sup> To the extent that this amount is insufficient to cover such losses, LCH proposes to allocate the remaining losses to its members (each, an “LCH Member” and collectively, “LCH Members”).<sup>2</sup> Additionally, the Proposed Rules would provide LCH and other members of the LCH.Clearnet Group an exclusion from liability for any damage, loss, cost or expense incurred by an LCH Member as a result of the default, failure or insolvency of certain third parties that are utilized by LCH in the operation of its treasury management activities.<sup>3</sup>

**I. Interest of FIA in the LCH’s Proposed Rules**

FIA’s regular and associate members, their affiliates, and their customers actively participate in LCH’s markets as intermediaries, principals and users.<sup>4</sup> FIA represents several

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<sup>1</sup> See LCH Proposed Rule – Solvency Threatening Treasury Default Loss, Regulation 1(b).

<sup>2</sup> See LCH Proposed Rule – Solvency Threatening Treasury Default Loss, Regulation 1(c).

<sup>3</sup> See LCH Proposed Rule – Regulation 39(i) and “equivalent provision to be inserted into the LCH FCM Rulebook”.

<sup>4</sup> FIA is the leading trade organization for the futures, options and OTC cleared derivatives markets. FIA members are active users of the commodity futures and cleared derivatives transactions markets and include derivatives clearing firms of all sizes as well as leading derivatives exchanges and large commodity firms. Given the

members of LCH. Consequently, FIA and its members have a significant interest in any rules that LCH proposes, including rules, such as the Proposed Rules, that relate to the treatment and investment of margin or other property posted to LCH by LCH Members on behalf of their customers (such property, “Customer Property”) or on behalf of the LCH Member and its affiliates, including proprietary margin and guaranty fund deposits (such property, “Non-customer Property”) and that impact the risk to and liability of LCH Members.

## **II. Summary of FIA’s Comments**

Application of the Proposed Rules as they relate to Customer Property would violate certain regulations of the Commodity Futures Trading Commission (“CFTC”). In addition, application of the Proposed Rules as they relate to Non-customer Property would create undue and potentially unlimited and unquantifiable risk for LCH Members. Accordingly, FIA respectfully requests that LCH not adopt the Proposed Rules as drafted.

### **III. FIA’s Comments**

#### **A. Application of the Proposed Rules as they relate to Customer Property would raise accounting concerns and violate certain CFTC regulations.**

LCH is a CFTC-registered derivatives clearing organization (“DCO”) and, as such, is subject to the jurisdiction of the CFTC and the CFTC regulations when it provides clearing services in relation to certain “Cleared Swaps” as such term is defined in the Commodity Exchange Act, as amended (“CEA”)<sup>5</sup>. Customer Property posted to LCH by a Futures Commission Merchant (“FCM”) to support such customers’ Cleared Swaps that are cleared by LCH is governed by Part 22 of the CFTC regulations and constitutes “Cleared Swaps Customer Collateral” as such term is defined in CFTC Rule 22.1. CFTC Rule 22.3(d) permits a DCO to invest Cleared Swaps Customer Collateral in accordance with CFTC Rule 1.25.

CFTC Rule 1.29 governs the treatment of gains and losses resulting from the investment of customer funds by FCMs and DCOs and is made applicable to Cleared Swaps Customer Collateral pursuant to CFTC Rule 22.10. In relevant part, CFTC Rule 1.29(b) states that a DCO shall bear sole responsibility for any losses resulting from the investment of customer funds in instruments described in CFTC Rule 1.25 and prohibits a DCO from allocating such investment losses to FCMs. Any Proposed Rule that would make an FCM liable or LCH not liable for investment losses related to Customer Property incurred by LCH would clearly violate CFTC Rule 1.29(b). FIA suggests that LCH specifically exclude the investments of Customer Property from Regulation 39(i) and sections (c), (d), (e), (f) and (g) of Regulation 1 from the Proposed Rules.

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variety of enterprises that comprise our regular and associate members, FIA is the only association representative of all organizations that have an interest in the cleared derivatives markets.

<sup>5</sup> CEA section 1a(7)

In addition, from an accounting perspective, the allocation of losses from the investment of customer funds to LCH Members (without the ability to pass such losses on to clients) runs counter to existing US GAAP accounting treatment under an agency analysis which permits a clearing member to treat a client's trades as belonging to the client, rather than as the clearing member's own principal derivatives. Any change in agency treatment from an accounting perspective could result in a significant increase in balance sheet exposure and potential capital implications for LCH Members. Because of the accounting concerns raised by the Proposed Rules, LCH should specifically exclude the investments of Customer Property from Regulation 39(i) and Regulation 1.

**B. Application of the Proposed Rules as they relate to Non-customer Property would create undue and potentially unlimited and unquantifiable risk for LCH Members.**

As a DCO, LCH is permitted to invest Customer Property and Non-customer Property pursuant to CFTC Rule 39.15(e). Whereas CFTC Rule 39.15(e) restricts a DCO's ability to invest Customer Property to those investments permitted under CFTC Rule 1.25, there is no such restriction with respect to a DCO's investment of Non-customer Property. Rather, CFTC Rule 39.15(e) requires investments of Non-customer Property to be "held in instruments with minimal credit, market and liquidity risks." Without the additional protections provided for in CFTC Rule 1.25, LCH has total discretion over the investments it makes with Non-customer Property. Together with the fact that the Proposed Rules cap LCH's liability for losses, LCH Members would be required to absorb any losses above and beyond the LCH Contribution should LCH take undue investment risks.

