

16 August 2010

**Response by LCH.Clearnet Group Limited  
to the Committee of European Securities Regulators Consultation on  
Standardisation and Exchange Trading of OTC Derivatives**

***LCH.Clearnet Group  
is registered in England as a private company limited by shares  
Company No. 4743602***

**Introductory comments**

LCH.Clearnet Group Limited welcomes the opportunity to respond to the Consultation Paper published by the Committee of European Securities Regulators (CESR) on 19 July 2010 addressing standardisation and exchange trading of OTC derivatives.

LCH.Clearnet Group Limited is a private company, limited by shares and registered in the United Kingdom. It is a holding company created as part of a merger in December 2003 to oversee the two wholly-owned operating subsidiaries of the Group, LCH.Clearnet Limited (formerly The London Clearing House Limited) and Banque Centrale de Compensation SA (which trades under the name of LCH.Clearnet SA and which became an independent legal entity at the time of the merger, having previously been part of the Euronext group of companies).

The Group owns Europe's leading CCP services, which have over 120 years' experience in clearing derivatives. The two operating entities have led many innovations in clearing and risk management techniques over that time. The robustness of their procedures was demonstrated in the successful management of the Lehman default in September 2008 where they successfully transferred or liquidated positions in a range of asset classes – cash equities, bonds and repos, exchange-traded financial and commodity derivatives with a nominal amount of \$1 trillion together with a nominal amount \$9 trillion in interest rate swaps – without loss to other clearing members.

**1 Do you agree with CESR's assessment of the degree of standardisation of OTC derivatives? Is there any other element that CESR should take into account?**

We generally agree with CESR's assessment, however we have a few additional observations that we would hope the Committee could take into consideration.

**1.1 LCH.Clearnet Ltd is the global leader in interest rate swap clearing, with one third of the IRS market and USD229 trillion in notional trades outstanding. Our service caters to the lack of homogeneity in the OTC marketplace and is highly flexible; as such it allows participants to submit tailored trades, customised to their particular requirements.**

All these trades must: be submitted to us via the same standardised messaging service; be subject to the same sets of definitions and legal master agreements; and be susceptible to our default management process. In many other respects they are not fully 'standardised'. Indeed, on a review of our portfolio of 720,000 cleared swaps trades in December 2009, we found that 94 per cent of the trades were not homogeneous. Notwithstanding the heterogeneous character of the cleared swap portfolio, the submitted trades are still susceptible to highly efficient 'tear-up' processes such as that operated by TriOptima's TriReduce. Indeed on the last such run in August 2010, over 60,000 sides (30,000 trades), representing USD6 trillion in notional risk exposure, were eliminated from the system.

Although we do not operate any sort of trading facility, we accept OTC IRS trades from a number of fully automated trading venues that also allow for a significant degree of customisation.

LCH.Clearnet SA launched a credit default swap clearing service in March 2010 which operates on similar lines to the interest rate swap clearing service outlined above.

**1.2 In relation to the table printed under paragraph 41, we were not aware of any CCP that cleared either Forward Rate Agreements or Caps and Floors (although it is our intent to begin clearing some FRAs in the fourth quarter of this year and we are currently undertaking a study on the feasibility of introducing Swaptions).**

We would also observe that whilst the table says that "interest rate swaps and overnight indexed swaps are cleared", in fact not all currencies and tenors are yet cleared. The LCH.Clearnet group, which offers the broadest range of cleared OTC interest rate products globally, and which is continually expanding its range of cleared products, currently clears IRS in 14 currencies and OIS in four currencies. For further detail on the tenors and currencies cleared we would direct you to the details on our website at:

[http://www.lchclearnet.com/swaps/swapclear\\_for\\_clearing\\_members/products.asp](http://www.lchclearnet.com/swaps/swapclear_for_clearing_members/products.asp)

**2 Do you agree with the benefits and limitations of standardisation noted above? Please specify. Can you also describe and where possible quantify the potential impact of the limitations to standardisation? Are there any other elements that should be considered?**

**2.1 Broadly speaking we agree with the benefits listed in the consultation paper. We would however point that, at least from a clearing perspective, only a certain degree of standardisation is necessary.**

**2.2 We would stress that any regulatory effort to increase standardisation should be very granular in approach, such that the each market and each product type be considered individually.**

**2.3 Finally we would point out that the comment in 40.1 that says "*the drive to greater standardisation should be balanced with the need to preserve the ability of non-financial institutions to use OTC derivatives to hedge their risks*" might more helpfully be extended to cover all market participants.**

**3 Do you agree that greater standardisation is desirable? What should the goal of standardisation be?**

- 3.1 LCH.Clearnet Group's primary interest is in being able to safely and prudently clear OTC derivatives in such a way that does not dilute the strengths of the safeguards offered, damage liquidity or otherwise negatively impact on the market in question.

We understand that the Committee's overriding aim is to reduce systemic risk, and in light of this we would suggest that the more immediate 'goal' should be to encourage the usage and development of prudent, robust clearing services. For this reason we believe that efforts should be focused on eliminating barriers to clearing (see 5.3), rather than on standardisation per se.

