SENATE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS

“Building the New Derivatives Regulatory Framework: Oversight of Title VII of the Dodd-Frank Act”

Written Testimony of
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Chairman Johnson, Ranking Member Shelby, Members of the Committee, my name is Ian Axe and I am Chief Executive of LCH.Clearnet Group Ltd (the "Group"). On behalf of the Group I would like to thank the Committee for asking me here today.

LCH.Clearnet is the world's leading independent clearinghouse group. Formed out of the merger of the London Clearing House Ltd and Clearnet SA, we continue to operate two clearinghouses, LCH.Clearnet Limited[1] in London and LCH.Clearnet SA[2] in Paris. Additionally we have a fast-growing presence in the US to support our rapidly expanding US swaps activity. We opened a New York office in late 2009 and staff numbers have since grown quickly. Our New York headcount has already doubled in the year to date.

We are a user-owned, user-governed organisation, being 83% owned by our clearing members, and 17% owned by exchanges such as the NYSE Euronext group. We have been clearing commodities for 120 years, and LCH.Clearnet Limited has been registered with and regulated by the Commodity Futures Trading Commission ("CFTC") as a Derivatives Clearing Organization ("DCO") since 2001. We serve major international exchanges and trading platforms, as well as a range of over-the-counter ("OTC" or "swaps") markets and we clear a broad range of asset classes, including cash equities, exchange-traded derivatives, energy, freight, interest rate swaps and euro- and British pound-denominated bonds and repos.

OTC Clearing Expertise

LCH.Clearnet Limited pioneered the development of OTC clearing in 1999 with our SwapClear and RepoClear services, respectively the market-leaders in global interest rate swap and European repo clearing. In addition, our London arm clears a range of OTC freight, energy and commodity products, while LCH.Clearnet SA clears European OTC index-based credit default swaps and repo products.

LCH.Clearnet Limited currently clears over 50% of the global interest rate swap market. This represents trades with a total notional principal of over $276 trillion in 14 currencies with tenors out to as far as 50 years. Last year SwapClear cleared over 120,000 trades involving US counterparties with a notional value in excess of $64 trillion. Of the total swaps portfolio cleared, approximately $91 trillion is in US dollars.

We recently extended this capability to include a Futures Commission Merchant ("FCM") clearing service for US end user clients. We currently have 12 FCMs offering such services, and have since successfully cleared our first trades under the FCM structure.

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1 LCH.Clearnet Ltd is regulated by, *inter alia*, the Financial Services Authority of the United Kingdom and by the Commodity Futures Trading Commission (as a "Derivatives Clearing Organization") of the United States.

2 LCH.Clearnet SA is regulated as a Credit Institution and Clearing House by a regulatory college consisting of, amongst others, the market regulators and central banks from the jurisdictions of: France, Netherlands, Belgium and Portugal. It is also regulated as a Recognised Overseas Clearing House by the UK Financial Services Authority.

We are working closely with market participants to expand our service in the US and have set up formal working groups with FCMs and buyside firms. Our Buyside Advisory Committee meets monthly to discuss the development of the service. It comprises representatives from a number of large US firms, including Citadel, BlackRock, the D.E. Shaw Group, the Federal Home Loan Banks and Freddie Mac amongst others.

SwapClear is the largest swaps clearing service globally and is widely recognized as a major contributor to financial stability[3]. This important capability was put to the test during the collapse of Lehman Brothers. LCH.Clearnet Limited was required to default-manage Lehman Brothers' cleared portfolio of 66,000 interest rate swap trades across five major currencies, with a notional value in excess of $9 trillion. Together with SwapClear clearing members, who are contractually obligated to participate in the default management process and to bid in the ensuing auctions, LCH.Clearnet Limited successfully neutralized and sold off the entire swap portfolio.

The management of the default involved:

- At default (Monday, 15 September 2008) SwapClear clearing members seconded their experienced traders to work alongside LCH.Clearnet Limited's risk management team to execute hedges and to neutralize the market risk on the defaulter's portfolio. All participants adhered to strict confidentiality rules.

- Over the ensuing days, LCH.Clearnet Limited's risk position was constantly reviewed and recalibrated, and additional hedges were executed by the default management group in response to the changing portfolio and volatile market.

- From Wednesday, September 24 to Friday, October 3, competitive auctions of the five hedged currency portfolios were successfully completed and the group transferred all 66,000 trades to the successful bidders, all of whom were surviving SwapClear clearing members.

