



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Clearing and Risk
Division of Market Oversight

Diane Bouwmeester
General Counsel and Head of Compliance
LCH Limited
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Re: Request for Relief from Section 2(h)(8) of the Commodity Exchange Act for Swap Transactions Executed in Connection with Default Management Processes

Dear Ms. Bouwmeester:

This letter responds to the letter dated September 4, 2020 from LCH Limited (“LCH”), a Commission-registered derivatives clearing organization (“DCO”), to the Division of Market Oversight and the Division of Clearing and Risk (collectively, “Divisions”) of the Commodity Futures Trading Commission (“Commission”). In the letter, LCH requests that the Divisions confirm that they will not recommend that the Commission take enforcement action against any futures commission merchant (“FCM”) that is a clearing member of LCH (“FCM Clearing Member”) or any LCH clearing member acting at the direction of an FCM Clearing Member for, in the event of a default of an FCM Clearing Member’s customer, effecting transactions in swaps subject to the trade execution requirement under section 2(h)(8) of the Commodity Exchange Act (“CEA”) (the “Trade Execution Requirement”)¹ without executing such transactions on (i) a swap execution facility (“SEF”); (ii) a SEF that is exempt from SEF registration (“exempt SEF”); or (iii) a designated contract market (“DCM”).

Background

Based on LCH’s representations in its letter, the Divisions understand the relevant facts to be as follows:

LCH seeks relief from the Trade Execution Requirement for transactions made by or at the direction of an FCM Clearing Member while it is managing a customer default in accordance with LCH rules. In the event of a customer default, LCH rules permit an FCM Clearing Member, either on its own or through another LCH clearing member, to execute hedging or

¹ 7 U.S.C. § 2(h)(8).

liquidating transactions in order to mitigate or eliminate the risk to the FCM Clearing Member and LCH presented by the defaulted customer's portfolio.² LCH represents that some of these transactions will involve swaps subject to the Trade Execution Requirement.³

LCH represents that while an FCM Clearing Member managing a customer default may, in some circumstances, choose to execute a transaction itself or through an LCH clearing member on a SEF, exempt SEF, or DCM to manage a customer default, the requirement to do so could hinder its risk management capabilities. For example, LCH represents that executing on a SEF, exempt SEF, or DCM could prevent an FCM Clearing Member or an LCH clearing member acting at its direction from liquidating a defaulted customer's positions together as a portfolio. LCH represents that it is more efficient and effective to allow the FCM Clearing Member or LCH clearing member acting at its direction to enter into bilateral offsetting swap transactions with a counterparty willing to purchase the entire defaulted customer's portfolio, as it is unlikely that any single SEF, exempt SEF, or DCM would have sufficient liquidity in all of the implicated products. Moreover, according to LCH, only a limited number of potential non-defaulting clearing member counterparties at LCH are authorized to effect trades on any given SEF, exempt SEF, or DCM. As a result, requiring execution on a SEF, exempt SEF, or DCM could limit the number of available counterparties for particular products and hinder the FCM Clearing Member's ability to effectively manage a customer default.

Applicable Legal Requirements

The Trade Execution Requirement provides in pertinent part that “[w]ith respect to transactions involving swaps subject to the clearing requirement . . . , counterparties shall— (i) execute the transaction on a [DCM] . . . ; or (ii) execute the transaction on a [SEF] or a [SEF] that is exempt from registration” under section 5h(g) of the CEA.⁴ Regulation 37.9(a) requires

² Section 2.1.13 of the LCH FCM Procedures provides LCH's FCM Clearing Members with several options to execute offsetting transactions and effect transfers that have the net effect of liquidating or hedging the Cleared Swaps Customer's defaulted positions. For example, an FCM Clearing Member has the ability to effect an offsetting transaction through another LCH clearing member's proprietary account and then subsequently transfer the Cleared Swaps Customer's corresponding defaulted position(s) to the other clearing member. Before taking any such action, the FCM Clearing Member must have executed an agreement with the Cleared swaps Customer permitting it to take such actions in the event of a default, and the transactions must comply with applicable law, including the CEA and Commission regulations.

³ The Trade Execution Requirement does not apply to swaps that have not been “made available to trade” by a SEF or DCM. Regulations 37.10 and 38.12 specify the process through which a SEF or DCM, respectively, make a swap available to trade. For a list of swaps made available to trade, *see*

<https://www.cftc.gov/sites/default/files/idc/groups/public/@otherif/documents/file/swapsmadeavailablechart.pdf>.

