

Mr Christopher Kirkpatrick  
Commodity Futures Trading Commission  
1155 21<sup>st</sup> Street NW  
Three Lafayette Centre  
Washington DC 20581

07 September 2017

## **Major Currency Non-Deliverable Forwards**

Dear Mr Kirkpatrick,

Pursuant to CFTC §39.5(b), LCH Limited ("LCH"), a derivatives clearing organization registered with the Commodity Futures Trading Commission (the "CFTC" or "Commission"), is submitting to the CFTC, a subset of major currency pair non-deliverable foreign exchange forward ("NDF") contracts for determination of whether mandatory clearing should apply.

LCH notes that there is currently no mandate in place for any NDF contracts to be cleared.

### **Background**

LCH launched its ForexClear service in Q1-2012 with the introduction of clearing of non-deliverable foreign exchange forward contracts ("NDFs") in six emerging market ("EM") currency pairs. This was followed by another five EM currency pairs in Q3-2012 and one further EM currency pair in September 2014, bringing the total to twelve NDF EM Currency pairs able to be cleared through the ForexClear service.

As part of its NDF clearing service LCH is launching an offering to clear Major Currency NDFs in five currency pairs (EUR/USD, GBP/USD, AUD/USD, USD/CHF, USD/JPY).

Industry data sources show not only that NDF volume has been increasing recently, but that cleared volumes in the NDF market have also rapidly increased<sup>1</sup>, as a consequence of the Uncleared Margin Rules. Clearing of Major Currency NDF market is still at its infancy, however the 2016 BIS Triennial Survey shows that the Foreign Exchange ("FX") market has seen large shifts in the past three years, in terms of both participants and instruments. A key driver of change to participation in the FX market is capital constraint, which remains an industry-wide focus. FX market participants have embraced clearing in order to reduce bilateral counterparty credit risk, in turn potentially reducing capital constraints. This drive to reduce bilateral risk has led a number of market participants to request additional NDF currency pairs, specifically those more commonly traded for physical settlement.

### **Statement of ability to maintain compliance with the Core Principles**

Under CFTC Regulation 39.5(a)(1), LCH is eligible to clear these additional currency pairs, since they are within the same asset class of swaps as those already cleared by the ForexClear service.

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<sup>1</sup> ForexClear has witnessed a significant increase in its EM markets NDF volumes in the past four months, with average daily cleared notional going from ~\$4 million to ~\$40 million.

Were there to be a Commission determination that NDFs should be cleared, LCH compliance with the Core Principles for DCOs would not be impacted.

#### Factors for determination

- A. “The existence of the significant outstanding notional exposures, trading liquidity, and adequate pricing data”

No published market volumes are available for NDF contracts in these Major Currency pairs, as traditionally such contracts are executed as physically settled. Outright forward and FX Swap execution in these five currency pairs account for \$2.4 trillion of the total \$5.1 trillion daily foreign exchange market (BIS Triennial Central Bank Survey 2016<sup>2</sup>). If 5% of the current dealer to dealer physical market in these currencies moves to cleared non-deliverable contracts, ForexClear could expect daily a cleared notional increase of around \$50 billion within the first year, which is comparable with the current volumes cleared in EM NDFs.

The price data currently used in the ForexClear service is provided real-time directly by clearing members. Price data for Major Currency pairs will be sourced in the same way. Price data includes FX spot rates and swap points for specified tenors for all currency pairs.

- B. “The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded”

LCH already has a well-developed rule framework and support infrastructure for clearing NDFs. LCH will leverage this existing operational capability when extending its offering to cover Major Currency pair NDFs.

ForexClear systems have been tested to 80% above any experienced peak to date with no issues.

Further, LCH has consulted with its clearing members on the minor rule changes required in support of these new currency pair contracts. The LCH rule changes will be self-certified with the CFTC and will be made available on the LCH website.

- C. “The effect on the mitigation of system risk, taking into account the size of the market for such contract and the resources of the derivatives clearing organisation available to clear the contract”

LCH’s ForexClear service will accept trades for clearing that have a remaining maturity between 3 business days and 2 year. This is consistent with the clearing of EM NDFs and this tenor range reflects the bulk of trading activity in the Foreign Exchange NDF Market.

The addition of these five new currency pairs<sup>3</sup> does not introduce any novel risk to LCH, as the operational capability to manage the product, albeit in other currencies, is already in place. Expanding the ForexClear service offering to include a subset of Major Currency pair NDFs will allow clearing members to manage a larger portion of their risk via a CCP.

