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KATTEN MUCHIN & ZAVIS

LOS ANGELES, CA
NEW YORK, NY
WASHINGTON, D.C.

525 WEST MONROE STREET • SUITE 1600
CHICAGO, ILLINOIS 60661-3693

TELEPHONE
(312) 902-5200
TELECOPIER
(312) 902-1061

WRITER'S DIRECT DIAL NUMBER
312-902-5241
AHAHN@KMZ.com

COMMENT

October 9, 1998

VIA FACSIMILE AND FEDERAL EXPRESS

Mr. I. Michael Greenberger
Director
Division of Trading and Markets
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW, 4th Floor
Washington, DC 20036

Re: SwapClear Petition

Dear Mr. Greenberger:

As requested by the staff of the Division of Trading and Markets, we are writing on behalf of The London Clearing House Limited ("LCH") to provide our thoughts regarding the letters submitted to the Commodity Futures Trading Commission ("Commission") by the International Swaps and Derivatives Association, Inc. ("ISDA"), The Board of Trade of the City of Chicago ("CBOT") and The New York Mecantile Exchange ("NYMEX") in response to the Commission's request for comment on LCH's petition (the "Petition") requesting an exemption pursuant to Section 4(c) of the Commodity Exchange Act (the "Act") for forward rate agreements ("FRAs") and interest rate swap transactions cleared through its new swap clearing facility, SwapClear. (63 Fed. Reg. 36657, July 7, 1998.)

We are pleased that none of the comment letters disagree with the proposition that clearing over-the-counter ("OTC") products would be beneficial to market participants. We are also pleased that none of the comment letters take issue with LCH's specific proposals for SwapClear's design (with one minor exception expressed by NYMEX, to which we respond below). We welcome CBOT's support for OTC clearing in general, and its view that the market would greatly benefit from a clearing facility provided by LCH. (CBOT Letter at 1.) We are also gratified that NYMEX is generally of the view that SwapClear "incorporates in many respects the financial and operational safeguards that NYMEX believes should be inherent in any prudently managed clearing facility." (NYMEX Letter at 1.)

We note at the outset that the comment letters focus almost entirely on questions concerning (1) the extent of the Commission's jurisdiction over swap agreements under the Act, and (2) the administrative procedures to be applied to the granting of LCH's request for exemptive relief. LCH thus finds itself caught in the cross-fire between those that believe the CFTC has no jurisdiction over OTC derivatives (and, therefore, that CFTC consideration of the Petition is unnecessary) and those that would hold the Commission's approval of the Petition hostage to various self-serving agendas. Our detailed response to the issues raised in the comment letters is set forth below.

ISDA's Comment Letter

ISDA believes that the Petition is unnecessary because, in its view, "the Commission has no jurisdiction" over the clearing of privately-negotiated swaps. (ISDA Letter at 1.) However, given the prior statements of the Commission in the adopting release of its Part 35 swaps safe harbor regarding the inapplicability of such safe harbor to cleared swaps (58 Fed. Reg. 5587, 5591, January 22, 1993) and the Commission's recent reiteration that "Clearing of swaps is not permitted under Part 35" (63 Fed. Reg. 26114, 26122, May 12, 1998), LCH considered it desirable to file its petition in order to obtain a greater degree of legal clarity regarding the regulatory status of swap agreements cleared through SwapClear.

At the same time, because LCH was, and continues to be, acutely sensitive to the jurisdictional concerns of swap market participants, its submission of the Petition was predicated upon LCH's understanding that in acting upon the petition the Commission would not be required to make a determination that swap agreements cleared through SwapClear are subject to the provisions of the Act. (Petition at 2. See also, Letter of I.Michael Greenberger, Director, Division of Trading and Markets, to Arthur W. Hahn, June 22, 1998.) Accordingly, LCH agrees with ISDA that "the Commission could grant an exemption under Section 4(c) of the [Act] while specifying that granting the exemption does not imply that the exempted transactions or activities are futures under the [Act]." (ISDA Letter at 2.)

