

13.3.3 OSC Notice and Request for Comment – LCH.Clearnet LLC – Application for Exemption from Recognition as a Clearing Agency

OSC NOTICE AND REQUEST FOR COMMENT

LCH.CLEARNET LLC

APPLICATION FOR EXEMPTION FROM RECOGNITION AS A CLEARING AGENCY

A. Background

LCH.Clearnet LLC (**LCH**) has applied (the **Application**) to the Commission for an order pursuant to section 147 of the *Securities Act* (Ontario) (**OSA**) to exempt LCH from the requirement to be recognized as a clearing agency in subsection 21.2(0.1) of the OSA. Among other factors set out in the Application, the exemption is being sought on the basis that LCH is subject to an appropriate regulatory and oversight regime in its home jurisdiction in the United States by its regulator, the Commodity Futures Trading Commission.

LCH operates a service for the clearing and settlement of a range of interest rate derivatives.

B. Proposed Regulatory Approach

In reviewing the Application, staff followed the process and assessed the Application against the criteria set out in OSC Staff Notice 24-702 *Regulatory Approach to Recognition and Exemption from Recognition of Clearing Agencies* (**Staff Notice**). As noted in the Staff Notice, we are prepared to exempt a clearing agency if it does not pose significant risk to Ontario capital markets and is subject to an appropriate regulatory and oversight regime in another jurisdiction by its home regulator(s).

In determining whether a clearing agency posed significant risk to Ontario, staff consider the level of activity of the clearing agency in Ontario (using indicators such as notional value and volume of transactions cleared for Ontario-based market participants) and other qualitative and quantitative factors, such as interconnectedness, size of obligations and the role and central importance of a clearing agency to a particular market. The existence of different regulatory regimes is acknowledged in the recent CPSS-IOSCO's Principles for financial market infrastructures that require authorities to cooperate with each other in promoting the safety and efficiency of financial market infrastructures. The proposed exemption of LCH is based on the level of risk it posed to Ontario at this time and the regulatory regime that it is currently subject to.

C. Draft Order

In the Application, LCH describes how it addresses each of the criteria set forth in the Staff Notice. Subject to comments received, staff propose to recommend to the Commission that it issue to LCH an exemption order with terms and conditions in the form of the proposed draft order (**Draft Order**).

The Draft Order requires LCH to comply with various terms and conditions, including relating to:

1. Regulation of LCH
2. Governance
3. Filing requirements
4. Information sharing
5. Submission to jurisdiction and agent for service

D. Comment Process

The Commission is publishing for public comment the Application and Draft Order. The Draft Order is published in the same edition of the OSC Bulletin as is this notice and on the OSC website. The Application can be found on the OSC website. We are seeking comment on all aspects of the Application and Draft Order.

You are asked to provide your comments in writing, via e-mail and delivered on or before March 24, 2014 addressed to the attention of the Secretary of the Commission, Ontario Securities Commission, 20 Queen Street West, 22nd floor, Toronto, Ontario, M5H 3S8, e-mail: comments@osc.gov.on.ca.

The confidentiality of submissions cannot be maintained as comments received during the comment period will be published.

Questions may be referred to:

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DRAFT ORDER

**IN THE MATTER OF
THE SECURITIES ACT,
R.S.O. 1990, CHAPTER S. 5, AS AMENDED
(THE ACT)**

AND

**IN THE MATTER OF
LCH.CLEARNET LLC (LCH)**

**ORDER
(Section 147 of the Act)**

WHEREAS LCH has filed an application (**Application**) with the Ontario Securities Commission (**Commission**) pursuant to section 147 of the Act requesting an order exempting LCH from the requirement to be recognized as a clearing agency under subsection 21.2(0.1) of the Act (**Order**);

AND WHEREAS LCH has represented to the Commission that:

1. LCH is a clearing house organized under the laws of the state of Delaware, United States (**U.S.**). LCH operates as a central counterparty (**CCP**) clearing house and receives most of its revenue from treasury income and clearing fees charged to its clearing members (**Clearing Members**);
2. LCH is wholly-owned by LCH.Clearnet (US) LLC, which is wholly-owned by LCH.Clearnet Group Ltd. (**LCH Group**). LCH Group is 57.8 per cent owned by the London Stock Exchange (C) Limited (**LSEG**), a wholly owned subsidiary of London Stock Exchange Group plc, and 42.2 per cent owned by clearing participants and exchanges;
3. LCH Group, which is incorporated in the United Kingdom, is regulated as a Compagnie financière by the Autorité de Contrôle Prudentiel et de Résolution (France);
4. LCH is a Derivatives Clearing Organization (**DCO**) within the meaning of that term under the U.S. Commodity Exchange Act (**CEA**). As a DCO, LCH is subject to regulatory supervision by the United States Commodity Futures Trading Commission (**CFTC**), a U.S. federal regulatory agency. The CFTC reviews, assesses, and enforces a DCO's adherence to the CEA and the regulations promulgated thereunder on an ongoing basis, including but not limited to, the DCO's compliance with "Core Principles" relating to financial resources, participant and product eligibility, risk management, settlement procedures, treatment of funds, default rules and procedures, rule enforcement and system safeguards. LCH is subject to ongoing examination and inspection by the CFTC;
5. LCH currently operates the SwapClear US Service which clears and settles a range of interest rate derivatives;
6. Other than with respect to certain elements of the SwapClear service operated by LCH.Clearnet Limited, a clearing agency recognised by the Commission (**Global SwapClear Service**), that are not part of the SwapClear US Service of LCH, the clearing models of the SwapClear US Service and the Global SwapClear Service are substantially similar in all material respects. One example of an element that is part of the Global SwapClear Service but not the SwapClear US Service is that the SwapClear US Service does not offer a 'principal to principal clearing model', which permits Clearing Members who are non-Futures Commission Merchants (**FCMs**) to clear trades for and on behalf of clients. Only Clearing Members who are registered with the CFTC as FCMs can clear trades for and on behalf of clients in the SwapClear US Service;
7. Transactions cleared through the SwapClear US Service are executed by parties and either cleared directly with LCH or through Clearing Members. Transactions may be executed bilaterally, on swap execution facilities or on other execution venues recognized by LCH;
8. Under LCH's regulations, there are two types of recognized participants in the SwapClear US Service, a Clearing Member and a SwapClear Dealer. An applicant must enter into a Clearing Membership Agreement with LCH before it can become a Clearing Member. The Clearing Membership Agreement contains an acknowledgement that the applicant accepts the regulations and procedures of the LCH Rulebook, which contains the operating rules of LCH;
9. A Clearing Member may clear trades originally transacted by itself (including those in the name of one of its branches, being within the same legal entity), and may also clear trades transacted by a SwapClear Dealer with whom it has entered into a SwapClear Dealer Clearing Agreement;

10. LCH acts as CCP to swap transactions registered with it by a Clearing Member or by a SwapClear Dealer. On registration of a transaction with SwapClear US, the counterparty's transactions, which can be entered by either a Clearing Member or a SwapClear Dealer, are novated to LCH;
11. LCH maintains Clearing Member criteria that all applicants must satisfy before their applications are accepted, including fitness criteria, review of corporate constitutive documentation, financial standards, operational standards, appropriate registration qualifications with applicable statutory regulatory authorities, and LCH applies a due diligence process to ensure that all applicants meet the required criteria;
12. There are no material differences in terms of membership standards and financial requirements between Ontario-resident Clearing Members and other Clearing Members;
13. LCH utilizes processes to minimize systemic risk, which processes include operational and financial criteria for all Clearing Members, margining and financial protections, the maintenance of a clearing/guarantee fund, sound information systems, comprehensive internal controls, ongoing monitoring of Clearing Members, and appropriate oversight by the LCH Board of Directors;
14. LCH does not pose a significant risk to the Ontario capital markets and is subject to an appropriate regulatory and oversight regime in a foreign jurisdiction;
15. LCH does not have any office or maintain other physical installations in Ontario or any other Canadian province or territory. LCH does not currently have any plans to open such an office or to establish any such physical installations in Ontario or elsewhere in Canada; and

