

February 23, 2004

VIA E-MAIL AND FEDERAL EXPRESS

Ms. Jean A. Webb
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st., NW, 6th Floor
Washington, DC 20581

Re: Application for Amendment to CFTC Order Registering the London Clearing House as a Derivatives Clearing Organization

Dear Ms. Webb:

I. INTRODUCTION

On behalf of our client, LCH.Clearnet Ltd (formerly, The London Clearing House Limited) (“LCH”),¹ we hereby apply to extend the scope of LCH’s clearing activities under its status as a registered derivatives clearing organization (“DCO”) to include clearing financial futures contracts² and options on such futures contracts (collectively, “futures contracts”) traded on or subject to the rules of designated contract markets (“DCMs”), derivatives transaction execution facilities (“DTEFs”) and/or exempt boards of trade (collectively, “US Exchanges”).

LCH became registered with the Commodity Futures Trading Commission (“CFTC” or “Commission”) as a DCO pursuant to a CFTC Order dated October 29, 2001 (the “Order”) and accordingly is currently approved to clear over-the-counter (“OTC”) derivatives instruments in the US.³ This letter provides information to support LCH’s application to amend the Order to

¹ As notified to you in LCH’s letter dated December 17, 2003, and as further described below, LCH recently completed a merger with Banque Centrale de Compensation SA (“Clearnet”) pursuant to which LCH’s name changed to LCH.Clearnet Ltd.

² The term “financial futures contract” as used in this Application is meant to include futures contracts based on financial products such as debt or interest rates, exchange rates, currencies, stock indices, indices or measures of inflation or other macroeconomic indices, as opposed to contracts based on agricultural commodities, metals or energy products.

³ Specifically, pursuant to the Order, LCH has been approved to clear agreements, contracts or transactions excluded from the CEA by Section 2(c), 2(d), 2(f) or 2(g) of the CEA or Title IV of the Commodity

provide that LCH may clear futures contracts for US Exchanges in compliance with the core principles for DCOs that are enumerated in Section 5b(c)(2) of the Commodity Exchange Act (“CEA”) and Part 39 of the CFTC Regulations (the “Core Principles”). This letter supplements the information set forth in LCH’s original DCO Application to the CFTC dated August 28, 2001, and the supplemental materials and explanations related thereto and previously provided to the CFTC (the “Original Application”⁴) by specifically addressing those Core Principles that relate to LCH’s application to clear futures contracts traded on or subject to the rules of US Exchanges.

II. COMPLIANCE WITH CORE PRINCIPLES APPLICABLE TO DCOs

Core Principle A: In General

Based on LCH’s Original Application, the Commission found that LCH had demonstrated compliance with the requirements under the CEA and the Commission’s regulations thereunder applicable to it as a DCO for OTC derivatives instruments.⁵ As you are aware, LCH is a Recognised Clearing House (“RCH”) in the United Kingdom (“UK”) under the UK’s Financial Services and Markets Act 2000 and as such is approved by the UK Financial Services Authority (“FSA”) to clear futures contracts as well as securities and OTC derivatives instruments.⁶ In addition, LCH also clears “cash settled” forwards for Dutch electricity – traded OTC and registered with ENDEX, a Dutch sister company of the Dutch grid operator TENET.

Futures Modernization Act of 2000, or exempted under Section 2(h) or 4(c) of the CEA, or other over-the-counter derivative instruments (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991). In addition, the Order limits LCH’s clearing activity in the US to eligible contract participants as defined in Section 1a(12) of the CEA or eligible commercial entities as defined in Section 1a(11) of the CEA. Such limitation would not apply to LCH’s proposed clearing activities on behalf of DCMs or DTEFs, as may be applicable.

⁴ A copy of the Original Application is attached hereto as Appendix A.

⁵ See page 1 of the Order. Also, please refer to Schedule I of the Original Application, which sets forth an index listing the 14 DCO Core Principles and cross-referencing the portions of the Original Application that demonstrate compliance with such principles.

⁶ Effective February 2, 2004, LCH began to clear equity derivatives for EDX London (a majority owned subsidiary of the London Stock Exchange). Members of EDX London trade standardized and flexible futures and options contracts on indices and single stocks on linked international derivatives exchanges through a common order book. EDX London is a Recognised Investment Exchange, regulated by the FSA.