LCH also shares ISDA's concern that "an exemption might contain conditions that could create greater uncertainty for cleared swaps and swaps generally." (ISDA Letter at 2.) However, as set forth in the Petition, because LCH is already subject to prudential regulation and oversight by the U.K. Financial Services Authority ("FSA"), which is recognized by the Commission as a competent foreign regulator, and because FSA is reviewing the arrangements that LCH will be making in respect of SwapClear, the Commission could reasonably conclude that it should rely upon FSA's regulatory oversight over LCH's operation of SwapClear. Thus, there would be no need for the Commission to impose duplicative regulation on LCH or SwapClear participants. Such an approach would be consistent with the recent recommendations

of the Bank for International Settlements contained in its report on OTC Derivatives Settlement Procedures and Counterparty Risk Management, which states: "Central banks and prudential supervisors of counterparties should ensure that there are no unnecessary legal or regulatory barriers to the establishment of clearing houses for OTC derivatives...it should be noted that existing and prospective clearing houses for OTC derivatives of which the study group is aware are clearing houses for exchange-traded derivatives that are already subject to prudential regulation and oversight by national authorities." (Report by the Committee on Payment and Settlement Systems, Basle, September 1998, at 7.) The adoption of such an approach by the Commission would also obviate ISDA's concern about the Commission imposing "regulatory limits without appropriate administrative procedures." (ISDA Letter at 2.)

CBOT and NYMEX Comment Letters

CBOT and NYMEX clearly feel that they have been at regulatory disadvantage with respect to certain activities that they wish to pursue (unrelated to the clearing of swaps), which has coloured many of their comments on LCH's Petition. It is not appropriate for LCH to comment on CBOT's and NYMEX' relationship with the Commission. However, we wish to make the following points regarding their comment letters as they relate to the Commission's ability to act on LCH's Petition.

The Act, Commission regulations, and the policy of the Commission are all clear that the appropriate vehicle for the consideration of exemptive relief for a swaps clearing facility is through the submission and publication of a petition for specific relief pursuant to Section 4(c) of the Act, and that it is permissible and appropriate for the Commission to grant such relief by order rather than by rulemaking. Congress provided in Section 4(c)(1) of the Act 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 application of any person*, including any board of trade...) exempt any agreement, contract or transaction...from any other provision of this Act." (Emphasis supplied.) Likewise, Commission Rule 35.2(d) contemplates particularized requests for relief from the limitation on swap clearing, providing that "any person may apply to the Commission for exemption from any provision of the Act...for other arrangements or facilities, on such terms and conditions as the Commission deems appropriate, including...the applicability of other regulatory regimes."

In explaining the applicability of Section 4(c) of the Act and Rule 35.2(d) to exemptive relief for swap clearing facilities the Commission has clearly and repeatedly taken the position that proposals for swap clearing facilities should be evaluated by the Commission in the context of specific proposals. The Commission observed that "as such mechanisms are not yet in existence, and may take many forms and raise different regulatory concerns depending upon their structure

or participants or whether another regulatory regime is applicable, the Commission will consider the terms and conditions of such an exemption from swap clearing houses in the context of specific proposals from exchanges, other regulators or others." (58 Fed. Reg. 5587,5591, January 22, 1993.) The Commission stated further that "[t]o the extent that market participants wish to use or establish...clearing systems involving mutualized risk or multiparty netting of payment obligations, the Commission will evaluate the terms and conditions, if any, that would be appropriate under Section 4(c) of the Act in connection with any request for exemptive relief involving such a facility." (58 Fed. Reg. 5587,5593, January 22, 1993.) Likewise, in its 1993 Report to Congress the CFTC stated that "the regulatory issues presented by such a [swap clearing] facility would depend materially upon the facility's design, such as for example, the extent to which the construction of such facility is consistent with the minimum standards for netting systems recommended by the...Lamfalussy Report. *Therefore, swap clearing mechanisms would be most appropriately evaluated in the context of specific proposals.*" (OTC Derivative Markets and Their Regulation, October 25, 1993, at 136-7, emphasis supplied.)