⁴ 7 U.S.C. § 2(h)(8). CEA section 2(h)(8)(A)(ii) contains a typographical error that specifies CEA section 5h(f), rather than CEA section 5h(g), as the provision that allows the Commission to exempt a SEF from registration. The correct reference is to Section 5h(g) of the CEA, which provides that “[t]he Commission may exempt, conditionally or unconditionally, a [SEF] from

any transaction, except block trades, involving a swap that is subject to the Trade Execution Requirement to be executed on an order book or a request for quote system, providing enhanced pre-trade transparency in the swap market.

Section 5b(c)(2)(D) of the CEA and Regulation 39.13 require a DCO to ensure that it possesses the ability to manage the risks associated with discharging its responsibilities as a DCO through the use of appropriate tools and procedures and to limit its exposure to potential losses from defaults by its clearing members.⁵

Discussion of Request for No-Action Relief

In order to limit its exposure to potential losses from defaults by its FCM Clearing Members, LCH has implemented rules that allow an FCM Clearing Member to, in the event of a customer default, execute hedging or liquidating transactions in the defaulted customer's account itself or through another LCH clearing member. Because losses resulting from a customer default can affect the financial integrity of an FCM Clearing Member and potentially lead it to also default, an FCM Clearing Member must be able to effectively manage a customer default.

LCH represents that absent relief from the Trade Execution Requirement for FCM Clearing Members and LCH clearing members acting at their direction, an FCM Clearing Member may not be able to effectively hedge and liquidate a defaulted customer's transactions. In particular, LCH argues that liquidity in all implicated products on any single SEF, exempt SEF, or DCM may be insufficient to allow an FCM Clearing Member to perfectly offset a defaulted customer's entire portfolio. Therefore, the Divisions believe granting the requested relief will enable LCH to limit its exposure to potential losses from defaults by its FCM Clearing Members by allowing its FCM Clearing Members to limit their exposure to customer defaults.

Grant of No-Action Relief

Based on the facts presented by LCH and its representations to the Divisions as discussed above, the Divisions will not recommend that the Commission take enforcement action against any FCM Clearing Member or any LCH clearing member acting at the direction of an FCM Clearing Member for, in the event of a customer default, effecting swap transactions pursuant to LCH's default rules and procedures without executing such transactions on a SEF, exempt SEF, or DCM as required by the Trade Execution Requirement.

This relief is subject to the condition that in any future default management-related rule or policy changes LCH files with the Commission that could affect the nature or scope of this relief, LCH must identify and discuss in its rule submission any such potential effect on the relief provided in this letter.

registration under this section if the Commission finds that the facility is subject to comparable, comprehensive supervision and regulation on a consolidated basis by the Securities and Exchange Commission, a prudential regulator, or the appropriate governmental authorities in the home country of the facility.”

⁵ 7 U.S.C. § 5b(c)(2)(D); 17 CFR § 39.13(a), (f).

The position taken herein concerns enforcement action only and does not represent a legal conclusion with respect to the applicability of any provision of the CEA or the Commission's regulations. Industry participants should note that the no-action positions taken herein do not excuse affected persons from compliance with any other applicable requirements of the CEA or the Commission's regulations thereunder. In addition, the Divisions' position does not necessarily reflect the views of the Commission or any other division or office of the Commission. Because this position is based upon the representations made by LCH to the Divisions, including the representations contained in its letter dated September 4, 2020, any different, changed, or omitted material facts or circumstances may require a different conclusion or render this letter void. Finally, as with all no-action letters, the Divisions retain the authority to condition further, modify, suspend, terminate, or otherwise restrict the terms of the no-action relief provided herein, in its discretion.

If you have any questions concerning this correspondence, please contact Joe Opron, Special Counsel, Division of Clearing and Risk (jopron@cftc.gov, (312) 596-0653), Roger Smith, Associate Chief Counsel, Division of Market Oversight (rsmith@cftc.gov, (202) 418-5344), or Theodore Polley, Associate Director, Division of Clearing and Risk (tpolley@cftc.gov, (312) 596-0551).

Sincerely,

Dorothy DeWitt
Director
Division of Market Oversight

Clark Hutchison
Director
Division of Clearing and Risk