

VIA CFTC PORTAL

18 October 2016

Mr Christopher Kirkpatrick
Commodity Futures Trading Commission
115 21st Street NW
Three Lafayette Centre
Washington DC 20581

LCH.Clearnet Limited Self-Certification: Characterisation of unallocated excess as FCM's buffer

Dear Mr Kirkpatrick,

Pursuant to Commodity Futures Trading Commission (the "CFTC") Regulation §40.6(a), LCH.Clearnet Limited ("LCH"), a derivatives clearing organization registered with the CFTC, is submitting for self-certification changes to its rules to recognise unallocated excess collateral as FCM's buffer and to recognise margin posted by the FCM as FCM's buffer, subject to certain conditions.

Part I: Explanation and Analysis

LCH holds FCMs' customer funds under two models: "LSOC¹ account with excess" and "LSOC account without excess". This self certification concerns the latter model.

Under the "LSOC account without excess" model, as required by the CFTC rules, the customer's initial margin requirement determined by the DCO is subject to the customer protection rules as a "legally segregated value" ("LSV"). The DCO does not know the customer-specific attribution of any excess collateral value that arises on a cleared swap LSOC account. As a result, LCH holds such excess collateral in an unallocated excess account. Currently the LCH rules do not allow such excess to be used to cover the liabilities of any customer; the FCM must withdraw it and repost it before it can be used. This process may not complete until after the start of the US trading day, meaning that any unallocated excess is unavailable for trade registration or to cover intraday margin calls during the beginning of the trading day in Europe; as a result, FCMs may be required to provide additional funds to the DCO during that period.

¹ "Legally segregated, operationally commingled": the model required for the segregation of customer funds under Part 22 of CFTC Regulations.

To reduce the frictional costs and the operational steps involved with the withdrawal/ repost process, LCH proposes to modify its rules to allow FCMs to instruct the DCO as to the true characterisation of the unallocated excess. LCH is providing two means to facilitate this.

First, an FCM may instruct the movement of unallocated excess to its buffer account at the end of day. Such buffer would then be available for trade registration and to cover its intraday margin calls generated by any customer of that FCM.

Second, LCH proposes changes to its rules to minimise the amount of unallocated excess collateral which may be generated at the end of the day. LCH calculates intraday margin as Initial Margin; the value of intraday margin is legally segregated, as explained above. As part of the end of day process the value of intraday margin is released, becoming unallocated excess and LCH issues the variation margin calls to the FCM. However, the FCM is unable to use the unallocated excess to cover such margin calls, as noted above. Under the proposed rules, where intraday margin calls in respect to a customer (leading to changes to that customer's LSV on a given day) were in fact covered by the FCM's own funds and not by means of calls on the customer, the FCM will be able to request that such margin be recognised as its buffer in LCH's books and records at the end of the day, instead of as unallocated excess.

The changes will go live on, or after, November 3, 2016.

Part II: Description of Rule Changes

The FCM Procedures has been changed in section 4.9 (renamed as *Return and Re-Application of Unallocated Excess and Return of FCM Buffer*) to note the process and the conditions for the FCMs to request that LCH i) recognises any unallocated excess collateral as a FCM's buffer and ii) applies margin attributable to an FCM's customer account to the FCM's buffer account; in order to effect the latter request, LCH will reset the customer account's Legally Segregated Value (LSV) to the Start of Day (SOD) Value, where intraday margin calls have in fact been met by the FCM's own funds.

Importantly, the rules require the FCM to confirm that the collateral to be recognised as the FCM's buffer was not provided by the customer.

The texts of the changes to the FCM Procedures are attached hereto as **Appendix I**.

Part III: Core Principle Compliance

LCH has reviewed the changes to its rules against the Core Principles, in particular Core Principle F, and finds that these will continue to comply with all the requirements and standards therein.

Part IV: Public Information

LCH has posted a notice of pending certification with the CFTC and a copy of the submission on LCH's website at:

<http://www.lch.com/rules-regulations/proposed-rules-changes>

Part V: Opposing Views

There were no opposing views expressed to LCH by governing board or committee members, members of LCH or market participants that were not incorporated into the rule.

Certification

LCH hereby certifies to the Commodity Futures Trading Commission, pursuant to the procedures set forth in Commission Regulation § 40.6, that attached rule submission complies with the Commodity Exchange Act, as amended, and the regulations promulgated there under.

Should you have any questions please contact me at julian.oliver@lch.com .

Yours sincerely



P.P. Julian Oliver
Chief Compliance Officer
LCH.Clearnet Limited

Appendix I
FCM Procedures



**FCM PROCEDURES OF
THE CLEARING HOUSE**

LCH.CLEARNET LIMITED

Clearing Members should consult their own tax advisers before lodging Collateral with the Clearing House or submitting any tax documentation.

