

# SUBMISSION COVER SHEET

Registered Entity Identifier Code (optional) LCHLTD Date: 3 December 2012

**IMPORTANT: CHECK BOX IF CONFIDENTIAL TREATMENT IS REQUESTED.**

**ORGANIZATION** LCH.Clearnet Limited

**FILING AS A:**  DCM  SEF  DCO  SDR  ECM/SPDC

## TYPE OF FILING

- **Rules and Rule Amendments**

- Certification under § 40.6 (a) or § 41.24 (a)
- “Non-Material Agricultural Rule Change” under § 40.4 (b)(5)
- Notification under § 40.6 (d)
- Request for Approval under § 40.4 (a) or § 40.5 (a)
- Advance Notice of SIDCO Rule Change under § 40.10 (a)

- **Products**

- Certification under § 39.5(b), § 40.2 (a), or § 41.23 (a)
- Swap Class Certification under § 40.2 (d)
- Request for Approval under § 40.3 (a)
- Novel Derivative Product Notification under § 40.12 (a)

## RULE NUMBERS

## DESCRIPTION

LCH.Clearnet Limited is submitting for a mandatory clearing determination two new Freight contracts and one new Fertilizer contract within the existing class of contracts cleared by the DCO prior to 1 February 2012; and within the same class of contracts previously submitted for a mandatory clearing determination on 29 February 2012.

**SUBMISSION OF SWAPS FOR COMMISSION CLEARING  
DETERMINATION**

TO THE

**COMMODITY FUTURES TRADING COMMISSION**

SUBMITTED BY

**LCH.Clearnet Limited**

an English limited company

**FILING AS A REGISTERED DERIVATIVES CLEARING ORGANIZATION**

**Pursuant to Commission Regulation § 39.5(b)**

**Submission Notification Regarding the Addition of Two New Freight  
Delivery Contracts and One New Fertilizer Contract**

- New Dry Timecharter Trip Basket Freight option contract (P20)
- New cash settled Freight Forward Baltic option contract (D14)
- New premium paid Fertilizer swap option contract

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Submitted: 3 December 2012

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**LCH.CLEARNET LIMITED SUBMISSION OF SWAPS FOR COMMISSION MANDATORY  
CLEARING DETERMINATION**

LCH.Clearnet Limited (“LCH.Clearnet”), a derivatives clearing organization registered with the Commodity Futures Trading Commission (the “CFTC”), is submitting for determination by the CFTC pursuant to CFTC Regulation §39.5(b), contracts being introduced to its service for a new cash settled premium paid option on the Dry Timecharter Route, (P20 - Continental Trip Far East), a new cash settled Freight Forward Contract on the Tanker Voyage route – (D14 - US Gulf – Continent) and a new Premium paid option on the underlying UREA – New Orleans Fertilizer Swap option contract. LCH.Clearnet intends to begin accepting the new contracts for clearing from December 10<sup>th</sup>, 2012.

This submission follows the requirements set out in Commission regulation §39.5(b)(3)(i) – (ix).

**Eligibility to clear swaps and ability to maintain compliance under a mandatory clearing determination**

Under CFTC regulation §39.5(a)(1), LCH.Clearnet is eligible to clear the additional contracts, because they are within the same class of swaps as those it already clears.

**Information related to the five factors**

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

The freight market currently stands at approximately \$13.5bn and is expected to grow by a further \$2bn in the next two years. The cleared market is highly liquid as 95% of the freight contracts are already cleared; therefore it is the bilateral market that is thin from a liquidity perspective.

The global physical fertilizer industry experienced robust growth during the last five years (2006-2011) and is expected to reach an estimated \$193.82 billion in 2017 with a compound annual growth of 5.4% over the next five years (2012-2017). Some 1.5 billion tonnes of raw materials and products are traded annually.