The success of the default management process was largely due to the strong commitment and contractual relationship between the SwapClear clearing members and LCH.Clearnet Limited. The process was wholly reliant on SwapClear clearing members' dedicated resources, including key and experienced front office, risk, and operations personnel who worked closely alongside the clearinghouse, in our offices.

LCH.Clearnet Limited used only 35 per cent of Lehman Brothers' margin in managing the default and returned the remaining funds, in excess of $850 million, to their administrators. No LCH.Clearnet Limited counterparties incurred any loss as a result of the default, and the clearing services operated by the Group continued to function in full, with no disruption to member firms or clients, before, during or after the Lehman Brothers' default. The Group thereby fulfilled its commitment to its members, clients and the wider financial system by ensuring market integrity and providing much-needed stability at a critical juncture.

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[3] *Deciphering the 2007-08 Liquidity and Credit Crunch,* Markus K. Brunnermeier, Princeton University, Journal of Economic Perspectives, May 2008: http://www.newyorkfed.org/research/conference/2008/rmm/Brunnermeier.pdf
New developments in clearing and settlement arrangements for OTC derivatives, Committee on Payment and Settlement Systems, BIS, Basel; March 2007. Link: http://www.bis.org/publ/cpss77.htm

The Dodd-Frank Wall Street Reform and Consumer Protection Act

The Group supported the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") because of the new law's provisions in Title VII designed to reduce risk and increase transparency in the OTC derivatives market through mandated clearing.

The Group strongly supports the policy goals underpinned by the Dodd-Frank Act, and believes that this important piece of legislation will do much to improve stability in the marketplace and much reduce the risk of the taxpayer funding further bailouts.

In particular we welcome both stronger risk management and heightened financial standards for clearinghouses; a greater level of supervision for clearinghouses; mandatory clearing obligations and trade reporting requirements.

We have been following the US rulemaking process closely, and applaud both the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") for the thoughtfulness and openness with which they have approached these important matters. We have been invited to participate in the Agencies' roundtables; have attended their open meetings; responded to their proposed rulemakings and met with their Commissioners.

At the same time we are directly involved in the legislative proposals in Europe and are closely following the development of the European Markets and Infrastructure Regulation ("EMIR"). The EMIR proposal, which governs clearinghouses and trade repositories, was put forward by the European Commission in September, and is now working its way through the European Parliament and Council.

We believe it is of paramount importance that the legislation and detailed rules emerging from the US and EU, as well as the timetables for implementation and adherence, are as closely aligned as possible. This harmonization should ensure that: there is no opportunity for regulatory arbitrage; capital is able to flow freely and that economic recovery is not constrained.

Clearinghouses such as our own are global operations, supporting global markets. Divergences in risk standards for clearinghouses amongst key jurisdictions such as the US and EU will likely lead to the balkanisation of clearing; such an outcome would result in a significant increase in the amount of capital tied up in clearing and be prejudicial for the economy, for jobs and for the recovery.

While we have generally supported the rules promulgated by the CFTC and SEC and commend their efforts to remain in close dialogue with supervisors in the EU, we have been concerned by the emergence of some notable differences in their proposals to those under consideration in Europe.

Our three greatest areas of concern in this regard include the differences between the US and Europe in rules governing: (1) the Mitigation of Conflicts of Interest; (2) Risk Management Requirements; and (3) Protection of Cleared Swaps.

Requirements regarding the Mitigation of Conflicts of Interest

Sections 726(a) and 765 of the Dodd-Frank Act empower the CFTC and SEC to adopt rules mitigating conflicts of interest with respect to any DCO or Clearing Agency that clears swaps or security-based swaps. These rules may include numerical limits on the control of, or the voting rights with respect to, such a DCO or Clearing Agency by a specified market participant ("Enumerated Entity").

LCH.Clearnet has long recognized that there are potential conflicts of interest in clearinghouses. Although LCH.Clearnet's substantial OTC derivatives clearing book plainly evidences the contrary, it is entirely possible that clearinghouse shareholders who deal in OTC derivatives may have an interest in seeing that the clearinghouse does not clear the instruments in which they deal. Equally, exchanges may have an interest in ensuring that a clearinghouse in which they are shareholders does not clear instruments traded on competing exchanges, execution facilities or in the OTC market. End users shareholders may meanwhile have an interest in ensuring that a clearinghouse keeps margin requirements and other associated costs artificially low.

