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SEC Proposes Enhanced Regulatory Framework for Certain Registered Clearing Agencies

The proposal is consistent with international recommendations and Basel III criteria.

On March 12, the Securities and Exchange Commission (SEC) proposed new rules and rule amendments (the Proposal) that would enhance the oversight of registered clearing agencies that are deemed systematically important or that have complex risk profiles.[1] Clearing agencies covered under the Proposal would be subject to new requirements regarding their financial risk management, operations, governance, and disclosures to market participants and the public. The Proposal comes as international banking standards encourage banks to use qualified central counterparties, such as clearing agencies that are overseen by a regulator applying international clearing standards.

Comments on the Proposal are due 60 days after publication in the *Federal Register*.

Covered Clearing Agencies

The Proposal would apply to "covered clearing agencies," which would include the following:

- Clearing agencies designated as systemically important by the Financial Stability Oversight Council (FSOC), for which the SEC acts as the supervisory agency under Title VIII of the Dodd-Frank Act[2]
- Clearing agencies that provide central counterparty (CCP) services for security-based swaps or are otherwise involved in activities with a more complex risk profile, unless they have been designated systemically important by the FSOC and their supervisory agency under Title VIII of the Dodd-Frank Act is the Commodity Futures Trading Commission (CFTC)
- Clearing agencies that the SEC has determined are "covered clearing agencies" pursuant to a framework established under the Proposal

As explained by the SEC, the Proposal would create a two-tiered approach to the oversight of clearing agencies encompassing (1) enhanced rules for covered clearing agencies and (2) the current rules for all other registered clearing agencies.[3]

Overview of Proposed Requirements

Under the Proposal, a covered clearing agency would be required to establish, implement, maintain, and enforce policies and procedures reasonably designed to address certain aspects of its risk management and operation, including the following:

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1. Standards for Covered Clearing Agencies, Exchange Act Release No. 71699 (Mar. 12, 2014), *available at* http://www.sec.gov/rules/proposed/2014/34-71699.pdf.

2. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). As of the date of this LawFlash, the following clearing agencies have been designated by the FSOC as systemically important: the Chicago Mercantile Exchange; the Depository Trust Company (DTC); the Fixed Income Clearing Corporation (FICC); ICE Clear Credit LLC; the National Securities Clearing Corporation (NSCC), and the Options Clearing Corporation (OCC). The SEC is the supervisory agency for DTC, FICC, NSCC, and OCC.

3. The SEC adopted clearing agency standards (i.e., Rule 17Ad-22) in November 2012. *See* Clearing Agency Standards, Exchange Act Release No. 68080 (Oct. 22, 2012), 77 Fed. Reg. 66220 (Nov. 2, 2012). The Proposal amends and adds new paragraph (e) to Rule 17Ad-22, which contains the enhanced standards.

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- General organization (including legal basis, governance, and comprehensive risk management framework)
- Financial risk management (including credit risk, collateral, margin, and liquidity risk)
- Settlement (including settlement finality, money settlements, and physical deliveries)
- Central securities depositories and settlement systems (including enhanced policies and procedures to maintain securities in an immobilized or dematerialized form for their transfer by book entry and to prevent the unauthorized creation or deletion of securities)
- Default management (including default rules and procedures and segregation and portability)
- Business and operational risk management (including general business risk, custody and investment risks, and operational risk)
- Access (including access and participation requirements, tiered participation arrangements, and links)
- Efficiency (including efficiency and effectiveness and communication procedures and standards)
- Transparency

The SEC stated that these requirements reflect enhancements of its existing oversight program for registered clearing agencies and that several requirements would be newly specified in light of the nature and extent of covered clearing agencies' activities.