- 3.2 When considering whether or not we can clear an instrument we necessarily have regard to standardisation – however the 'standardised' elements we require in order to clear a product will differ in each case. As far as we can generalise on the standardisation front, what we consistently require is that products within any given class: a) can be managed in a default situation; b) are submitted to us in a standardised messaging format; and c) are defined by and subject to the same standard definitions and governing terms and conditions.
- 3.3 Taking a wider perspective, we would observe that the operational ease and economies of scale that can be derived from standardised methods of trading, processing or documentation are very compelling. Further that where instruments and or markets are standardised, comparisons (whether of price, risk or otherwise) are facilitated. Nonetheless LCH.Clearnet Group is not certain that "standardisation for standardisation's sake" will deliver such benefits as would necessarily outweigh the resultant costs and or potentially adverse impact on markets or users. Nor, as stated earlier, is full standardisation always a precondition for clearing.

**4 How can the industry and regulators continue to work together to build on existing initiatives and accelerate their impact?**

- 4.4 LCH.Clearnet Group would observe that market participants, infrastructures and regulators have worked well both together and independently in some key areas to create and build on OTC derivatives initiatives.

The Group has worked with various groups of market participants to design and develop OTC clearing services, including: Credit Derivative, Repo (or Repurchase Agreement) and Interest Rate Swap facilities. In all cases we have successfully developed the clearing facilities and attracted a large amount of business into clearing, without any particular legislative obligation. In the case of Repo the introduction of clearing helped propel the take-up of electronic trading and accelerate the adoption of standardised legal agreements, whilst in the Interest Rate Swap market our initiative accompanied a twin move to electronic trade capture and confirmation. We expect that over time the usage of the recently launched credit derivative clearing service will have similarly beneficial effects on market practices.

We believe efforts such as these should be encouraged and supported by regulators, perhaps in conjunction with "carrot and stick" approaches such as reduced capital charges for OTC derivatives that are cleared within robust, regulated CCPs.

**5 Are there any obstacles to standardisation that could be removed by regulatory action? Please elaborate.**

The below listed observations are perhaps not so pertinent to standardisation as to the provision of clearing services, but we believe they deserve mention here since they are of paramount importance in any consideration of obstacles and barriers:

- 5.1 With regard to the global, cross border nature of these markets we would point out that conflicting regulatory or legislative requirements can significantly complicate the provision and adoption of

clearing services. Compliance costs can also be very significant, particularly where no effective information sharing and or mutual recognition arrangements are in place between supervisors.

For this reason we would encourage the Committee to initiate (where it can) the maximum possible cooperation with authorities outside the member states such that exemptive regulatory relief may be granted where appropriate and mutual recognition arrangements instated.

- 5.2 Whereas LCH.Clearnet Group understands that this comment goes beyond the scope of this consultation, we would observe that legal, accounting and fiscal differences between jurisdictions can preclude the evolution and or adoption of standardised trade, confirmation and clearing processes. On a related matter, we would highlight the fact that the introduction of a standardised clearing offering in the European OTC equity derivatives landscape, would be challenged by the differing corporate action processes followed in individual member states.
- 5.3 On a more specific note, one of the most significant barriers we have encountered is in intellectual property rights. On more than one occasion we have sought to license market benchmarks (such as equity indices), but have been prevented from doing so, either by the pre-existence of exclusive licensing arrangements, or by the outright refusal of the owners of the intellectual property rights to engage in discussions of commercial terms.

This issue is particularly pertinent to this Consultation because the majority of trades in all OTC derivatives markets (with the notable exception of foreign exchange) are linked or referenced to indexes or benchmarks, all of which are subject to IP rights, and many of which are licensed only on a restrictive basis. It is axiomatic therefore that access to benchmarks must be taken into any consideration of any form of standardisation. Further, we would suggest that regulators and legislators (and, where relevant, central banks) urgently look to impose a requirement on benchmark providers such that they are obliged to license their products on an open and non-exclusive basis. They should be required to license their products on an unbundled basis and at a comparable per unit cost, such that new market entrants are not priced out of delivering a competing or complementary service to that of the index owner, owners or their existing licensors.

- 6 Should regulators prioritise focus on a) a certain element of standardisation and/or b) a certain asset class? Please provide supporting rationale.**

NA – see Paragraph (3) above.

- 7 CESR is exploring recommending to the European Commission the mandatory use of electronic confirmation systems. What are the one-off and ongoing costs of such a proposal? Please quantify your cost estimate.**

LCH.Clearnet Group cannot estimate the one-off or ongoing costs of such a proposal, but believes that mandatory usage of electronic confirmation systems across all products and participants would ill-serve the markets. Such a requirement could: hamper the innovation; restrict the ability of market participants to trade tailored and customised products; and prove prohibitively expensive for an occasional user, thereby potentially discouraging such derivatives users from engaging in prudent risk management.