In recognition of the potential conflicts, LCH.Clearnet's corporate charter prohibits any individual shareholder from exercising votes representing more than five percent of the shares in issue, even if a shareholder actually holds a number of shares amounting to more than five percent of the total number of shares in issue. This measure has effectively ensured that neither a single shareholder nor a small group of shareholders – whatever their origin or collective interests - has been able to dominate management of LCH.Clearnet's clearinghouses and determine their policies, such as which asset classes will be cleared.

At the same time, the direct involvement of market participants in our clearinghouses has facilitated innovation. Their expertise has directly contributed to our ability to develop complex and technically challenging services such as those we offer to the OTC marketplace. For this reason, we would caution that any regulation that limits the aggregate involvement of Enumerated Entities in clearinghouses might risk limiting innovation in OTC clearing, as well as stifling competition and increasing the cost of business in the US.

During passage of the Dodd-Frank Act, Congress correctly rejected the imposition of aggregate ownership and voting caps on clearinghouses. We have therefore been concerned to see proposals emerge from the Agencies[4] that would re-introduce such caps. Any such aggregate restriction on clearinghouse ownership or governance would, in our view, lead to increased cost, with no commensurate benefits. Rather, we believe that individual limitations on voting rights such as those already in place at LCH.Clearnet, coupled with the obligations to minimize and resolve conflicts of interest that clearinghouses will be subject to[5], should be sufficient to allay concerns about corporate governance within clearinghouses.

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4 RIN 3038 AD01, "Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest". RIN 3235-AK7, "Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with respect to Security-Based Swaps Under Regulation MC".

5 CFTC Proposed Rule 39.25(a), 75 Fed.Reg. 63732, 63750 (October 18, 2010). There is a similar provision contained in SEC Proposed Rule 17Ad-25, 76 Fed.Reg. 14472, 14539 (March 16, 2011).

Minimizing jurisdictional differences in rules such as those mitigating conflicts in clearinghouses will be key to keeping costs low and to reducing implementation challenges. In this regard we would respectfully observe that in Europe, where we have been closely tracking EMIR's progress through the legislature, there have been no proposals to attempt to limit clearinghouse ownership or voting rights by groups of entities – either from the European Commission, the European Parliament, or the European Council. Indeed, the restrictions on the ownership of shares or voting interests of the type proposed by the Agencies would likely be deemed contrary to the fundamental freedoms set out in the primary EU Treaty (the Treaty on the Functioning of the European Union, "TFEU"), in particular, those protecting the freedom of establishment and the free movement of capital.[6]

Risk Management Requirements

LCH.Clearnet acknowledges and endorses the Dodd-Frank requirement that clearinghouses permit "fair and open access".

The Group employs open and transparent membership eligibility criteria for each market that it clears. The criteria are approved by both our clearinghouses' Risk Committees and Boards of Directors, all of which are chaired by independent directors, and the criteria are subject to subsequent regulatory approval. We are committed to exploring all the ways in which we can expand our membership, whilst maintaining the highest standards of risk management and ensuring the safe and sound operation of our clearinghouses.

We have been concerned by the Agencies' proposed membership requirements for clearinghouses offering OTC clearing services[7]. The Agencies propose to enforce the separation of participation in clearinghouses from risk underwriting and default management responsibilities.

We have seen no such requirements in the European Commission's EMIR Proposal, nor during its subsequent passage through the European Parliament and European Council.

In our view, the SEC's and CFTC's proposed requirements for access to clearinghouses, whilst founded on important policy considerations, risk watering down our well-tested and proven default management processes, upon which the integrity of our clearinghouses depend.

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6 The provisions of the TFEU relating to free movement of capital provide that "all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited." The EU's Supreme Court (the European Court of Justice, "ECJ") has consistently found that, for these purposes, capital movements include "direct investment in the form of participation in an undertaking by way of shareholding or the acquisition of securities on the capital market … [and] … the possibility of participating effectively in the management of a company or in its control."
The free movement of capital and freedom of establishment are fundamental tenets of the TFEU, and any exceptions to these rules would needs therefore to be justified by overarching public policy requirements. Moreover, the TFEU sets out that "only the Council, acting in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament, adopt measures which constitute a step backwards in Union law as regards the liberalisation of the movement of capital to or from third countries." Accordingly, such an amendment would require unanimity amongst Member States.

7 RIN 3038-AC98 Risk Management Requirements for Derivatives Clearing Organizations, 21 January 2011.
RIN 3235-AL13 Clearing Agency Standards for Operation and Governance, 3 March 2011.