While LCH has substantial experience in clearing futures contracts,⁷ LCH initially limited its DCO application to OTC derivatives instruments pending determination of suitable generic settlement and segregation procedures and rules with respect to clearing futures contracts traded on US Exchanges. As further described below, LCH has now completed certain settlement arrangements and drafted amendments to its rules (referred to herein as the “LCH Amended Rules” and attached hereto as Appendix B), which will facilitate the expansion of its business to include the clearing and settlement of futures contracts traded on or subject to the rules of US Exchanges and encompassing participants on such US Exchanges.⁸ LCH is required to notify the FSA of proposed changes to its Default Rules at least 14 days before their introduction and, accordingly, has notified the FSA of the draft amendments to the Default Rules as set forth in Appendix B hereto. Please note that LCH does not intend to effectuate the LCH Amended Rules until such time as LCH has entered into a contractual arrangement to clear futures contracts for a US Exchange and such clearing commences. LCH will, in accordance with CFTC Reg. 39.4, file the LCH Amended Rules with the CFTC in advance of implementation.

Set forth below is a description of LCH’s ability to comply with Core Principles B, D, E, F, G, J and K as they relate to LCH’s application to clear futures contracts effected on US Exchanges. Please see the Original Application for LCH’s compliance with all other Core Principles.

Core Principle B: Financial Resources (financial, operational and managerial)

LCH maintains substantial default resources, over and above initial margin requirements, that must be met by each clearing member.⁹ As notified separately to the CFTC, the size of LCH’s Default Fund was increased significantly during the course of 2003, from approximately £340 million (approx. US\$629 million) to £583 million (approx. US\$1.076 billion) with a provision for a maximum Default Fund size of £640 million (approx. US\$1.184 billion) (using an

⁷ LCH was founded in 1888 to clear commodity contracts traded in London. Currently, LCH clears futures contracts on behalf of four UK domiciled futures exchanges – namely, The London International Financial Futures and Options Exchange (“LIFFE”), London Metal Exchange (“LME”), the International Petroleum Exchange (“IPE”), and EDX London.

⁸ The LCH General Regulations, Default Rules and Procedures are collectively referred to herein as the “LCH Rules”. At this time no amendments have been drafted to the LCH Procedures, as such procedures are sufficiently detailed for each specific exchange for which LCH clears. In the event LCH enters into a contractual arrangement to provide clearing services for futures contracts traded on a US Exchange, LCH will amend the LCH Procedures accordingly and will file such amended procedures as required.

⁹ On an annual basis LCH provides a detailed listing of its resources in the LCH Annual Reports and Accounts. LCH provided its 2002 Annual Reports and Accounts document to the CFTC under separate cover in April 2003. LCH’s 2003 Annual Reports and Accounts will be provided in the near future to the CFTC.

exchange rate of 1.85 US dollars to the British pound). Further, LCH maintains additional insurance cover of £200 million (approx. US\$370 million) as well as its own funds of £76 million (approx. US\$141 million).

LCH will require its clearing members that clear futures contracts traded on US Exchanges cleared by LCH to contribute to the Exchange Fund Amount of the Default Fund on terms substantially similar to clearing members clearing futures contracts on non-US exchanges (*i.e.*, clearing members of EDX London, IPE, LIFFE and LME) or to a new Fund Amount maintained on similar terms.¹⁰ LCH's final decision with respect to contributions to the Default Fund will depend on the product scope and size of any US Exchange cleared.