In submitting a petition for exemption of swap agreements cleared through SwapClear pursuant to Section 4(c) LCH has done exactly what Congress, Commission regulations, and Commission policy contemplated and required. In its petition LCH thoroughly explained how its SwapClear proposal meets the standards for relief enumerated in Section 4(c) of the Act, detailing how the proposed relief would be consistent with the public interest, the prevention of fraud, the preservation of the financial integrity of the markets, and the promotion of responsible economic or financial innovation and fair competition, that the transactions covered by the exemption would be entered into solely between appropriate persons, and that there would be no material adverse effect on the ability of the Commission or any contract market to fulfill its regulatory duties under the Act. LCH's proposals for SwapClear have been in the public domain for over a year. LCH issued a press release on July 30, 1997, which was reported in the Financial Times and other publicly available media, announcing that after the completion of its feasibility study LCH would implement a swaps clearing facility. The CFTC published LCH's petition for public comment on July 7, 1998. The extended public comment period ended on September 23, 1998. Thus, the public, including U.S. contract markets, market participants, and other regulatory authorities have already had ample opportunity to brief the Commission on issues relating to LCH's SwapClear proposal.

Notwithstanding the foregoing, CBOT states that it is "opposed to the granting of piecemeal exemption from the clearing ban imposed by the Part 35 Rules." (CBOT Letter at 1.) Similarly, NYMEX states that before ruling upon any particular petition for exemption for the purpose of clearing swaps, the CFTC should first publish for public comment proposed standards for all prospective entities that might petition for such an exemption. (NYMEX Letter at 1.) The position advocated by CBOT and NYMEX is inconsistent with the policy and procedures

enunciated by the Act, Commission rule and prior Commission statements. Additionally, the NYMEX and CBOT positions are not supported by any valid public policy concerns.

There are a number of reasons why granting the SwapClear exemption on the basis of its Section 4(c) Petition is reasonable and desirable. First, as the Commission has previously recognized, it makes good sense to review proposals for clearing individually because the regulatory issues involved will depend materially on the design of the facility, the nature of the market being served and the type of participants in such facility (please see the discussion of appropriate participants on page 6 below). For example, the issues surrounding a clearing facility for interest rate swaps may differ from the issues relating to a facility for energy. or other commodity swaps. Additionally, the approach that LCH has taken to managing its risks may not be the only way to structure a swaps clearing facility. However, other approaches may raise different issues regarding the ability of a clearing house to manage its risks. As the Commission has previously recognized, such issues should not be considered in the abstract, but rather in the context of a fully developed proposal. Second, LCH is regulated by the FSA, and thus, the Commission may conclude that a Section 4(c) exemption is entirely appropriate for a swap clearing facility that is already subject to another regulatory regime without requiring the formulation of a generic set of standards for U.S-based clearing facilities. Third, as the Commission is aware, LCH's proposed SwapClear system is scheduled to go on line in 1999, thus there is an imperative business need for the LCH's petition to be dealt with expeditiously. The granting of LCH's exemption will not result in any practical disadvantage to any U.S. clearing houses that wish to offer such services, as no other U.S. clearinghouses or exchanges have, as far as we are aware, such advanced plans as LCH.

CBOT argues that in lieu of considering individual no-action requests, the Commission is currently soliciting comments on requests of foreign exchanges to place computer terminals in the U.S. through the concept release process and that Commission action without first establishing an appropriate generic regulatory framework would be at variance with this precedent. (CBOT Letter at 5.) We have two responses. First, LCH has not submitted a no-action letter, but in contrast, has submitted a Section 4(c) petition which, unlike a no-action letter, is open to public comment. Second, and in complete contrast to the foreign exchange terminal issue, no other exchanges or clearing houses are currently before the Commission proposing to establish a swaps clearing facility. Therefore, unlike the situation with the foreign exchange terminals, there is no pressing need to establish a generic regulatory framework. There is, however, an urgent need to clarify the legal status of transactions of U.S. participants that will be cleared through SwapClear.