Absent clear default management rules that ensure the protection of surviving members, clearinghouses such at our own would face significant technical challenges that would put at risk our ability to extend and develop our OTC clearing services. As such, the proposed rules would seem to run contrary both to the Agencies' intent and to their statutory and prudential responsibilities.

In undertaking to clear certain swaps products, particularly those that are long-dated and less liquid than exchange-traded futures, a clearinghouse needs to rely on clearing member participation in the event of a default. We firmly believe that access criteria for OTC clearing members must be proportionate to the risk each member introduces into the system and should be contingent on default management and risk underwriting participation, such that the integrity of the clearinghouse is fully protected and there is no cost to or impact on other members, their customers or the wider financial system.

CPSS-IOSCO[8], the global organization of securities and futures regulators, has recently endorsed this view." The March 2011 report by CPSS-IOSCO on Financial Market Infrastructures stipulates:

> *"An OTC derivatives CCP may need to consider requiring participants to agree in advance to bid on the defaulting participant's portfolio and, should the auction fail, accept an allocation of the portfolio. A CCP that employs such procedures should carefully consider, where possible, the risk profile and portfolio of the receiving participant before allocating positions so as to minimise additional risk for the surviving participant."*[9]

In the interests of harmonization, we would also draw the Committee's attention to the submission made by the UK's Financial Services Authority[10] to the CFTC on this matter. The letter stated:

> *"Risk management standards for CCPs must be anchored in the characteristics of the products being cleared, and the FSA recognises that different product types may require different clearing models. This can extend to participant eligibility in models where the clearing members are required to perform specific actions to assist in a member default, for example Interest Rate Swap clearing models that include an obligation to bid for, or be allocated, portfolios from the defaulting clearing member."*

SwapClear clearing members must be able to demonstrate that they can support a swaps book from a front office, risk, technology and operations perspective. We rely on surviving clearing members: to be able to hedge a defaulting member's swaps portfolio; to provide liquidity for such hedging; to bid on hedged portfolios; and, if necessary, to accept a forced allocation of swaps.

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8 Committee on Payment and Settlement Systems, Technical Committee of the International Organization of Securities Commissions ("CPSS-IOSCO")

9 *Principles for Financial Market Infrastructures* CPSS-IOSCO Consultative Report, March 2011 (p64)

10 http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31986&SearchText=

LCH.Clearnet regularly tests and confirms that its clearing members maintain such a capability. This model was the basis upon which we successfully managed the Lehman Brothers default.

Upon reviewing the Agencies' proposed rules for access, we have asked ourselves whether the proposals would improve or reduce our ability to manage a large member or client default, and have concluded that such proposals still need work to ensure they would not be detrimental to our ability to do so.

Our SwapClear membership is expanding continually, and now includes 50 direct clearing members from North America, Europe and Asia. In addition, we recently extended this capability to include an FCM clearing service for US end users, and have since successfully cleared our first trades under the FCM structure. Firms that do not meet our direct membership criteria, or do not wish to commit to the risk underwriting and default management responsibilities, are thus able to access the clearinghouse under the full protections of the well-proven FCM structure.

We are open to keeping our SwapClear admission criteria under constant review and to materially modifying the current entry requirements for members. Provided that potential members prove they have the required risk underwriting and default management capabilities and commit to full participation in both, we will welcome their entry.

Futurization of Swaps

The Group has a number of concerns regarding the apparent "futurization" of Swaps in the provisions set out by the CFTC in its Risk Management Requirements Rules for DCOs[11] and other proposed rulemakings.

Among other requirements, the CFTC proposes that DCOs use a margining methodology that is ill-suited and inefficient for swaps clearing. Again there has been no evidence of such requirements in Europe.

In this regard we would respectfully point to the recent report from CPSS-IOSCO. This explicitly recognizes that swaps have unique characteristics, which may require clearinghouses to employ different risk management methods than they would for futures or cash instruments.

The CPSS-IOSCO report said:

> *"In addition to typical risk-management tools used by CCPs in listed markets, CCPs in OTC derivatives markets may employ other risk-management processes designed for the unique risks of the cleared OTC derivatives product. Participant requirements, margin requirements, financial resources and default procedures are particular areas where a CCP may need to consider additional tools tailored for OTC derivatives markets."*

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[11] RIN 3038-AC98 Risk Management Requirements for Derivatives Clearing Organizations, 21 January 2011.