AND WHEREAS LCH would like to permit Ontario-residents who meet the criteria set out in its rules to become registered as Clearing Members to clear and settle a range of interest rate derivatives, and as a result, would be considered by the Commission to be "carrying on business as a clearing agency" in Ontario. LCH cannot carry on business in Ontario as a clearing agency unless it is recognized by the Commission as a clearing agency under subsection 21.2(0.1) of the Act or exempted from such recognition under section 147 of the Act;

AND WHEREAS LCH has agreed to the respective terms and conditions as set out in Schedule "B" to this order;

AND WHEREAS based on the Application and the representations LCH has made to the Commission, the Commission has determined that LCH satisfies the criteria set out in Schedule "A" and that the granting of the Order exempting LCH from the requirement to be recognized as a clearing agency under subsection 21.2(0.1) of the Act would not be prejudicial to the public interest;

AND WHEREAS the Commission will monitor developments in international and domestic capital markets and LCH's activities on an ongoing basis to determine whether it is appropriate that LCH continue to be exempted from the requirement to be recognized as a clearing agency and, if so, whether it is appropriate to continue to be exempted subject to the terms and conditions in the Order;

IT IS HEREBY ORDERED by the Commission that, pursuant to section 147 of Act, LCH is exempt from recognition as a clearing agency under subsection 21.2(0.1) of the Act;

PROVIDED THAT LCH complies with the terms and conditions attached as hereto as Schedule "B".

DATED at Toronto, ●, 2014

SCHEDULE A

Criteria for Recognition and Exemption from Recognition by the Ontario Securities Commission as a Clearing Agency
Pursuant to Section 21.1(0.1) of the *Securities Act* (Ontario)

PART 1 GOVERNANCE

- 1.1 The governance structure and governance arrangements of the clearing agency ensures:
- (a) effective oversight of the clearing agency;
 - (b) the clearing agency's activities are in keeping with its public interest mandate;
 - (c) fair, meaningful and diverse representation on the governing body (Board) and any committees of the Board, including a reasonable proportion of independent directors;
 - (d) a proper balance among the interests of the owners and the different entities seeking access (participants) to the clearing services and facilities (clearing services) of the clearing agency;
 - (e) the clearing agency has policies and procedures to appropriately identify and manage conflicts of interest;
 - (f) each director or officer of the clearing agency, and each person or company that owns or controls, directly or indirectly, more than 10 percent of the clearing agency is a fit and proper person; and
 - (g) there are appropriate qualifications, limitation of liability and indemnity provisions for directors and officers of the clearing agency.

PART 2 FEES

- 2.1 All fees imposed by the clearing agency are equitably allocated. The fees do not have the effect of creating unreasonable barriers to access.
- 2.2 The process for setting fees is fair and appropriate, and the fee model is transparent.

PART 3 ACCESS

- 3.1 The clearing agency has appropriate written standards for access to its services.
- 3.2 The access standards and the process for obtaining, limiting and denying access are fair and transparent. A clearing agency keeps records of
- (a) each grant of access including, for each participant, the reasons for granting such access, and
 - (b) each denial or limitation of access, including the reasons for denying or limiting access to an applicant.

PART 4 RULES AND RULEMAKING

- 4.1 The clearing agency's rules are designed to govern all aspects of the clearing services offered by the clearing agency, and
- (a) are not inconsistent with securities legislation,
 - (b) do not permit unreasonable discrimination among participants, and
 - (c) do not impose any burden on competition that is not necessary or appropriate.
- 4.2 The clearing agency's rules and the process for adopting new rules or amending existing rules should be transparent to participants and the general public.
- 4.3 The clearing agency monitors participant activities to ensure compliance with the rules.
- 4.4 The rules set out appropriate sanctions in the event of non-compliance by participants.