*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”*

In developing an OTC clearing service, LCH.Clearnet ensures that the contracts it clears are economically equivalent to the contracts with the same underlying attributes in the uncleared market. For Freight Options, these are traded in almost exactly the same way that the underlying Forward Freight Agreements (“FFAs”) are transacted. Buyers and sellers of options agree on a strike price and then negotiate a premium. The premium is quoted in dollars per day for Time Charters (TC), and dollars per tonne for Capesize routes.

The three new contracts planned to be cleared by LCH.Clearnet, and those already cleared by the DCO, are done so under a rule framework and operational infrastructure accepted by its clearing members.

When considering the eligibility of a new product or contract for clearing, a key question addressed by LCH.Clearnet is whether it has the appropriate risk management, operations, default management, and technology in place to be able to dispose of positions in that new product in a member default scenario. It is naturally only prudent for any DCO to clear a product where it possesses a high degree of confidence that it can exit a position in that product during a default.

In order to be able to securely risk manage, and technologically and operationally process the settlement of the contract, LCH.Clearnet has developed very sophisticated operational models, controls and risk algorithms to ensure that LCH.Clearnet can process trades rapidly, safely, and with minimal impact on day-to-day market activity.

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

When appropriate clearable contracts are mandated for clearing, the inevitable result will be a less disparate marketplace from a risk perspective. Mandatory clearing will also remove a large portion of the interconnectedness of current OTC markets that leads to systemic risk. However, it is important to acknowledge that central clearing, by its very nature, concentrates risk in a handful of entities. Thus, DCOs that clear swaps must have exceptional risk, default, operational, legal, liquidity, technology standards and processes, and regulatory oversight to ensure that the DCO does not itself pose a greater systemic risk than the systemic risk it is alleviating.

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

As mentioned previously, LCH.Clearnet believes that the CFTC should use the clearing mandate to spur competition between DCOs, and to encourage DCOs to be innovative in developing the capability to safely clear new types of swaps and ways to collateralise those swaps. However, it is important for the CFTC to recognise the potential pitfalls of rushing new clearing products and services to market in the name of competitiveness. We suggest that the CFTC remain vigilant in permitting new products to be cleared only when DCOs have appropriate processes, procedures, risk management, and default procedures in place for these products.

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”*

LCH.Clearnet has obtained IOSCO compliant 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.

LCH.Clearnet has obtained a legal opinion from its US counsel regarding compliance with the protections afforded to FCM customers under New York law. Insofar as legal certainty in the event of the insolvency of the DCO is concerned, LCH.Clearnet would be wound up under English law and has provided opinions to the CFTC on this point.

### **Product specifications**

Product specifications, including generally accepted terms and standard practices, for both fertilizer and freight contracts are established by members of the fertilizer and freight broking community, respectively.

### **Fertilizer Options Contract**

LCH.Clearnet Limited (“LCH.Clearnet”) will offer clearing in a single expiry, premium paid option on the underlying UREA – New Orleans (UNO) Fertilizer Option contract for the corresponding expiry

Fertilizer Options Contracts reference the underlying Swap contract LCH currently clears. These contracts are subject to initial and variation margining.