In order for an LCH Member to fully evaluate the risks associated with the Proposed Rules, the LCH Member would need to understand the risks associated with LCH's treasury management activities. To the extent that losses from LCH's treasury management activities may be allocated to LCH Members, LCH must provide LCH Members with detailed reports on (i) investment counterparties, (ii) instruments in which LCH Member's cash is invested, and (iii) total cash investments and amount of each LCH Member's cash invested relative to other LCH Members, so that LCH Members at all times have the ability to calculate capital and track their exposure to underlying investment counterparties. The level of information that would be provided under the Proposed Rules is inadequate to enable LCH Members to report their exposure to underlying counterparties/instruments as a part of their large exposure reporting needs and we would urge LCH to provide granular information on amount and tenor invested with specific counterparties/instruments (at a minimum in line with the Fed PRC disclosure requirement with respect to CCP investments - [http://www.newyorkfed.org/prc/files/report\\_130205.pdf](http://www.newyorkfed.org/prc/files/report_130205.pdf)). In addition, the frequency at which information is provided to LCH Members should correspond with the frequency with which LCH marks to market the investment portfolio and can potentially allocates losses to LCH Members, so that the LCH Members can correspondingly track the profits and losses on investments. To this end, disclosure regarding the investment portfolio should be required more frequently than monthly. We understand that LCH has agreed to provide this information to Fed PRC members as part of the Fed PRC CCP transparency disclosure initiative. This disclosure should also include the type of information an FCM is required to provide to customers

regarding material risks pursuant to CFTC Rule 1.55(k)(5). Without adequate disclosure, LCH Members cannot evaluate the potential risk associated with LCH's treasury management activities and cannot determine whether the LCH Contribution would be adequate to cover any potential loss associated with the LCH treasury management activities.

We have serious concerns with the allocation of any investment losses to LCH Members, especially when investment decisions are currently controlled by LCH rather than the individual LCH Members. To the extent losses from an investment counterparty's default are allocated to LCH Members, LCH should commit to a timeline in its rules to also allocate investment gains to LCH Members using the same formula as for allocation of such losses. In essence, if LCH is required to allocate losses to LCH Members, it should also pass through gains to LCH Members. LCH Members must have complete transparency and governance over the investment policy that applies to investment of LCH Member collateral. We understand that LCH plans to include such a pass through of gains and losses in the near term, and we would welcome the opportunity to closely collaborate with LCH in developing such a long-term solution.

For the reasons set forth above, FIA suggests that LCH revise the Proposed Rules as described above and delay implementation until such time as adequate transparency and disclosures can be provided.

**C. The Proposed Rules should provide for an LCH Contribution that is calibrated to increases in the amount and risk of LCH's investment portfolio, and should provide for a loss allocation formula that more clearly reflects each LCH Member's contribution to the investment portfolio.**

The Proposed Rules do not include a formula for determining the amount of the LCH Contribution. Our understanding is that LCH plans to dedicate €15 million to absorb such losses before allocating any further losses to LCH Members. However, the Proposed Rules do not provide any assurance to LCH Members that the LCH Contribution will not be reduced, and does not account for changes in the size or risk profile of LCH's investment portfolio. The proposal for LCH to dedicate €15 million to absorb losses should be the minimum size of the LCH Contribution, and this amount should be scaled up in proportion to the size and risk profile of LCH's investment portfolio.

In addition, the formula in section 1(d) of the Proposed Rules for allocation of losses to each LCH Member does not correspond to each LCH Member's effective contribution to LCH's investment portfolio. LCH should consider that the allocation of losses should correspond to each LCH Member's proportionate share of cash contribution to the investment portfolio, as the investment portfolio is comprised of cash collateral contributed as margin or guaranty fund contribution and not other assets contributed as margin or guaranty fund contribution.

Further, any process for distribution of amounts recovered following investment losses should properly incentivize LCH to obtain the best recovery result. Accordingly, and given that investment decisions related to LCH's treasury management activities are currently made by LCH without direct LCH Member governance or input, the distribution of net proceeds of any recovery of losses should first be divided among LCH Members in the same proportion as losses

are allocated to each LCH Member, prior to replenishment of the LCH Contribution. Section 1(g) of the Proposed Rules should be modified to reflect the abovementioned recovery process.

**D. The Proposed Rules language on exclusion of liability should be deleted as it exceeds the stated purpose of the proposal.**

Section 39(i) of the Proposed Rules incorrectly and unjustifiably includes operational risks associated with LCH's treasury management activities within its scope. To the extent any losses related to LCH's treasury management activities are allocated to LCH Members, such losses should be restricted to those that arise from an issuer default or counterparty default. As the allocation of such losses is already included in Regulation 1 of the Proposed Rules, Regulation 39(i) should not be adopted.

**IV. Conclusion**

For the foregoing reasons, FIA respectfully requests that LCH not adopt the Proposed Rules with regard to Customer Property and revise the Proposed Rules overall to reflect the points raised above prior to implementation. If you have any questions, please contact Barbara Wierzynski, General Counsel, FIA, 202-772-3008 or [bwierzynski@fia.org](mailto:bwierzynski@fia.org).

Respectfully submitted,



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President and Chief Executive Officer

CC: Ananda Radhakrishnan, Director, Commodity Futures Trading Commission, Division of Clearing and Risk