CBOT complains that "To grant the LCH the exemptive relief it seeks in the absence of a [generic] framework would give the LCH an unwarranted competitive advantage of being first

in the Swaps-clearing market." (CBOT Letter at 3.) Any advantage that LCH may gain by being the first to offer swaps clearing will be entirely warranted because LCH has devoted significant resources to developing the SwapClear facility and submitting a Section 4(c) petition. Moreover, as set forth above, LCH's proposals have been in the public domain for over one year, accordingly, U.S. exchanges have had ample time to prepare a competitive facility. For whatever reasons CBOT and others have not chosen to do so.

CBOT also argues that "if the Commission grants the Petition it would enable...LCH to gain a nearly insurmountable lead toward a monopoly in the clearing of OTC swaps before the US based clearinghouses have an opportunity to compete." (CBOT Letter at 3.) The CBOT's fears are unwarranted. The financial markets are some of the most open and competitive markets in the world, as the recent history of the Bund contract clearly illustrates. If a U.S. clearing house implements a swaps-clearing facility that the market wishes to use, we have no doubt that it will be successful.

CBOT next asserts that "The terms of the Swaps to be cleared by the LCH will likely tend towards standardization, if only to qualify for clearing." (CBOT Letter at 4.) We disagree. As set forth clearly in the petition, LCH will only prescribe the non-economic terms of the contracts. LCH has deliberately designed SwapClear to support the clear desire of OTC market participants to retain the current non-standardized and individually negotiated nature of the OTC market.

NYMEX criticizes SwapClear's Swap Dealer admission criteria as being "unnecessarily restrictive" because LCH requires that such entities be dealers in the interbank wholesale market and excludes customers or "end-users" of such dealers. (NYMEX Letter at 7.) NYMEX then goes on to cite Shell Oil as an example of an end-user that, in NYMEX' opinion, should qualify for admission as a SwapClear Swap Dealer. (NYMEX Letter at 8, footnote 9.) While it may be the case that entities such as Shell Oil may certainly qualify as a participant in any *energy* swap clearing facility that NYMEX may wish to operate in the future, it is entirely reasonable for LCH to conclude, in its reasonable business judgement, that only wholesale interest rate swap market participants should be permitted to clear their *interest rate* swaps through SwapClear. There may very well be end-users that are "large, well-capitalized and sophisticated commercial entit[ies]", but participation in an interest rate swap clearing facility requires, in LCH's view, a level of product and market knowledge and operational capabilities that are possessed only by wholesale market participants. LCH's prudent admission criteria, which exclude retail market participants and others such as "hedge funds", are entirely appropriate in the context of an interest rate swap clearing facility. It is NYMEX' perogative to establish different admission requirements for any energy swap clearing facility that it may wish to establish and such admission standards should be the subject of individualized review by the Commission. This issue also illustrates why LCH's petition should be considered on its own merits and not in the context of a broader, generic

rulemaking process.

Finally, CBOT and NYMEX claim that "LCH-cleared Swaps will directly compete with exchange-traded products." (CBOT Letter at 4 and NYMEX Letter at 9.) We do not think that this is likely to occur for the following reasons. First, exchange-traded futures will remain the hedging vehicle of choice over FRAs and swaps. Second, as swap volumes increase, so will the need for exchange-traded futures hedges. Third, as longer-maturity swaps become more liquid, the need for longer-dated futures contracts will increase.