Protection of Cleared Swaps

The CFTC recently sought comment[12] through an Advanced Notice of Proposed Rulemaking ("ANPR") on the most appropriate customer protection regime for cleared swaps. In our view the introduction of a customer protection model that insulates clients from such fellow-customer risk would best uphold one of the key aims of the Act – that of protecting consumers. It would also ensure that the protections and safeguards afforded to the US client base are at least as strong as those that will be offered to customers in Europe, as required under EMIR[13].

In the ANPR consultation the CFTC asked respondents which of four client protection models would be most appropriate for customers clearing swaps[14]. As LCH.Clearnet stated in its response to the ANPR[15], we believe that customers should above all be able to preserve the collateral protections they are offered in the bilateral uncleared swaps environment.

Under current bilateral swaps market practice, some clients are able to negotiate for individual segregation of collateral that they post as margins. The collateral posted by clients that have made such arrangements, although subject to other risks, is not subject to the risk of the default of other market participants that have entered into transactions with their swaps counterparts. These clients – many of them pension funds, long-term savings institutions, Government and related fiscal authorities and other real money investors – believe it is inappropriate that they should be subject to an additional risk (that of fellow-customers) when clearing their swaps positions.

At the specific request of customers in Europe, LCH.Clearnet has developed a client clearing model that protects non-defaulting clients from the risks of defaulting clients. We believe that this client-clearing model is closely aligned to one of the models proposed by the Commission in its ANPR, Option 2, or "Legal Segregation with Commingling".

This model improves on the protections afforded in the bilateral swaps marketplace, by enabling the clearinghouse to offer clients portability of swaps margin-related collateral and market risk positions in the event of a clearing member's default. It is structured so as to enable the clearinghouse to identify and cover the risks associated with an individual customer's portfolio as if the clearinghouse were required to take on its management in isolation, as could happen in the event of a member default. This construct also enables the clearinghouse to monitor client profiles individually and to maximize the likelihood of the transfer of such clients' risks and positions in the event of their clearing member(s) defaulting.

Having implemented the above outlined model in Europe, the Group is confident that it gives rise to no further costs than the CFTC's other proposed models, either at the clearinghouse or at the clearing member level.

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12 RIN 3038–AD99 Protection of Cleared Swaps Customers Before and after Commodity Broker Bankruptcies, 2 December 2010

13 http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf, Article 37.

14 Option (1) Full Physical Segregation; Option (2) Legal Segregation with Commingling; Option (3) Moving Customers to the Back of the Waterfall; Option (4) Baseline Model.

15 http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27157&SearchText=

Further, LCH.Clearnet can confirm that the implementation of this clearing model has not changed the structure of resources that protect the clearinghouse following a default; it has not required an increase in margin collateral levels, nor has it caused the clearinghouse to raise clearing member contributions to the default fund.

LCH.Clearnet looks forward to extending its existing SwapClear client clearing service to US end users under the well-proven FCM structure. At the same time, we believe that the important client protection mechanisms outlined above and described the CFTC in its ANPR under "Option 2, Legal Segregation with Comingling' would best preserve the interests of the investors and other clients clearing swaps through FCMs. The introduction of such client-level protections would also, we believe, ensure closer harmonization with those protections afforded in Europe.

Conclusion

As stated at the start of this testimony, LCH.Clearnet is supportive of the goals of the Dodd-Frank Act. We also believe that the CFTC and SEC have approached the rulemaking process with care and thoroughness, and commend the Commissioners and staff for their hard work.

We applaud the Agencies for their engagement with the industry and with authorities in the EU and further afield. Nonetheless, we do believe that it would be helpful to reconcile the differences between the US and EU proposals, particularly with regard to: mitigation of conflicts of interest; risk management requirements; and the protection of cleared swaps, all of which we have outlined in this testimony.

We would respectfully urge the Committee to ensure that the final rules promulgated by the Agencies are aligned as closely as possible with those being finalized in the EU. Such a commonality of approach should reduce the cost of business, the tendency for regulatory arbitrage and the likelihood of flight of capital.

LCH.Clearnet looks forward to fulfilling its role in support of this important statutory initiative and to growing our US operations so that more US end users can benefit from the risk mitigation provided through our clearing services.

In closing, LCH.Clearnet would like to thank the Committee for inviting us to discuss the new derivatives regulatory framework. We appreciate the opportunity and the Committee's interest in our concerns.