- 8 Do you agree with the assessment done by CESR on the benefits and limitations of exchange trading of OTC derivatives? Should any other parameters be taken into account?**

The LCH.Clearnet group provides clearing services in conjunction with a range of different execution venues, including: interdealer brokers, electronic trading platforms, exchanges and MTFs. We also clear bilaterally negotiated instruments that are traded directly between participants on the telephone or through messaging facilities.

We are not sure that any particular one of these modes of execution is more likely to reduce the systemic risk arising from trading in the OTC marketplace at all times than any other. We therefore believe that the Committee should give due consideration to the benefits and limitations of all these different modes of execution and that any requirements imposed should allow for the maximum amount of flexibility, such that market participants are able to select the most suitable execution vehicle on a trade-by-trade basis.

**9 Which sectors of the market would benefit from/ be suitable for (more) exchange trading?**

As noted above LCH.Clearnet Group is venue-agnostic, in that it accepts trades from many different types of venue. There are many efficiencies to be gained from exchange trading (in the strictest sense) as well as from electronic execution more generally. These modes of execution should therefore continue to be encouraged *where appropriate*. Notwithstanding this, the benefits and efficiencies that can be derived by such forms of execution cannot be evidenced in all instruments or market segments; nor do they accrue to all participants at all times. Any consideration of the related benefits would therefore necessarily have to be very granular, and any subsequent regulatory requirements specific in scope and flexible in application. Given that there are already multiple providers in both exchange trading and in electronic execution, and that there tends to be a natural gravitation towards the most attractive, appropriate and efficient mode of execution, we are not sure that regulatory action need be considered in this area.

We believe that in order to reduce systemic risk, effort might better perhaps be focused on encouraging CCP clearing where appropriate as well as on the points raised in (5.3).

**10 In your view, for which sectors of the market will increased transparency associated with exchange trading increase liquidity and for which sectors will it decrease liquidity? Please specify.**

As a general observation we would note that 'lumpy' markets in which trades are executed in large size; in which trading is sporadic, or particularly customised (and thereby trading patterns or market participants readily identifiable) would be more likely to suffer from a fall-off in liquidity.

**11 Do you identify any other elements that would prevent additional OTC derivatives to be traded on organised platforms?**

As mentioned earlier, execution is not a direct concern for LCH.Clearnet Group unless it restricts the amount of business that can be cleared or causes liquidity to evaporate in markets that are already cleared. In this regard we would observe that the licensing restrictions we mentioned in (5.3) would also likely apply to exchanges or electronic execution venues seeking to offer trading in benchmark-linked products. We would therefore encourage the Committee to give wider consideration to the point raised in (5.3).

**12 How should the level of liquidity necessary/relevant to exchange trading be measured? NA.**

**13 Do you agree with CESR's assessment of the characteristics and level of standardisation which are needed for a contract to be traded on an organised trading platform? NA.**

**14 Is the availability of CCP clearing an essential pre-determining factor for a derivative contract to be traded on an organised trading platform? Please provide supporting rationale.**

Where a CCP can prudently and economically offer a clearing service to an electronic execution venue, it will typically deliver substantial benefits and efficiencies. Nonetheless it is not true to say that clearing is a pre-condition for trading on an organised trading platform – indeed, the

introduction of exchange traded derivatives pre-dated the introduction of clearing services in several cases. Even today there are many instances in which it is feasible to electronically execute a product, but impossible to clear it economically or prudently. The Committee might therefore give regard in its consideration of this issue as to whether partial clearing (or bilateral clearing, whereby a central infrastructure manages collateral flows, but does not act as a trade guarantor) might also be encouraged.

**15 Is contract fungibility necessary in order for a derivative contract to be traded on an organised trading platform? Please provide supporting rationale.**

- 15.1 We do not believe that fungibility is an essential pre-condition for organised execution, any more than full cross-market fungibility is a pre-condition for clearing. This said, where full fungibility *is* possible (for instance between listed derivatives products and OTC “lookalikes”) and/or where the same product can be traded on two or more execution venues, but cleared within the same CCP, we believe it should be encouraged.

Where full fungibility is difficult or impossible to accommodate, but a clearing house is instead able to offer risk offsets between economically equivalent positions (i.e. by margining the net risk exposure), we believe that it should also be encouraged to do so.

**16-28 Which derivative contracts which are currently traded OTC could be traded on an organised trading platform? Please provide supporting rationale.**

Questions 16-28 do not concern clearing houses directly, therefore LCH.Clearnet Group has instead made a summary response.

- 16.1 As the owner of two OTC derivatives clearing houses managing a large amount of OTC risk, LCH.Clearnet Group would encourage the Committee to give very considerable care prior to the imposition of any execution, transparency or trade reporting requirements that might adversely impact on market liquidity.
- 16.2 As a global provider we would urge the Committee to give due consideration to regulatory and legislative developments in other jurisdictions such that there be minimal scope for regulatory arbitrage and the maximum of global co-ordination.
- 16.3 Giving regard to the very dissimilar nature of the instruments considered under MiFID and those being considered here, as well as the different types of actors in these markets, we would suggest that the Committee might consider whether MiFID is the most appropriate vehicle through which to impose regulation on the OTC derivatives markets.