The location of LCH's operational and managerial resources will, in general, be determined based on the requirements of the US Exchange(s) for which LCH clears and the terms of each such clearing arrangement. For example, LCH is currently providing OTC clearing services for the InterContinental Exchange ("ICE"), an electronic exempt commercial market that operates almost continuously for 24 hours a day, seven days a week. LCH provides such services from its London offices, which are staffed from 6:30 am to 9:00 pm London time (12:30 am to 3:00 pm Chicago time). In addition, LCH's key staff and decision makers are on call 24 hours a day. If LCH contracts with a DCM to provide clearance and settlement services, LCH will establish and maintain a physical presence in the US with premises and specialist staff appropriate to service the business of such DCM. The specialist staff would be responsible for ensuring the day-to-day risk management and integrity of clearing and systems and appropriate interfaces with the DCM, clearing firms, settlement banks and settlement systems. LCH would expect certain functions of a policy nature to be run from London; for example, risk policies and standards (such policies and standards would be consistent, of course, with applicable CFTC Core Principles). In addition, LCH would make available to the CFTC a list of contact information for senior LCH persons who would be available and knowledgeable to address any issues with respect to LCH's US operations before, during and after US business hours.

Please note that, as notified to you in LCH's letter dated December 17, 2003, LCH's merger with Clearnet has resulted in the formation of a holding company, LCH.Clearnet Group Ltd (a company registered in England). LCH.Clearnet Group Ltd is the parent company of LCH and of LCH.Clearnet SA, a credit institution under French law which serves as the clearing house for markets operated by Euronext and for certain OTC securities transactions. As a result of the merger, LCH.Clearnet Group Ltd is owned 45.1% by users (clearing members) and 45.1% by exchanges, with the balance held by Euroclear. Euroclear is the securities settlement system and international central securities depository based in Brussels (which had acquired a share of just

¹⁰ Please see page 20 of the Original Application for a description of LCH's Default Fund and contributions thereto.

under 20% of Clearnet before its merger with LCH). Euronext remains the largest individual shareholder in LCH.Clearnet Group Ltd, with a 41.5% stake -- however, its voting rights are limited to 24.9%. LCH.Clearnet Group Ltd is committed to ensuring that all customers, whether users or exchanges, are treated fairly and neutrally and has introduced various governance mechanisms to that end.

The 19 member Board of Directors of LCH.Clearnet Group Ltd is comprised of three independents (one of whom is chairman), two executive representatives, eight user (clearing member) representatives, five exchange representatives and one representative of Euroclear. Also, after the merger, the Board of LCH is now comprised of four independent directors (including the chairman), the LCH.Clearnet Group Ltd Chief Executive Officer, the LCH.Clearnet Group Ltd Deputy Chief Executive Officer and the LCH Chief Executive Officer. Because the Board of LCH, as distinct from the Board of LCH.Clearnet Group Ltd, no longer has direct user (clearing member) representation, a user advisory group is being established.

LCH has retained its audit and risk committees. The audit committee, however, has become an entirely independent non-executive committee. The risk committee has maintained its majority user (clearing member) composition, but, is now chaired by an independent non-executive. Other than the aforementioned new composition of the audit and risk committees as a result of the Clearnet merger, these committees continue to oversee membership, risk policies and finances and operational risk controls, respectively. While the risk committee is charged with reviewing current and determining new risk policies, we note that the LCH executive (formally the Chief Executive Officer) retains responsibility for all day-to-day margining decisions, default declaration and default handling, in order to ensure speed of action and the avoidance of potential conflicts of interest.

Core Principle D: Risk Management

While, for all substantive purposes, the risk management policies and procedures discussed in the Original Application continue to apply, LCH will shortly introduce a new intra-day margining policy for the exchange-traded futures (and options thereon) and ICE contracts that it clears. The new policy is based on full re-valuation and re-calculation of initial margin requirements in respect of all registered contracts, including contracts entered into on the day of the call. The new intra-day margin policy provides for a routine call to clearing members in the middle of the day to collect additional margin liabilities above a *de minimis* value of £10,000 (US\$18,500). LCH will apply the same intra-day margin policy to the clearing of a US Exchange. As is typical of intra-day margining in the US, LCH will not pay out to firms any intra-day profits (*i.e.*, profits from mark-to-market movements). Rather, LCH will net intra-day profits against increases in initial margin, thus reducing the size of the potential intra-day call.

