



## U.S. COMMODITY FUTURES TRADING COMMISSION

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CFTC Letter No. 13-53  
No-Action  
September 27, 2013  
Division of Market Oversight

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Ms. Anita Herrera  
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Re: No-Action Relief with Regard to Clearing Futures and Options on Futures  
Executed on Nodal Exchange

Dear Mr. Iyer and Ms. Herrera:

This is in response to your letter dated September 19, 2013 (“Letter”), to the Division of Clearing and Risk and the Division of Market Oversight (“Divisions”) of the Commodity Futures Trading Commission (“Commission”). In the Letter you request, on behalf of LCH.Clearnet Ltd (“LCH”), a derivatives clearing organization (“DCO”) registered under Section 5b of the Commodity Exchange Act (“CEA”),<sup>1</sup> and Nodal Exchange LLC (“Nodal”), a platform operating as an exempt commercial market (“ECM”) in compliance with Section 2(h)(3)-(7) of the CEA (as that provision was in effect prior to July 16, 2011),<sup>2</sup> that the Divisions confirm that they will not recommend that the Commission commence an enforcement action against (1) LCH and its clearing members, if LCH clears futures contracts and options on futures contracts listed for trading on Nodal (“Nodal Contracts”) before LCH is authorized to provide such clearing services under an amended DCO registration order, in accordance with Section 5b(a) of the CEA and Commission regulations thereunder, and (2) Nodal, if Nodal Contracts are cleared by LCH

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<sup>1</sup> 7 U.S.C. § 7a-1.

<sup>2</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) repealed Section 2(h)(3)-(7) of the CEA, under which the Commodity Futures Modernization Act (“CFMA”) established ECMs as an exempt market category, thereby eliminating the ECM status. However, Nodal has been permitted to continue operating as an ECM pursuant to a series of Commission exemptive orders and subsequent time-limited, staff no-action relief preserving that status, as further discussed below.

before it is authorized to clear such transactions, as required by Section 5(d)(11)(A) of the CEA<sup>3</sup> and Commission Regulation 38.601.<sup>4</sup> You have requested that this relief be effective until the earlier of March 31, 2014 or the date on which the Commission amends LCH's DCO registration order to permit it to clear Nodal Contracts.

### Statement of Facts

Based upon the representations made by LCH and Nodal to the Divisions, including the representations made in the Letter, we understand the relevant facts to be as follows:

LCH was the first non-U.S. clearinghouse to register as a DCO with the Commission,<sup>5</sup> and currently it operates pursuant to two DCO registration orders that were issued in 2001 and 2004.<sup>6</sup> LCH also is a Recognised Clearing House in the United Kingdom, subject to the direct supervisory oversight of the Bank of England. LCH is wholly-owned by LCH.Clearnet Group Limited ("LCH Group"), a holding company incorporated in the United Kingdom that owns two other clearinghouses: LCH.Clearnet LLC, based in the United States, and LCH.Clearnet SA, based in France. On May 1, 2013, London Stock Exchange Group plc acquired a majority stake in LCH Group.

LCH is organized around several different clearing services divided by product line. Through its SwapClear, ForexClear, EnClear, and Nodal services, LCH offers clearing services to U.S. market participants for interest rate swaps, non-deliverable forwards, freight swaps and energy contracts, respectively. These products are executed in bilateral, over-the-counter ("OTC") transactions, or are executed on markets that were previously exempt from most of the provisions of the CEA.<sup>7</sup>

Nodal has been operating as an ECM in compliance with Section 2(h)(3)-(7) of the CEA (as that provision was in effect prior to July 16, 2011). Nodal currently lists for trading financially settled power contracts that are based on locational marginal pricing (energy, loss, and congestion) or components of locational marginal pricing of electricity at hubs, zones, and

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<sup>3</sup> 7 U.S.C. § 7(d)(11)(A).

<sup>4</sup> 17 C.F.R. 38.601.

<sup>5</sup> Prior to registering as a DCO, LCH cleared products for U.S. participants pursuant to an exemptive order issued by the Commission under Section 4(c) of the CEA on March 23, 1999. *See* 64 FR 53346 (Oct. 1, 1999).

<sup>6</sup> *See* In the Matter of the Application of London Clearing House For Registration as a Derivatives Clearing Organization, Order of Registration (Oct. 29, 2001); In the Matter of the Application of LCH.Clearnet Ltd For Registration as a Derivatives Clearing Organization, Amended Order of Registration (May 11, 2004).

<sup>7</sup> The CFMA established two categories of exempt markets under the CEA: ECMs, under former Section 2(h)(3)-(7) of the CEA, and exempt boards of trade ("EBOTs"), under Section 5d of the CEA. The CFMA also permitted markets to operate pursuant to former Section 2(d)(2) of the CEA, which excluded bilateral transactions in excluded commodities from most CEA provisions ("2(d)(2) markets"). Subject to certain conditions, ECMs, EBOTs, and 2(d)(2) markets were exempt from most provisions of the CEA and were neither licensed nor registered with the Commission. *See* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

nodes in the United States and Canada, as well as a natural gas contract whose final settlement price is equal to the final settlement price for the Henry Hub Natural Gas contract listed for trading on the New York Mercantile Exchange.