### **Fertilizer Option Contract Specification**

<b>Description</b>	Single expiry, premium paid option on the underlying UREA – New Orleans (UNO) Fertilizer Swap contract for the corresponding expiry.
<b>Contract Code</b>	ONO
<b>Lot Size</b>	500st
<b>Currency</b>	US Dollars
<b>Minimum tick</b>	US \$0.0001
<b>Option Type</b>	Options are European style and will be automatically exercised on the expiry day if they are “in the money”. If an option is “out of the money” it will expire automatically. It is not permitted to exercise the option on any other day or in any other circumstances. No manual exercise is permitted.
<b>Option Premium</b>	The Premium is paid at the time of purchase
<b>Last Trading Day</b>	Last publication day of the relevant index in the contract month ie the last business Thursday of every month  Exception – December contracts will expire on the penultimate Thursday, as there is no publication of an index in the week prior to New Year  Where the last Thursday of the month is a non-business day, the last trading day will be the first business day preceding.
<b>Expiry</b>	18:00 hours UK time on the last trading day  Automatic exercise settings are pre-set to exercise contracts which are one minimum price fluctuation or greater "in-the-money" when compared to the relevant reference price  <b>Members are not permitted to override automatic exercise settings or manually enter exercise instructions for this contract</b>  The reference price will be a price in US dollars, cents and hundredths of a cent (\$0.0001), per day equal to the final settlement price for the underlying UREA – New Orleans (UNO) Fertilizer Swap contract  For these purposes “final settlement price” means the final settlement price on the expiry day of the underlying UREA – New Orleans (UNO) Fertilizer Swap contract
<b>Contract series</b>	Front 6 months, 4 quarters
<b>Strike Price</b>	Any whole \$ value
<b>Margin</b>	Options will be subject to Initial Margin and Net Liquidation Value variation margin on a daily basis.
<b>Business Days</b>	UK business days

LCH.Clearnet will add to the existing Cash Settled Freight Forward Contracts: \$ Per Tonne Tanker Voyage Routes the following route: Baltic TC14 (D14) 38,000mt US Gulf - Continent

**Wet Freight Contract (TC14 / P2A)**

<b>Description</b>	Cash settled \$/t freight forward contracts on the following Tanker Voyage Routes:  Baltic TC14 (D14) (38,000 mt., U.S.Gulf - Continent)
<b>Lot size</b>	1,000 mt
<b>Currency</b>	US \$/tonne
<b>Minimum tick</b>	US \$ 0.0001 to account for final settlement
<b>Fixed price</b>	The traded price (in \$/t) or the previous day's settlement price, as supplied end of day by the Baltic Exchange
<b>Floating price</b>	In respect of daily settlement, the floating price will be the end of day price (in \$/t) as supplied by the Baltic Exchange  In respect of final settlement, the floating price will be a price in US\$ per mt calculated as the mean of the Baltic Exchange WS rate spot price assessments multiplied by the Flat Rate divided by 100 for each pricing date in the expiry month
<b>Last trading day</b>	At 18:00 hours UK time on last business day of each month within the contract series  Exception – December contracts will expire on the 24th December, or previous business day, where the 24th December is a non working day
<b>Contract series</b>	Traded as months, quarters and calendars, out to 2 whole calendar years (a maximum of 35 months)
<b>Final payment</b>	On the first business day following the expiry day
<b>Business days</b>	UK business days

LCH.Clearnet will add the following Cash settled Premium Paid Option on to the existing Dry Timecharter Trip & Basket Routes a P20 (Continent Trip Far East). Freight Option contract.

#### **P20 Dry Charter Freight Option Contract**

<b>Contract description – Cash Settled Premium Paid Option on Dry Timecharter Basket Routes</b>	
<b>Description</b>	Cash settled Premium Paid Option on the following Dry Timecharter Basket Route:  P20 (Cont Trip Far East)  These contracts, if “in the money” expire into their underlying freight forward contracts with a traded price equal to the Strike Price (see below)
<b>Lot size</b>	1 day
<b>Currency</b>	US Dollars
<b>Pricing</b>	US \$ per day
<b>Minimum tick</b>	US \$1 per day
<b>Option Type</b>	Options are European style and will be automatically exercised on the expiry day if they are “in the money”. If an option is “out of the money” it will expire automatically. It is not permitted to exercise the option on any other day or in any other circumstances. No manual exercise is permitted.
<b>Option</b>	The Premium is paid at the time of purchase