Core Principle E: Settlement Procedures

With respect to its US clearing activities, LCH has entered into agreements with certain US settlement banks,¹¹ which agreements are substantially similar to the London based Protected Payments System (“PPS”) arrangement.¹² LCH will initially use those arrangements exclusively in connection with its current RCH and DCO clearing. In respect of clearing for US Exchanges, the arrangement will relate to cash margin payments, cash settlements and payments for any physical deliveries for transactions on US Exchanges. Under the PPS arrangement, the US banks will contract to make irrevocable transfers to LCH accounts upon receiving payment instructions from LCH. LCH makes payments to clearing members via the PPS arrangement, instructing transfers from LCH’s accounts to clearing members’ accounts at the US PPS banks. Attached as Appendix C hereto is a form of PPS Agreement to be entered into between LCH and each US settlement bank.

In relation to the delivery obligations in respect of any physically deliverable contracts, LCH will, as necessary, design appropriate arrangements in conjunction with each US Exchange (which arrangements will be set forth in the LCH Rules and the rules of the applicable US Exchange, as appropriate). Such deliveries may be conducted through appropriate agents in the US but, depending upon the market, LCH may participate directly in delivery activity. LCH has extensive experience in the delivery of a wide range of “physical” commodities (from “soft” and “hard” commodities¹³ to debt and equity securities). For example, LCH participates in the delivery arrangements for LIFFE’s gilt, German government bond and German Two Year treasury note futures contracts, as well as LSE equity deliveries. LCH has direct daily experience with deliveries of securities on a large scale due to its clearance of cash financial instruments (*e.g.*, bonds and equities).

¹¹ The current US PPS banks are: Bank One (operating through London), Bank of New York (New York), Citibank NA (New York), Credit Lyonnais (New York), Dresdner Bank (New York), JP Morgan Chase (New York), Harris Trust & Savings Bank (Chicago), HSBC Bank USA (New York).

¹² Please see pages 14-15 of the Original Application for a detailed description of the PPS settlement arrangements.

¹³ While this Application is initially limited to financial futures contracts (see footnote 2 above), LCH’s extensive experience with deliveries currently includes two different kinds of physical delivery for IPE physically settled contracts (gasoil and natural gas); an automated warrant-based system for LME transactions; five different kinds of physical delivery for LIFFE physically settled contracts (cocoa, coffee, sugar, wheat and barley). In addition, LCH has experience with deliveries taking place outside of the UK as the IPE gasoil deliveries are effected in the Netherlands and Belgium. With regard to Dutch electricity, although LCH is not itself directly responsible for physical delivery, it has entered into arrangements for the transfer to APX SpotMarket B.V. of open contracts at the beginning of the delivery month.

Core Principle F: Treatment of Funds

Acting in its capacity as a US DCO, LCH will comply with the provisions of CEA Section 4d and applicable CFTC Regulations promulgated thereunder relating to customer funds segregation, including CFTC Regulations 1.20, 1.25, 1.26, 1.27, 1.36 and 1.49 as set forth below and in the LCH Amended Rules attached hereto as Appendix B.

All customer funds received by LCH from a clearing member to margin or settle the trades of the clearing member's customers and all funds accruing to such customers from the positions carried by LCH for a US DCM or DTEF, as applicable, will be segregated and separately accounted for as belonging to such customers.¹⁴ LCH will not hold, use or dispose of such customer funds except as belonging to such customers. Customer segregated accounts for such US Exchange business (referred to herein as the "US Customer Accounts") will not be commingled with house accounts, customer accounts for non-US Exchange business, or accounts for which OTC derivatives instruments are cleared by LCH. Pursuant to CFTC Regulation 1.20, LCH will deposit customer funds under an account name that clearly identifies that they are customer segregated funds of clearing members. As an initial matter, LCH intends to hold customer funds in US Customer Accounts in the United States. However, LCH may, hold certain customer funds outside of the US in accordance with CFTC Regulation 1.49. Nonetheless, in compliance with CFTC Regulation 1.49(e)(1)(i), LCH will, at the close of each business day in the US hold in US Customer Accounts sufficient US dollar denominated funds in the US to meet all customer segregated US dollar obligations.¹⁵ In accordance with CFTC Regulation 1.20, depository institutions will be required to acknowledge in writing that such funds belong to customers and are being held in accordance with the CEA and CFTC Regulations.¹⁶

¹⁴ Note that an exception may be made, as allowed by CFTC Regulation 1.68, for certain customers of participants on a DTEF who have chosen to "opt out" of segregation. Also, please note that we have not included "exempt boards of trade" ("EBOT"), as such boards of trade are not required to provide for segregation of customer funds. However, if LCH were to clear for an EBOT that chooses to require segregation of customer funds, LCH would keep such funds segregated in US Customer Accounts and would not commingle such funds with house accounts, customer accounts for non-US Exchange business or accounts in which OTC derivatives instruments are cleared.