When LCH has surveyed banks as to why they hedge with futures rather than with FRAs the answer it has received is that futures offer price transparency, liquidity and the ability to deal in size. Generally, the standardized nature of futures contracts make them the preferred vehicle for hedging because it makes it easier to adjust such hedges over time. The transaction speed and liquidity of FRAs and swaps does not match that of exchange-traded futures contracts. None of these factors will be impacted by SwapClear, thus there does not appear to be any reason why market participants would move from exchange-traded futures contracts as their preferred hedging vehicle.

As explained in the Petition, by reducing credit and capital costs, SwapClear is likely to facilitate increased inter-bank swap trading. Banks will, therefore, have a greater need to hedge in the exchange-traded futures market. This is not a linear relationship, as banks will tend to hedge their net position rather than their gross trading, but the overall impact should be positive for exchange-traded futures. It is difficult to estimate how significant this might be, but the clear trend towards bank consolidation suggests that credit is likely to be an increasing constraint on the market without a facility such as SwapClear.

Additionally, the credit and capital costs of swap trading increase significantly beyond five years maturity and accordingly, at present, many banks do very little longer-dated business. By reducing these costs, SwapClear will make it more profitable for banks to trade further out on the yield curve, which will likely tend to increase the demand for longer-dated exchange-traded interest rate futures contracts as hedges. As discussed in the Petition, it is proposed that SwapClear will eventually handle cross-currency swaps, which are very heavy consumers of credit and capital. This may result, for the first time, in significant demand for exchange-traded currency futures for bank hedging.

Obviously, without a crystal ball it is impossible to quantify any of the above effects. Even with the benefit of hindsight it may prove difficult to disentangle the effect of SwapClear from other significant market trends such as bank mergers, the effect on capital markets of the introduction of the Euro, and the general maturing of the "plain vanilla" swaps market. However,

overall it seems reasonable to conclude that the introduction of SwapClear should be generally positive for exchange-traded futures. We also note that CBOT and NYMEX do not offer any meaningful analysis that SwapClear will compete directly with U.S. contract markets.

NYMEX, however, asserts that by offering counter-party credit enhancement to OTC derivatives, SwapClear will be competing with futures exchanges by offering a benefit that currently is available exclusively on futures exchanges, and suggests that the quid pro quo for such reduction of counterparty credit risk is acceptance of the regulatory scrutiny associated with trading on futures exchanges. (NYMEX Letter at 9.) First, LCH, as a recognized clearing house in the U.K., is subject to a regulatory scheme comparable to the regulatory system under which U.S. clearing houses operate in the U.S. Second, as set forth in the Petition, market participants do not choose between swaps and futures based upon their credit characteristics. Rather, users of the OTC swaps market enjoy the ability to customize and structure products, whereas users of futures contracts enjoy the price transparency, competitive execution, liquidity and fungibility of such exchange-traded products. Third, it does not seem appropriate that U.S. contract markets should seek to use the Commission or its regulatory process to reserve for U.S. contract markets a monopoly over counterparty credit risk reduction facilities.

In summary, the real gravamen of CBOT's and NYMEX' complaint is not with LCH's SwapClear facility, but rather stems from their perception of the Commission's level of regulation of their exchange-traded markets. With all due respect to CBOT and NYMEX, other, more appropriate forums are available to CBOT and NYMEX for addressing their grievances with the Commission. It is not reasonable to suggest that LCH's Petition should be held-up until certain exchange initiatives, such as the NYMEX' exchange for swaps proposal or CBOT's exchange of OTC agricultural options for agricultural futures proposal have been addressed by the Commission (NYMEX Letter at 10 and CBOT Letter at 4). We stand ready to provide the Commission with any further information it may require regarding the SwapClear facility and urge the Commission to act expeditiously in granting the relief requested in the Petition.

Very truly yours,

Arthur W. Hahn

Arthur W. Hahn

AWH:rjm:860951.3

cc: Chairperson Brooksley Born
Commissioner Barbara Pedersen Holum
Commissioner James E. Newsome
Commissioner David D. Spears
Commissioner John E. Tull, Jr.
David Hardy, LCH