<sup>2</sup> <http://www.bis.org/publ/rpfx16.htm>

<sup>3</sup> EUR/USD, GBP/USD, AUD/USD, USD/CHF, USD/JPY

Further, the default management procedures remain consistent with existing processes, which will be extended to take account of the new currency pairs, enabling the additional currencies to be hedged alongside other currencies in the portfolios.

D. “The effect on competition, including appropriate fees and charges applied to clearing”

Major Currency pairs are traditionally physically settled. LCH will be the first CCP to offer clearing of Major Currency pairs NDF contracts, and fees will be comparable to those applied to EM NDF contracts. Fees are published at <http://www.lch.com/asset-classes/foreign-exchange/fees>

E. “The existence of reasonable legal certainty in the event of the insolvency of the relevant derivatives clearing organization or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds and property”

The level of legal certainty around the clearing of Major Currency pair NDFs is in all material aspects the same as that of the EM NDFs already clearing through the ForexClear service. LCH has obtained legal opinions which demonstrate the existence of such legal certainty in relation to the protection of customer and swap counterparty positions, funds, and property in the event of the insolvency of one or more clearing members.

In so far as legal certainty in the event of the insolvency of the DCO is concerned, LCH would be wound up under English law.

#### **Further Information 39.5(b)(iii-viii)**

Product specifications will be as per the “LCH G10 NDF Contract Templates” which will be set out in the publicly available Product Specific Contract Terms and Eligibility Criteria Manual at <http://www.lch.com/rules-regulations/rulebooks/ltd>

Participant eligibility standards for Major Currency NDFs are the same as for clearing members that clear EM NDFs. These standards are described in the publicly available LCH Rulebook.

Pricing sources models and procedures for Major Currency NDFs are the same as is in place for the currency EM NDF clearing service.

Risk management Procedures do not require any significant change. The existing ForexClear risk management framework for EM NDFs will be applied to Major Currency NDFs.

Applicable rules, manuals, policies and procedures that apply are publicly available on the LCH website at <http://www.lch.com/rules-regulations/rulebooks/ltd>

The key provisions that relate specifically to the ForexClear service are:

- General Regulations - Regulations 90 to 94
- Procedures, Section 1 - subsections 1.3.4 and 1.4.2
- Procedures, Section 2I
- Default Rules - ForexClear DMP Annex
- FCM Regulations - Regulations 49 to 51
- FCM Procedures - Section 2.2

- Product Specific Contract Terms and Eligibility Criteria Manual - Schedule 6
- FCM Product Specific Contract Terms and Eligibility Criteria Manual - Schedule 3

Minor rule changes in support of the introduction of Major Currency pair contracts will be submitted to the CFTC pursuant to §40.6(a) following a clearing member consultation period.

Notification of this submission was made to ForexClear clearing members on 23 August 2017. A copy of this notification is provided in Appendix A. Furthermore, this submission is publicly available at: <http://www.lch.com/rules-regulations/regulatory-responses>

Subject to regulatory approvals, LCH plans to launch this initiative to its ForexClear clearing members and clients on October 23, 2017.

Should you have any questions please contact me at [denise.holder@lch.com](mailto:denise.holder@lch.com)

Yours sincerely,



Denise Holder  
Regulatory Advisor, Compliance

# **LCH Rule Submission**

## **Appendix A**

### **Member Notification of Regulation 39.5(b) Submission**

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|         |   |
|---------|---|
| To      | ForexClear Clearing Members   |
| From    | David Horner, Head of Risk, Rates & FX Derivatives                              |
| Date    | 21 August 2017  |
| Subject | <b>Major Currency NDF submission for determination of clearing requirements</b> |

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Pursuant to CFTC regulation §39.5(b), LCH.Clearnet Limited (“LCH”), a derivatives clearing organization (“DCO”) registered with the Commodity Futures Trading Commission (the “CFTC”), is submitting Major Currency Non-Deliverable Forwards (NDF) for determination of whether mandatory clearing should apply.

As per CFTC regulation §39.5(b)(viii), LCH is required to notify members of its submission. This note does not constitute a notification that the products are live for clearing. A notice announcing the live date and arrangements for the formal product launch will be published separately.

Factors for determination

- A. “The existence of the significant outstanding notional exposures, trading liquidity, and adequate pricing data”

No published market volumes are available for NDF contracts in these Major Currency pairs, as traditionally such contracts are executed as physically settled. Outright forward and FX Swap execution in these five currency pairs account for \$2.4 trillion of the total \$5.1 trillion daily foreign exchange market (BIS Triennial Central Bank Survey 2016<sup>1</sup>). If 5% of the current dealer to dealer physical market in these currencies moves to cleared non-deliverable contracts, ForexClear could expect daily a cleared notional increase of around \$50 billion within the first year, which is comparable with the current volumes cleared in EM NDFs.