¹⁵ LCH will hold all margin collateral in respect of **non-customer** US Exchange transactions in the clearing members' LCH house accounts (which accounts and collateral may be located in both US and non-US jurisdictions).

¹⁶ Please see Exhibits A-1 and A-2 in the form of PPS Agreement set forth in Appendix C hereto for an example of the segregation letters which LCH will obtain from the US settlement banks. Further, LCH's draft amendment to LCH General Regulation 5(a) provides for the segregation of customer funds in accordance with the CEA and the applicable CFTC regulations and, accordingly, as set forth in CFTC Regulation 1.20(a), LCH will not need to provide separate segregation acknowledgement letters to its clearing members that maintain US Customer Accounts.

LCH will invest customer funds held in US Customer Accounts only in instruments permitted under CFTC Regulation 1.25, and, pursuant to CFTC Regulation 1.26, LCH will separately account for and segregate such investments as belonging to segregated futures customers.

Pursuant to CFTC Regulation 1.27, LCH will keep the following records showing separately for each clearing member from whom LCH receives documents representing investments of customer segregated funds:

- (1) the date on which such documents were received from the clearing member;
- (2) a description of such documents, including the CUSIP and ISIN numbers; and
- (3) the date on which such documents were returned by LCH to the clearing member or the details of disposition by other means.

Pursuant to CFTC Regulation 1.36, LCH will maintain records of all securities and other property held in US Customer Accounts at LCH or its custodian banks that are received from its clearing members to margin customer positions. Such records will show, separately for each clearing member, the date of receipt of such property, the identity of the depository, the date such property was returned to the clearing member or otherwise disposed of together with the facts and circumstances of such disposition including the authorization to return or dispose of such property. See Section II.G. below regarding LCH's obligations with respect to recordkeeping.

LCH will maintain deposits only with banks and custodians that meet defined credit rating standards, subject to quantitative limits also determined by ratings. Such credit rating standards and limits are set by the Board of LCH. All such depositories holding US customer segregated funds will also meet the qualification requirements set forth in CFTC Regulation 1.49(d).

Core Principle G: Default Rules and Procedures

In general, the same default protections and processes as set forth in the Original Application will continue to apply in the event of a clearing member default (see Section IV. of the Original Application). In addition, please refer to the attached reasoned memorandum of English law provided by Clifford Chance LLP, LCH's English counsel, regarding LCH's ability to "ring fence" the US Customer Accounts in the event of a default to provide for the effective segregation of the US Customer Accounts (attached hereto as Appendix D).

Core Principle J: Reporting

Although parts 15-21 of the CFTC's Regulations relate to the reporting obligations of traders, members of contract markets, FCMs, foreign brokers and contract markets, and does not directly impose any obligation on a DCO, LCH may undertake to provide its clearing members and US Exchanges serviced by LCH with certain trade and/or price information to assist them in fulfilling their regulatory reporting obligations. Again, the details regarding LCH's provision of any such services will depend on the terms of the contract between LCH as a DCO and each US Exchange. Further, LCH will make available to the CFTC upon its request information to enable the CFTC to perform properly its oversight function, including information regarding stress test results, internal governance, legal proceedings and other clearing activities.

As a "Recognised Clearing House," LCH is subject to direct supervisory oversight by the FSA and has reporting, recordkeeping and other regulatory obligations to the FSA (as set forth in the Original Application¹⁷). The FSA has the power to undertake any audit or inspection of LCH, or to instruct LCH to commission such audits or inspections by a qualified third-party and to make the findings available to the FSA. We have no reason to believe that FSA would object to the CFTC undertaking any such audit or inspection with respect to LCH's activities as a DCO. Please see Section I.B. of the Original Application for a list of the information LCH provides to the FSA (including LCH's annual audited reports and accounts and monthly management accounts). Further, we understand that the CFTC and the FSA are working on an updated information sharing agreement in order to set forth a description of their respective oversight responsibilities with respect to LCH's clearing activities.