4.6.3 **Withholding tax – CSDs/Custodians**

CSDs/custodians may offer a recovery service for overseas taxes on government bonds. The Clearing House will assist in the recovery process and remit to FCM Clearing Members any relevant recovery in withholding tax credited to the Clearing House's account by CSDs/custodians.

In certain cases the CSDs/custodian and Clearing House will withhold tax on a coupon if the correct documentation is not lodged with the CSD/custodian and the Clearing House at the time when a coupon is due.]

4.7 **References**

These procedures should be read in conjunction with the relevant user guides and/or manuals of the relevant CSD/custodian. Please also refer to each CSD/custodian for the relevant settlement deadlines in particular those for deliveries from local markets to Clearing House accounts.

4.8 **Contingency Arrangements**

In the event of an outage of the CMS FCM Clearing Members will be able to lodge and release securities by faxed instruction to the Clearing House.

FCM Clearing Member will be notified of a CMS outage via a Member Circular that will notify FCM Clearing Members of the switch to contingency arrangements. The FCM Clearing Members should then revert to the fax forms for securities found in the appendices to this Section 4.

Normal service hours and deadlines will apply to faxed instructions.

FCM Clearing Members will be notified via Member Circular when normal service resumes.

4.9 **Return and Re-Application of Unallocated Excess and Return of FCM Buffer**

Upon the request of an FCM Clearing Member, the Clearing House shall return all or a portion of such FCM Clearing Member's available Unallocated Excess or FCM Buffer (as requested) to such FCM Clearing Member; **provided, that** (i) FCM Clearing Members are not entitled to request the return of Encumbered FCM Buffer, and (ii) the Clearing House shall not be required to return FCM Buffer if the FCM Clearing Member is a defaulter. The FCM Clearing Member's request must contain the specific details of the amount of funds requested and whether such FCM Clearing Member is requesting the return of FCM Buffer or Unallocated Excess, and any other information reasonably requested by the Clearing House. The end of day report delivered to the FCM Clearing Member by the Clearing House shall constitute conclusive evidence of the amount of any FCM Buffer or Unallocated Excess returned to such FCM Clearing Member during that day, unless the Clearing House determines such report contained an error and subsequently delivers an amended report or other notice to the FCM Clearing Member in respect of such amounts.

FCM Regulation 15 (*Margining of Swap Product Client Accounts*) contains additional provisions relating to FCM Buffer, Encumbered FCM Buffer and Unallocated Excess.

Upon written request from an FCM Clearing Member (including via email), the Clearing House will apply Margin attributable to an FCM Clearing Member's (A) Unallocated Excess Sub-Account and/or (B) FCM Client Sub-Account to its FCM Buffer Sub-Account. In requesting such transfer, the FCM Clearing Member shall be deemed to represent and warrant that such re-application of Margin: (1) is in accordance with applicable law and regulation; and (2) has been requested by an individual that is appropriately authorized to make the request. Any request from an FCM Clearing Member to re-apply Margin must (i) contain the specific details of the amount of Margin to be re-applied; (ii) only request the re-application where such re-application reflects the true characterization of the Margin held by the Clearing House (in particular, the application of Margin to the FCM Buffer Sub-Account should only be requested where the relevant Margin is the property of the FCM Clearing Member); (iii) in the case of a re-application of Margin from an FCM Client Sub-Account to an FCM Buffer Sub-Account pursuant to (B) above, request the re-application of all Margin attributed to the relevant FCM Client Sub-Account since the start of that given Business Day; and (iv) include such other information that the Clearing House may require. The re-application of Margin shall become effective from such time that the re-application is reflected in the Clearing House's books and records.

4.10 Collateral Value Reports

In accordance with FCM Regulation 15(d) (*Margining of Swap Product Client Accounts*), an FCM Clearing Member that has elected to adopt the LSOC With Excess Model is required to provide the Clearing House with an eligible CVR (Collateral Value Report as defined in the FCM Regulations) at least once per Business Day.

4.10.1 Contents of the Collateral Value Report

The CVR should contain details of the following:

- (a) **FCM Client Sub-Account Balance:** The value of Margin delivered for and on behalf of each FCM Client and its respective FCM Client Sub-Account.
- (b) **FCM Buffer:** The value of FCM Buffer lodged in the FCM Buffer Sub-Account.

All values provided in a CVR must be the post haircut value in USD (or such other currency as agreed in writing by the Clearing House).

Where the CVR does not contain information for all of the FCM Clients of an FCM Clearing Member, the Clearing House will assume that the FCM Client Sub-Account Balance for those FCM Clients that are not included have not changed from that which is reflected in its books and records (either through delivery of a previous CVR or as a result of an Assumed Allocation).