The price data currently used in the ForexClear service is provided real-time directly by clearing members. Price data for Major Currency pairs will be sourced in the same way. Price data includes FX spot rates and swap points for specified tenors for all currency pairs.

- B. “The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded”

LCH already has a well-developed rule framework and support infrastructure for clearing NDFs. LCH will leverage this existing operational capability when extending its offering to cover Major Currency pair NDFs.

ForexClear systems have been tested to 80% above any experienced peak to date with no issues.

Further, LCH has consulted with its clearing members on the minor rule changes required in support of these new currency pair contracts. The LCH rule changes will be self-certified with the CFTC and will be made available on the LCH website.

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<sup>1</sup> <http://www.bis.org/publ/rpfx16.htm>

- C. “The effect on the mitigation of system risk, taking into account the size of the market for such contract and the resources of the derivatives clearing organisation available to clear the contract”

LCH’s ForexClear service will accept trades for clearing that have a remaining maturity between 2 business days and 2 years. This is consistent with the clearing of EM NDFs and this tenor range reflects the bulk of trading activity in the Foreign Exchange NDF Market.

The addition of these five new currency pairs<sup>2</sup> does not introduce any novel risk to LCH, as the operational capability to manage the product, albeit in other currencies, is already in place. Expanding the ForexClear service offering to include a subset of Major Currency pair NDFs will allow clearing members to manage a larger portion of their risk via a CCP.

Further, the default management procedures remain consistent with existing processes, which will be extended to take account of the new currency pairs, enabling the additional currencies to be hedged alongside other currencies in the portfolios.

- D. “The effect on competition, including appropriate fees and charges applied to clearing”

The majority of trading in major Currency pairs is traditionally physically settled however trading in non-deliverable contracts exists and is expected to increase. Major currency cleared non-deliverable or cash settled products are already offered by at least one other CCP.

LCH fees are published at <http://www.lch.com/asset-classes/foreign-exchange/fees>.

- E. “The existence of reasonable legal certainty in the event of the insolvency of the relevant derivatives clearing organization or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds and property”

The level of legal certainty around the clearing of Major Currency pair NDFs is in all material aspects the same as that of the EM NDFs already clearing through the ForexClear service. LCH has obtained legal opinions which demonstrate the existence of such legal certainty in relation to the protection of customer and swap counterparty positions, funds, and property in the event of the insolvency of one or more clearing members.

In so far as legal certainty in the event of the insolvency of the DCO is concerned, LCH would be wound up under English law.

#### **Further Information 39.5(b)(iii-viii)**

Product specifications will be as per the “LCH G10 NDF Contract Templates” which will be set out in the publicly available Product Specific Contract Terms and Eligibility Criteria Manual at <http://www.lch.com/rules-regulations/rulebooks/ltd>

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<sup>2</sup> EUR/USD, GBP/USD, AUD/USD, USD/CHF, USD/JPY

Participant eligibility standards for Major Currency NDFs are the same as for clearing members that clear EM NDFs. These standards are described in the publicly available LCH Rulebook.

Pricing sources models and procedures for Major Currency NDFs are the same as is in place for the currency EM NDF clearing service.

Risk management Procedures do not require any significant change. The existing ForexClear risk management framework for EM NDFs will be applied to Major Currency NDFs.

Applicable rules, manuals, policies and procedures that apply are publicly available on the LCH website at <http://www.lch.com/rules-regulations/rulebooks/ltd>

The key provisions that relate specifically to the ForexClear service are:

- General Regulations - Regulations 90 to 94
- Procedures, Section 1 - subsections 1.3.4 and 1.4.2
- Procedures, Section 21
- Default Rules - ForexClear DMP Annex
- FCM Regulations - Regulations 49 to 51
- FCM Procedures - Section 2.2
- Product Specific Contract Terms and Eligibility Criteria Manual - Schedule 6
- FCM Product Specific Contract Terms and Eligibility Criteria Manual - Schedule 3

Minor rule changes in support of the introduction of Major Currency pair contracts will be submitted to the CFTC pursuant to §40.6(a) following a clearing member consultation period.

Clearing Members have been formally notified on the changes which LCH is required to make to its Rulebook.

Further information will form part of the full §39.5(b) filing which will be publically available on the LCH website.

LCH looks forward to working with Clearing Members and the CFTC in the determination of clearing requirements. Please do not hesitate to contact me regarding any questions raised by this information.

Regards

David Horner  
**Head of Risk, Rates & FX Derivatives**