PART 5 DUE PROCESS

- 5.1 For any decision made by the clearing agency that affects an applicant or a participant, including a decision in relation to access, the clearing agency ensures that:
- (a) an applicant or a participant is given an opportunity to be heard or make representations; and
 - (b) the clearing agency keeps a record of, gives reasons for, and provides for appeals or reviews of, its decisions.

PART 6 RISK MANAGEMENT

- 6.1 The clearing agency's clearing services are designed to minimize systemic risk.
- 6.2 The clearing agency has appropriate risk management policies and procedures and internal controls in place.
- 6.3 Without limiting the generality of the foregoing, the clearing agency's clearing or functions are designed to achieve the following objectives:
- 1. Where the clearing agency acts as a central counterparty, it rigorously controls the risks it assumes.
 - 2. The clearing agency minimizes principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.
 - 3. Final settlement occurs no later than the end of the settlement day. Intraday or real-time finality is provided where necessary to reduce risks.
 - 4. Where the clearing agency extends intraday credit to participants, including a clearing agency that operates net settlement systems, it institutes risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle.
 - 5. Assets used to settle the ultimate payment obligations arising from derivatives transactions carry little or no credit or liquidity risk. If central bank money is not used, steps are to be taken to protect participants in clearing services from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.
 - 6. If the clearing agency establishes links to settle cross-border trades, it designs and operates such links to reduce effectively the risks associated with cross-border settlements.
- 6.4 The clearing agency engaging in activities not related to clearing services carries on such activities in a manner that prevents the spillover of risk to the clearing agency that might affect its financial viability or negatively impact any of the participants in the clearing service.

PART 7 SYSTEMS AND TECHNOLOGY

- 7.1 For its clearing services systems, the clearing agency:
- (a) develops and maintains,
 - (i) reasonable business continuity and disaster recovery plans,
 - (ii) an adequate system of internal control,
 - (iii) adequate information technology general controls, including controls relating to information systems operations, information security, change management, problem management, network support, and system software support;
 - (b) on a reasonably frequent basis, and in any event, at least annually, and in a manner that is consistent with prudent business practice,
 - (i) makes reasonable current and future capacity estimates,
 - (ii) conducts capacity stress tests to determine the ability of those systems to process transactions in an accurate, timely and efficient manner,

(iii) tests its business continuity and disaster recovery plans; and

(c) promptly notifies the regulator of any material systems failures.

7.2 The clearing agency annually engages a qualified party to conduct an independent systems review and prepare a report in accordance with established audit standards regarding its compliance with section 7.1(a).

PART 8 FINANCIAL VIABILITY AND REPORTING

8.1 The clearing agency has sufficient financial resources for the proper performance of its functions and to meet its responsibilities and allocates sufficient financial and staff resources to carry out its functions as a clearing agency in a manner that is consistent with any regulatory requirements.

PART 9 OPERATIONAL RELIABILITY

9.1 The clearing agency has procedures and processes to ensure the provision of accurate and reliable settlement services to participants.

PART 10 PROTECTION OF ASSETS

10.1 The clearing agency has established accounting practices, internal controls, and safekeeping and segregation procedures to protect the assets that are held by the clearing agency.

PART 11 OUTSOURCING

11.1 Where the clearing agency has outsourced any of its key functions, it has appropriate and formal arrangements and processes in place that permit it to meet its obligations and that are in accordance with industry best practices. The outsourcing arrangement provides regulatory authorities with access to all data, information, and systems maintained by the third party service provider required for the purposes of regulatory oversight of the agency.

PART 12 INFORMATION SHARING AND REGULATORY COOPERATION

12.1 For regulatory purposes, the clearing agency cooperates by sharing information or otherwise with the Commission and its staff, self-regulatory organizations, exchanges, quotation and trade reporting systems, alternative trading systems, other clearing agencies, investor protection funds, and other appropriate regulatory bodies.