Enhanced Standards

General Business Risk

Under the proposed rules, a covered clearing agency would be required to hold sufficient liquid net assets funded by equity to cover potential business losses so it may continue operating as a going concern if such losses materialize. More specifically, a covered clearing agency would have to hold a maximum of either **six months** of its current operating expenses or an amount determined by the board that is sufficient to ensure a recovery or orderly wind-down of the covered clearing agency's critical operations and services. Such an amount would have to be held in liquid assets. The Proposal also would require policies and procedures to maintain a viable plan—approved by the board of directors and updated at least annually—for raising additional equity should its equity fall close to or below the amount required.

Governance and Comprehensive Risk Management

The Proposal requires covered clearing agencies to establish and maintain a "living will" or "plans for the recovery and orderly wind-down of the covered clearing agency in the event of credit losses, liquidity shortfalls, losses from general business risk, or any other losses." The enhanced governance rules demonstrate the SEC's interest in an area that it typically focuses on when it examines a clearing agency. Under the proposed governance rules, covered clearing agencies would be required to have policies and procedures

- establishing the qualifications of their boards of directors and senior management; and
- designed to ensure that risk management and internal audit personnel have sufficient authority, resources, independence from management, and access to the board to fulfill their functions effectively as well as policies and procedures providing for an independent audit committee.

Financial Risk Management

LIQUIDITY RISK

The Proposal would require covered clearing agencies to hold "qualifying liquid resources" sufficient to withstand the default of the participant family that would generate the largest aggregate payment obligation in extreme but plausible market conditions (i.e., a cover one requirement). "Qualifying liquid resources" include three types of assets:

- Cash held at the central bank of issue or a credit-worthy commercial bank

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- Assets that are readily available and convertible into cash through certain types of prearranged funding arrangements
- Other assets that are readily available and eligible for pledging to, or conducting other appropriate forms of transactions with, a relevant central bank, if the covered clearing agency has access to routine credit at such central bank

In this connection, the SEC stated that the “mere ownership of assets . . . may not be sufficient alone to make the assets count towards qualifying liquid resources unless one of the [stipulated] prearranged funding arrangements is in place under which the covered clearing agency would receive cash in a timely manner.”

The SEC also described the following as factors that a covered clearing agency may take into account when determining whether assets are qualifying liquid resources:

- The portion of its default fund that is held as cash
- The portion of its default fund that is held as securities
- The portion of any excess default fund contributions held as cash that could be used by the covered clearing agency to meet liquidity needs
- The portion of any excess default fund contributions held as securities that could be used by the covered clearing agency to meet liquidity needs
- The amount at any given time of securities or cash delivered by members that a covered clearing agency may be able to use to meet liquidity needs on the default of a member
- The borrowing limits under any committed funding arrangement

CREDIT RISK

Depending on the type of covered clearing agency (e.g., a systemically important agency or one with a complex risk profile), the Proposal would require a covered clearing agency to address a wide range of stress scenarios, including a default by the two participant families that could cause the largest credit exposure for the covered clearing agency in extreme but plausible market conditions (i.e., a cover two requirement). A covered clearing agency would be required to perform daily stress tests of its total financial resources using standard, predetermined parameters and assumptions, in addition to a monthly (or, more frequently, when cleared products or relevant markets demonstrate high volatility or become less liquid) comprehensive analysis of stress-test models and other components of the stress test. A covered clearing agency would have to report the results of these analyses to the appropriate decisionmakers within the organization so that they may determine the adequacy of the models and the covered clearing agency’s risk management framework.

MARGIN

Under the Proposal, a covered clearing agency would be required to establish policies and procedures regarding marking positions to market, collecting margin at least daily (with the authority and operational capacity to make intraday margin calls), and conducting daily backtesting, monthly sensitivity analyses, and annual model validation.

COLLATERAL

The Proposal would require policies and procedures for setting and enforcing appropriately conservative haircuts and concentration limits and subjecting them to annual review.

Segregation and Portability for Complex Risk Profile and Security-Based Swap Covered Clearing Agencies

The Proposal would require covered clearing agencies that have a complex risk profile or that are CCPs for security-based swaps to maintain policies and procedures to enable the segregation and portability of customer positions and collateral to protect customer positions and funds from a clearing member default or insolvency. The SEC stated that the reason it is proposing to apply this standard to only certain covered clearing agencies is because other initiatives, such as the preexisting customer protection rules applicable to broker-dealers and the

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Securities Investor Protection Act of 1970 (which protects customer security positions and funds in cash securities and listed options), do not already encompass these clearing agencies.