LCH has cleared energy contracts executed on Nodal since 2009. On October 11, 2012, Nodal submitted an application for designation as a designated contract market (“DCM”), pursuant to Section 5(a) of the CEA<sup>8</sup> and Commission regulations thereunder. As part of its application, Nodal classified its energy contracts as futures (and options thereon). As of the date of the Letter, the Commission had not approved Nodal’s application for designation as a DCM.

In discussions with the Divisions, LCH and Nodal indicated that they intended LCH to continue to provide clearing services for Nodal Contracts after Nodal received DCM designation. The Divisions advised LCH and Nodal that LCH was not permitted under its current DCO registration orders to clear Nodal Contracts once Nodal began operating as a DCM. In response, LCH submitted a draft application for an amended DCO registration order that would permit it to clear, among other things, all futures and options on futures, including Nodal Contracts. LCH also requested that the Divisions grant the no-action relief described above, in order to permit LCH to clear Nodal Contracts until the Commission approves or denies LCH’s application for an amended DCO registration order.

#### Applicable Legal Requirements

Section 5d(11)(A) of the CEA and Commission Regulation 38.601 provide that all transactions executed through a DCM must be cleared through a registered DCO, in order to ensure the financial integrity of the transactions.<sup>9</sup> Section 5b(a) of the CEA provides that a DCO may not perform the functions of a DCO with respect to futures (and options thereon) and swaps unless the DCO is registered.<sup>10</sup> Therefore, in order for Nodal to be designated as a DCM, Nodal Contracts must be cleared through a DCO that is registered to clear such transactions.

As noted above, LCH currently operates as a registered DCO pursuant to two orders of registration. On October 29, 2001, the Commission issued LCH’s first DCO registration order (“Original Order”), which granted LCH registration as a DCO for the clearing of OTC derivatives contracts, agreements or transactions that were at the time excluded or exempt from the CEA. Specifically, the Original Order granted LCH authority to clear “OTC derivatives contracts, agreements or transactions excluded or exempt under sections 2(c), 2(d), 2(f), 2(g), 2(h) or 4(c) of the [CEA] or that are OTC derivative instruments as defined in section 408 of Federal Deposit Insurance Corporation Improvement Act of 1991 [(‘FDICIA’)].”<sup>11</sup>

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<sup>8</sup> 7 U.S.C. § 7(a).

<sup>9</sup> See *infra* n. 3, 4.

<sup>10</sup> See *infra* n. 1.

<sup>11</sup> Original Order at 1.

On May 11, 2004, the Commission issued an additional order (“Supplemental Order”) that permitted LCH “to clear certain types of futures contracts and options on such futures contracts... traded on or subject to the rules of U.S. designated contract markets... derivatives transaction execution facilities... and/or exempt boards of trade...,” subject to the limitation that “futures contracts cleared by LCH for any U.S. Market will be based on financial instruments (including securities)...”<sup>12</sup> As the Supplemental Order did not replace or supersede the Original Order, both DCO orders are still in effect and LCH currently is permitted to clear all of the products described therein.

The Dodd-Frank Act repealed the provisions of the CEA and FDICIA that established exempt market categories and that contained the definition of OTC derivative instruments, including the provisions referenced in the Original Order.<sup>13</sup> Therefore, as of July 16, 2011, the effective date of the Dodd-Frank Act,<sup>14</sup> LCH could no longer clear transactions executed on those exempt markets that had operated pursuant to those repealed provisions of the CEA and FDICIA.

However, in order to ensure that industry practices were not unduly disrupted during the transition to the Dodd-Frank Act regulatory regime, the Commission issued a series of exemptive orders (the “Exemptive Orders”) pursuant to its authority under Section 4(c) of the CEA<sup>15</sup> and Section 712(f) of the Dodd-Frank Act<sup>16</sup> that, among other things, provided exempt markets temporary relief from the effective date of the Dodd-Frank Act.<sup>17</sup> The Division of Market Oversight subsequently issued two no-action letters that provided time-limited no-action relief to those markets from December 31, 2012, the expiration date set forth in the Second Amendment to July 14, 2011 Order for Swap Regulation, to October 2, 2013.<sup>18</sup>

LCH may continue to clear Nodal Contracts under the Original Order while Nodal operates pursuant to the time-limited no-action relief.<sup>19</sup> However, from the date of Nodal’s DCM

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<sup>12</sup> See In the Matter of the Application of LCH.Clearnet Ltd For Registration as a Derivatives Clearing Organization, Amended Order of Registration (May 11, 2004) at 1-3.

<sup>13</sup> Sections 723 and 734 of the Dodd-Frank Act amended the CEA to repeal the provisions that created the various exempt market categories, and Section 740 of the Dodd-Frank Act repealed Section 408 of FDICIA, which contained the definition of “over-the-counter derivative instrument.”