SCHEDULE "B"
TERMS and CONDITIONS

DEFINITIONS

For the purposes of this Schedule:

"Clearing Member" means a clearing member as defined under LCH rules;

"client clearing" means the ability of a Clearing Member to clear transactions at LCH for and on behalf of a client who is not a Clearing Member;

"Ontario Clearing Member" means Ontario-residents who are Clearing Members of LCH;

"rule" means any provision or other requirement in LCH's rulebook, operating manuals, user guides, or similar documents governing rights and obligations between LCH and the Clearing Members or among the Clearing Members;

Unless the context otherwise requires, other terms used in this Schedule "B" have the meanings ascribed to them in Ontario securities law (including terms defined elsewhere in this exemption order).

REGULATION OF LCH

1. LCH will maintain its registration as a DCO in the U.S. and will continue to be subject to the regulatory oversight of the CFTC.
2. LCH will continue to comply with its ongoing regulatory requirements as a DCO.
3. LCH will continue to meet the criteria for exemption from recognition as a clearing agency as set out in Schedule "A".

OWNERSHIP OF LCH

4. LCH will provide to the Commission 90 days prior, written notice and a detailed description and impact of any material change to its ownership.

GOVERNANCE

5. LCH will continue to promote a corporate governance structure that minimizes the potential for any conflicts of interest between LCH Group (and its affiliates) and LCH that could adversely affect the clearance and settlement of trades in contracts or the effectiveness of LCH's risk management policies, controls, and standards.

FILING REQUIREMENTS

Filings with the CFTC

6. LCH will promptly provide staff of the Commission the following information, and to the extent that it is required to file such information with the CFTC it will file such information concurrently with staff of the Commission:
 - (a) the annual audited financial statements of LCH;
 - (b) details of any material legal proceeding instituted against it;
 - (c) notification that LCH has failed to comply with an undisputed obligation to pay money or deliver property to a Clearing Member for a period of 30 days after receiving notice from the Clearing Member of LCH's past due obligation;
 - (d) notification that LCH has instituted a petition for a judgment of bankruptcy or insolvency or similar relief, or to wind up or liquidate LCH or has a proceeding for any such petition instituted against it;
 - (e) the appointment of a receiver or the making of any voluntary arrangement with creditors; and
 - (f) material changes to its regulations and procedures.

Prior Notification

7. LCH shall provide 60 days prior written notice and a detailed description of any new clearing service (including client clearing) to be offered to Ontario-residents;
8. LCH shall provide 45 days prior written notice and a detailed description of any material change or enhancement to the SwapClear US Service where such change is not implemented for the Global SwapClear Service. Notwithstanding the foregoing, in the event that LCH needs to implement a material change or enhancement and is unable to provide 45 days prior written notice to the Commission, LCH shall provide a written notice and description of the change, together with the reasons for the shorter implementation, as soon as possible prior to the effective date of the change;

Prompt Notice

9. LCH will promptly notify staff of the Commission of any of the following:
 - (a) any material change to its business or operations or the information as provided in the Application;
 - (b) any material problem with the clearance and settlement of transactions in contracts cleared by LCH that could materially affect the safety and soundness of LCH;
 - (c) any event of default by a Clearing Member;
 - (d) any material system failure of a clearing service utilized by an Ontario Clearing Member;
 - (e) any material change or proposed material change in LCH's status as a DCO or to the regulatory oversight by the CFTC;
 - (f) the admission of any new Ontario Clearing Member or any other Ontario resident that has entered into a direct connection arrangement with LCH for facilitating the Ontario resident's direct access to one or more LCH systems; and
 - (g) the clearing of new products that are proposed to be offered to Ontario Clearing Members or products that will no longer be available to Ontario Clearing Members.