<b>Premium</b>	
<b>Last trading day</b>	At 18:00 hours UK time on last business day of each month within the contract series  Exception – December contracts will expire on the 24th December, or previous business day, where the 24th December is a non working day
<b>Expiry</b>	18:00 hours UK time on the last trading day  Automatic exercise settings are pre-set to exercise contracts which are one minimum price fluctuation or greater "in-the-money" when compared to the relevant reference price  <b>Members are not permitted to override automatic exercise settings or manually enter exercise instructions for this contract</b>  The reference price will be a price in US dollars, cents and hundredths of a cent (\$0.0001), per day equal to the final settlement price for the underlying freight forward contracts  For these purposes "final settlement price" means the final settlement price on the expiry day of the underlying freight forward contracts
<b>Contract series</b>	Traded as months, out to 1 whole calendar years (a maximum of 23 months)
<b>Strike Price</b>	Any whole \$ value
<b>Business Days</b>	UK business days

### Participant eligibility standards

In order to participate in the EnClear service as a *clearing member*, applicants must meet the following eligibility requirements, which are set out in Section 1 of the Clearing House Procedures:

- have a net capital of US\$50 million or more;
- have, within its corporate group, at least one banking, credit or investment institution licensed in the US or an EU member state, or an equivalent in another jurisdiction;
- complete all relevant documentation; and
- complete all necessary testing and training as required by LCH.Clearnet.

EnClear places no access criteria upon *clients* of FCMs. FCMs are free to take on the business of clients based on their own due diligence and analysis and become responsible for the performance of the trades upon registration.

### Pricing sources, models and procedures

OTC Fertilizer swaps contracts settle against the Fertilizer Index. This index provides reference prices calculated from data provided by FertilizerWEEK, FERTECON and FMB.

Daily and final settlement of Freight contracts is based on prices provided by the Baltic Exchange. These prices are based on assessments received from the FFABA.

The Variation Margining approach is dependent on the type of contract. A contingent variation margin is calculated for Wet Freight contracts quoted in World Scale Points (WSP) and a realised variation margin for all other contracts

LCH uses a variety of data from, price reporting agencies and brokers for the purposes of producing reference prices for intraday and end-of-day margin runs each business day.

Wet freight contracts excluding implied WSP contracts (i.e. those quoted in \$/ tonne) are traded in World Scale Points (WSP) and held in Ltd systems at a \$/tonne amount.

The conversion from WSP to \$/tonne of original contracts takes place using the World Scale Flat Rates which are the values published every year on Jan 1st by the World Scale Association. These WSFR are also used to convert WSP to \$/tonne for EOD valuations.

### **Risk management procedures**

EnClear risk management policies and procedures adhere to the principles adopted within LCH.Clearnet based on its extensive experience in OTC clearing.

Initial Margin (IM) is collected from each clearing member to cover potential losses in the event of that member's default. The EnClear IM methodology, SPAN (*Standard Portfolio Analysis and Risk*), is a value-at-risk model based on filtered historical simulation.

Variation Margin (VM) and Price Alignment Interest (PAI) are calculated every day through a trade's life up to settlement day for all cleared trades. VM is payable/receivable in cash in the settlement currency.

### **Applicable rules, manuals, policies and procedures**

The applicable rules, manuals, policies and procedures that currently apply are available publicly on LCH.Clearnet's website at [http://www.lchclearnet.com/rules\\_and\\_regulations/ltd/default.asp](http://www.lchclearnet.com/rules_and_regulations/ltd/default.asp)

The main provisions relating specifically to the additional contracts to EnClear service are:

- General Regulations, 73, Amendment to Part A (OTC Contract Terms) and Part B (Product Eligibility)
- Clearing House Procedures, Section 2E (EnClear), subsections 2.2.1 and 2.2.4

LCH.Clearnet made a submission pursuant to Commission Regulation §40.6 in light of the above rule changes on November 23, 2012.

### **Notice of the submission to members**

LCH.Clearnet has posted a copy of this submission on LCH.Clearnet's website at: [http://www.lchclearnet.com/rules\\_and\\_regulations/ltd/proposed\\_rules.asp](http://www.lchclearnet.com/rules_and_regulations/ltd/proposed_rules.asp).