<sup>14</sup> See Section 754 of the Dodd-Frank Act.

<sup>15</sup> 7 U.S.C. § 6(c).

<sup>16</sup> Section 712(f) of the Dodd-Frank Act.

<sup>17</sup> See 76 FR 42508 (Jul. 19, 2011) (“Effective Date for Swap Regulation”); 76 FR 80233 (Dec. 23, 2011) (“Amendment to July 14, 2011 Order for Swap Regulation”); 77 FR 41260 (Jul. 13, 2012) (“Second Amendment to July 14, 2011 Order for Swap Regulation”).

<sup>18</sup> See Commission No-Action Letter No. 12-48 (Dec. 11, 2012); Commission No-Action Letter No. 13-28 (June 17, 2013).

<sup>19</sup> Under the Original Order, LCH has authority to clear “OTC derivatives contracts, agreements or transactions excluded or exempt under...4(c) of the Act...” which is the section of the CEA pursuant to which the Commission issued the Exemptive Orders. See Original Order at 1.

designation, Nodal Contracts will be categorized as futures on energy products (and options thereon) executed on a DCM, which are products that LCH is not permitted to clear under the terms of either the Original Order or the Supplemental Order (which, as noted above, only permits LCH to clear futures and options on futures related to financial instruments). Nodal may operate pursuant to the time-limited no-action relief through October 2, 2013, after which Nodal may only operate as a DCM. Once Nodal is registered as a DCM, and the Nodal Contracts are categorized as futures (and options thereon) executed on a DCM, LCH will no longer be permitted to clear Nodal Contracts, absent an amendment to its DCO registration orders or no-action relief.

#### Discussion of Request for No-Action Relief

In support of your request, you have represented that LCH is, and will continue to be, compliant in all other respects with the Core Principles set forth in Section 5b of the CEA and in Part 39 of the Commission's regulations, and that LCH will continue to fulfill its obligations thereunder in accordance with its DCO registration orders. In particular, you have represented that as soon as technologically practicable on the effective date of Nodal's designation as a DCM, LCH and all of its clearing members will ensure that all funds and assets held for, or on behalf of, customer positions in Nodal Contracts will be held in segregated accounts as required by, and in accordance with, Section 4d of the CEA<sup>20</sup> and Commission regulations thereunder.

The Divisions believe that the time-limited relief sought by LCH and Nodal in this instance is appropriate, especially given that (i) the request only extends to the Nodal Contracts that LCH already clears, and (ii) LCH has submitted to the Division of Clearing and Risk a draft application for an amended DCO registration order to permit it to clear all futures and options on futures, including Nodal Contracts, and LCH has indicated that it will submit a final application soon.

#### Grant of No-Action Relief

Based on the facts presented and the representations you have made, and subject to the conditions set forth herein, the Divisions will not recommend that the Commission take enforcement action against (1) LCH and its clearing members, if LCH clears Nodal Contracts before LCH is authorized to provide such clearing services under an amended DCO registration order, in accordance with Section 5b(a) of the CEA and Commission regulations thereunder, and (2) Nodal, if Nodal Contracts are cleared by LCH before it is authorized to clear such transactions, as required by Section 5(d)(11)(A) of the CEA and Commission Regulation 38.601, subject to the following conditions:

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In addition, the Exemptive Orders provided relief, subject to certain conditions, to "agreements, contracts, and transactions, *and any person or entity offering*, entering into, or rendering advice *or rendering other services with respect to*, any such agreement, contract, or transaction... including any agreement, contract, or transaction in an exempt or excluded (but not agricultural) commodity..." (emphasis added). 77 FR 41260, 41265. LCH's clearing activities fall in the "other services" category.

<sup>20</sup> 7 U.S.C. § 6d(a).

- (1) Product Scope. This relief is limited to the Nodal Contracts currently accepted for clearing by LCH.
- (2) Participant Scope. This relief applies to current and future clearing members of LCH that clear Nodal Contracts.
- (3) Segregation. As soon as technologically practicable on the effective date of Nodal's designation as a DCM, LCH and all of its clearing members that clear Nodal Contracts must ensure that all customer positions in Nodal Contracts and related customer property are held in segregated accounts as required by, and in accordance with, Section 4d of the CEA and Commission regulations thereunder, as may be amended from time to time.
- (4) Limited Duration. This relief shall expire on the earlier of: (i) March 31, 2014 or (ii) the date upon which the Commission approves or denies LCH's application for an amended DCO registration order to permit it to clear all futures and options on futures, including Nodal Contracts.<sup>21</sup>

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. 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 and on behalf of LCH and Nodal to the Divisions, including the representations made in the Letter, it should be noted that any materially different, changed, or omitted 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.

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<sup>21</sup> Should the Commission deny LCH's application for an amended DCO registration order, the Divisions will provide LCH and its clearing members with guidance and, as appropriate, no-action relief to facilitate the orderly disposition of open positions in Nodal Contracts.

Mr. Jay Iyer  
Ms. Herrera  
September 27, 2013  
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Sincerely,

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