Quarterly Reporting

10. LCH will maintain the following updated information and submit such information to the Commission in a manner and form acceptable to the Commission on a quarterly basis (by the end of the month following the end of the calendar quarter), and at any time promptly upon the request of staff of the Commission:
 - (a) a current list of all Ontario Clearing Members;
 - (b) a list of all Ontario Clearing Members against whom disciplinary action has been taken in the quarter by LCH or, to the best of LCH's knowledge, by the CFTC with respect to such Ontario Clearing Members' clearing activities on LCH;
 - (c) a list of all investigations by LCH relating to Ontario Clearing Members;
 - (d) a list of all Ontario applicants who have been denied clearing member status by LCH in the quarter;
 - (e) the following statistics for each Ontario Clearing Member organized by currency:
 - a. the aggregate nominal volumes cleared during the quarter;
 - b. the number of transactions cleared during the quarter;
 - c. the high and low daily nominal volumes cleared during the quarter;
 - d. the high and low number of transactions cleared during the quarter;
 - e. the open interest outstanding as of the end of the quarter;
 - f. the total amount of margin received as of the end of the quarter;

- g. the total amount of default fund contributions received as of the end of the quarter;
- (f) the proportion of the metrics identified in paragraph (e) above for Ontario Clearing Members related to the activity of all Clearing Members in each of the LCH clearing services provided to Ontario Clearing Members;
- (g) for LCH's SwapClear US service and any other clearing service provided to Ontario Clearing Members, a summary of risk management analysis related to the adequacy of required margin and the adequacy of the level of the default fund, including but not limited to stress testing and back testing results;
- (h) for LCH's SwapClear US service and any other clearing service provided to Ontario Clearing Members, the anonymized aggregated average daily notional position of the five and ten largest clearing members in cleared products;
- (i) for LCH's SwapClear US service and any other clearing service provided to Ontario Clearing Members, a description of any material services outages with regard to cleared products that have occurred since the last quarterly report;
- (j) based on information available to LCH, the aggregate notional value and volume of transactions cleared during the quarter by Clearing Members for and on behalf of clients that are Ontario residents; and, where LCH has subsequently verified the accuracy of such aggregate client clearing information for any previous quarters, any summary that describes the results of such verification including any reconciliation of the information previously reported to the Commission;
- (k) to the extent LCH becomes aware of the offering of client clearing to Ontario residents by a Clearing Member, the identity of such Clearing Member and its jurisdiction of incorporation (including that of its ultimate parent) that provides such client clearing services to Ontario residents including, where known,
 - a. the name of each of the Ontario residents receiving such services; and
 - b. the value and volume of transactions cleared by Clearing Product during the quarter for and on behalf of each Ontario resident;
- (l) any other information in relation to an OTC derivative cleared by LCH for Ontario Clearing Members as may be required by the Commission from time to time in order to carry out the Commission's mandate; and
- (m) a copy of the bylaws and rules showing all cumulative changes to the bylaws and rules made during the quarter.

INFORMATION SHARING

- 11. LCH shall provide to the Commission such information as it may request from time to time, and otherwise cooperate with the Commission or its staff, subject to any applicable privacy or other laws (including solicitor-client privilege) governing the sharing of information and the protection of personal information.
- 12. Unless otherwise prohibited under applicable law, LCH shall share information relating to regulatory and enforcement matters and otherwise cooperate with other recognized or exempt clearing agencies on such matters, as appropriate.

SUBMISSION TO JURISDICTION AND AGENT FOR SERVICE

- 13. With respect to a proceeding brought by the Commission arising out of, related to, concerning or in any other manner connected with the Commission's regulation and oversight of LCH's activities in Ontario, LCH shall submit to the non-exclusive jurisdiction of (i) the courts and administrative tribunals of Ontario and (ii) an administrative proceeding in Ontario.
- 14. For greater certainty, LCH shall file with the Commission a valid and binding appointment of an agent for service in Ontario upon whom may be served a notice, pleading, subpoena, summons or other process in any action, investigation or administrative, criminal, quasi-criminal, penal or other proceeding arising out of or relating to or concerning the Commission's regulation and oversight of LCH's activities in Ontario.