Core Principle K: Recordkeeping

As set forth in LCH's Original Application (see Sections II.L. and VI(c)), LCH will adhere to the record retention requirements set forth in CFTC Regulation 1.31. LCH will maintain its books and records pertaining to its activities as a DCO for a US Exchange in any US office that may be established by LCH (see discussion above under Section II, Core Principle B). For example, LCH will maintain in the US its books and records pertaining to its holding and investment of customer funds in US Customer Accounts (see Section II, Core Principle F, herein). Further, LCH will permit onsite review of its records by the CFTC, the US Department of Justice or their respective representatives.

¹⁷ As noted in the December 17, 2003, letter regarding the Clearnet merger, FSA continues to be responsible for overseeing LCH's compliance with the Financial Services and Markets Act 2000. Further, as a result of the merger, LCH's parent company, LCH.Cleant Group Ltd, is subject to the consolidated supervision of the French Banking Commission.

III. UNDERTAKINGS

To our knowledge, LCH has filed all rule changes and/or provided notice to the CFTC as required pursuant to its obligations as a DCO and as required by the Order granting LCH DCO registration. For example, pursuant to the Order, LCH is required to notify the CFTC of any material modification to the operation of LCH or its clearing activities. On or about May 7, 2003, LCH provided notice to the CFTC regarding its designation as a “system” for the purposes of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (discussed more fully in such filing and in the Clifford Chance LLP memorandum of English law attached hereto as Appendix D). In addition, LCH provided notice to the CFTC in a letter dated December 17, 2003, of LCH’s change of ownership and name in connection with the Clearnet merger. Further, LCH has provided its amended rules to the CFTC when introducing new contracts for clearance (see, *e.g.*, May 29, 2003, filing with respect to ICE III Gas Basis Swaps contracts and April 9, 2002, filing with respect to West Texas Intermediate Crude Oil bullet swaps and Henry Hub Natural Gas bullet swaps). On or about September 1, 2003, LCH filed amendments to the LCH Default Rules to substantially increase the size of its Default Fund. Other than as may be described in the aforementioned notices to the CFTC, since the time of the Original Application, we believe that there has been no material change to the LCH Rules that would impact LCH’s ability to act as a DCO.

In connection with this Application for Amendment, LCH undertakes and commits to the following:

1. LCH will hold all funds held in the US Customer Accounts in accordance with Section 4d of the CEA and applicable CFTC Regulations regarding segregation of customer funds.
2. LCH reaffirms all undertakings set forth in the Original Application.

Ms. Jean Webb
February 23, 2004
Page 11

IV. CONCLUSION

This Application to amend the Order demonstrates LCH's ability to comply with the DCO core principles as they relate to the clearance of futures contracts on US Exchanges. Given (i) LCH's more than 100 years of experience in clearing futures contracts, (ii) its agreement to maintain all US Customer Accounts in accordance with the applicable CFTC segregation requirements, and (iii) the substantial default protections afforded clearing members trading on US Exchanges cleared by LCH, we respectfully request, on behalf of LCH, that the CFTC amend its Order registering LCH as a DCO to provide that LCH may clear financial futures contracts (and options thereon) traded on or subject to the rules of US Exchanges for any market participant thereof.

Should you have any questions regarding this Application to amend the Order, please feel free to contact Arthur Hahn (312-902-5241), Michael Philipp (312-902-5367) or Andrew Lamb, at LCH (+44-20-74-26-70-55; andrew.lamb@lchclearnet.com).

Very truly yours,

KATTEN MUCHIN ZAVIS ROSENMAN

Attachments

cc: David Hardy
Andrew Lamb, LCH.Clearnet Ltd
Susan Ward
Heidi Rauh, KMZR
Lynn Johansen, Clifford Chance LLP
Patrick Buckingham, Clifford Chance LLP
James Carley, Director,
CFTC Division of Clearing and Intermediary Oversight
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Eileen Donovan, Assistant Secretary to the Commission for FOI,
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