Tiered Participation Agreements

The proposed rules would require a covered clearing agency to manage material risks that arise from indirect participation (e.g., a customer who accesses the covered clearing agency through a clearing member deemed to be a "tiered participation" arrangement).

Communications Procedures and Standards

The Proposal would require a covered clearing agency to use or, at a minimum, to accommodate internationally accepted communication standards to achieve prompt and accurate clearance and settlement, among other goals.

SEC Determinations

The Proposal would provide the SEC with procedures to make the following three determinations regarding registered clearing agencies:

- Whether a registered clearing agency should be considered a covered clearing agency
- Whether a covered clearing agency meets the definition of "systemically important in multiple jurisdictions"
- Whether the activities of a clearing agency that provides CCP services has a more complex risk profile

Under the Proposal, the SEC could make such a determination on its own initiative or on the request of a clearing agency or one of its members. In doing so, the SEC would publish notice—with at least a 30-day comment period—of its intention to consider such a determination with a brief statement of the grounds under consideration. The clearing agency subject to such determination may be provided an opportunity for a hearing on the matter.

Implications

The Proposal signals the SEC's attempt to adopt rules consistent with the Principles for Financial Market Infrastructures (PFMIs) published by the Committee on Payment and Settlement Systems and the Board of the International Organization of Securities Commissions. In this connection, both the SEC and CFTC[4] are working to adopt rules consistent with the PFMIs, in part, to satisfy the requests of CCPs, whose clearing member banks have an incentive under new Basel III rules to use CCPs that are overseen by a regulator that applies rules consistent with the PFMIs. This incentive arises from rules published in July 2012 by the Basel Committee on Banking Supervision, the international organization that establishes standards for the regulation of banks (CCP Capital Requirements).

The CCP Capital Requirements introduce new capital charges that banks incur from their exposure to CCPs related to certain types of transactions.[5] These rules incentivize banks to use "qualified CCPs," that is, CCPs that are licensed in jurisdictions where the relevant regulator has established rules consistent with the PFMIs and has publicly indicated that it applies such rules on an ongoing basis to CCPs. As a result of the CCP Capital Requirements, a clearing agency or derivatives clearing organization that is not deemed to be a qualified CCP could become competitively disadvantaged. For example, banks may decide not to use a clearing agency or derivatives clearing organization unless it is a qualified CCP or may reduce or discontinue their clearing business

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4. In December 2013, the CFTC adopted enhanced rules consistent with the PFMIs. The CFTC's rules govern systemically important derivatives clearing organizations (DCOs) and DCOs that elect to be governed by the systemically important DCO regulatory requirements. A DCO that elects to be governed by the heightened requirements is deemed to be a "Subpart C DCO" and, thus, a qualified DCO for purposes of the Basel III CCP Capital Requirements. *See* Derivatives Clearing Organizations and International Standards, 78 Fed. Reg. 72,476 (adopted Dec. 2, 2013). Earlier in 2013, the CFTC adopted enhanced risk management rules for systemically important DCOs. *See, e.g.*, Enhanced Risk Management Standards for Systemically Important Derivatives Clearing Organizations, 78 Fed. Reg. 49,663 (adopted Aug. 15, 2013).

5. Bank for International Settlements' Basel Committee on Banking Supervision, "Capital Requirements for Bank Exposures to Central Counterparties," (July 2012), *available at* http://www.bis.org/publ/bcbs227.pdf. The types of transactions that would cause a bank to incur greater capital charges include over-the-counter derivatives, exchange-traded derivatives, and securities financing transactions.

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with such entities. The Proposal demonstrates the SEC's attempt to accommodate the clearing agencies under its jurisdiction to maintain their global competitiveness.

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