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17 CFR Parts 1, 21, 39 et al.
Derivatives Clearing Organization General Provisions and Core Principles; Final Rule

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1, 21, 39, and 140

RIN 3038–AC98

Derivatives Clearing Organization General Provisions and Core Principles

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (Commission) is adopting final regulations to implement certain provisions of Title VII and Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) governing derivatives clearing organization (DCO) activities. More specifically, the regulations establish the regulatory standards for compliance with DCO Core Principles A (Compliance), B (Financial Resources), C (Participant and Product Eligibility), D (Risk Management), E (Settlement Procedures), F (Treatment of Funds), G (Default Rules and Procedures), H (Rule Enforcement), I (System Safeguards), J (Reporting), K (Recordkeeping), L (Public Information), M (Information Sharing), N (Antitrust Considerations), and R (Legal Risk) set forth in Section 5b of the Commodity Exchange Act (CEA). The Commission also is updating and adding related definitions; adopting implementing rules for DCO chief compliance officers (CCOs); revising procedures for DCO applications including the required use of a new Form DCO; adopting procedural rules applicable to the transfer of a DCO registration; and adding requirements for approval of DCO rules establishing a portfolio margining program for customer accounts carried by a futures commission merchant (FCM) that is also registered as a securities broker-dealer (FCM/BD). In addition, the Commission is adopting certain technical amendments to parts 21 and 39, and is adopting certain delegation provisions under part 140.

DATES: The rules will become effective January 9, 2012. DCOs must comply with §§ 39.11; 39.12; 39.13 (except for 39.13(g)(8)(i)); and 39.14 by May 7, 2012; with §§ 39.10(c); 39.13(g)(8)(i); 39.18; 39.19; and 39.20 by November 8, 2012; and all other provisions of these rules by January 9, 2012.

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I. Background

A. Title VII of the Dodd-Frank Act

On July 21, 2010, President Obama signed the Dodd-Frank Act.[1] Title VII of the Dodd-Frank Act[2] amended the CEA[3] to establish a comprehensive statutory framework to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (1) Providing for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposing clearing and trade execution requirements on standardized derivative products; (3) creating rigorous recordkeeping and real-time reporting regimes; and (4) enhancing the Commission's rulemaking and enforcement authorities with respect to all registered entities and intermediaries subject to the Commission's oversight.

Section 725(c) of the Dodd-Frank Act amended Section 5b(c)(2) of the CEA, which sets forth core principles with which a DCO must comply in order to be registered and to maintain registration as a DCO.

The core principles were added to the CEA by the Commodity Futures Modernization Act of 2000 (CFMA).[4] The Commission did not adopt implementing rules and regulations, but instead promulgated guidance for DCOs on compliance with the core principles.[5] Under Section 5b(c)(2) of the CEA, as amended by the Dodd-Frank Act, Congress expressly confirmed that the Commission may adopt implementing rules and regulations pursuant to its rulemaking authority under Section 8a(5) of the CEA.[6]

In light of Congress's explicit affirmation of the Commission's authority to adopt regulations to implement the core principles, the Commission has chosen to adopt regulations (which have the force of law) rather than guidance (which does not have the force of law). By issuing regulations, the Commission expects to increase legal certainty for DCOs, clearing members, and market participants, and prevent DCOs from lowering risk management standards for competitive reasons and taking on more risk than is prudent. The imposition of legally enforceable standards provides

[1] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at *http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm.*

[2] Pursuant to Section 701 of the Dodd-Frank Act, Title VII may be cited as the ''Wall Street Transparency and Accountability Act of 2010.''

[3] 7 U.S.C. 1 *et seq.*

[4] *See* Commodity Futures Modernization Act of 2000, Public Law 106–554, 114 Stat. 2763 (2000).

[5] *See* 66 FR 45604 (Aug. 29, 2001) (adopting 17 CFR part 39, app. A).

[6] Section 8a(5) of the CEA authorizes the Commission to promulgate such regulations ''as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of [the CEA].'' 7 U.S.C. 12a(5).

assurance to market participants and the public that DCOs are meeting minimum risk management standards. This can serve to increase market confidence which, in turn, can increase open interest and free up resources that market participants might otherwise hold in order to compensate for weaker DCO risk management practices. Regulatory standards also can reduce search costs that market participants would otherwise incur in determining that DCOs are managing risk effectively.

B. Title VIII of the Dodd-Frank Act

Section 802(b) of the Dodd-Frank Act states that the purpose of Title VIII is to mitigate systemic risk in the financial system and promote financial stability. Section 804 authorizes the Financial Stability Oversight Council (FSOC) to designate entities involved in clearing and settlement as systemically important.[7]

Section 805(a) of the Dodd-Frank Act allows the Commission to prescribe regulations for those DCOs that the Council has determined are systemically important (SIDCOs). The Commission proposed heightened requirements for SIDCO financial resources and system safeguards for business continuity and disaster recovery.

Section 807(c) of the Dodd-Frank Act provides the Commission with special enforcement authority over SIDCOs, which the Commission proposed to codify in its regulations.

C. Regulatory Framework for DCOs

The Commission, now responsible for regulating swaps markets as well as futures markets, has undertaken an unprecedented rulemaking initiative to implement the Dodd-Frank Act. As part of this initiative, the Commission has issued a series of eight proposed rulemakings that, together, would establish a comprehensive regulatory framework for the clearing and settlement activities of DCOs. Through these proposed regulations, the Commission sought to enhance legal certainty for DCOs, clearing members, and market participants, to strengthen the risk management practices of DCOs, and to promote financial integrity for swaps and futures markets.

In this notice of final rulemaking, the Commission is adopting regulations to implement 15 DCO core principles: A (Compliance), B (Financial Resources), C (Participant and Product Eligibility),[8] D (Risk Management), E (Settlement Procedures), F (Treatment of Funds), G (Default Rules and Procedures), H (Rule Enforcement), I (System Safeguards), J (Reporting), K (Recordkeeping), L (Public Information), M (Information Sharing), N (Antitrust Considerations), and R (Legal Risk).[9] In addition, the Commission is adopting regulations to implement the CCO provisions of Section 725 of the Dodd-Frank Act.[10]

The final rules adopted herein were proposed in five separate notices of proposed rulemaking.[11] Each proposed rulemaking was subject to an initial 60-day public comment period and a re-opened comment period of 30 days.[12] After the second comment period ended, the Commission informed the public that it would continue to accept and consider late comments and did so until August 25, 2011. The Commission received a total of approximately 119 comment letters directed specifically at the proposed rules, in addition to many other comments applicable to the Dodd-Frank Act rulemaking initiative more generally.[13] The Chairman and Commissioners, as well as Commission staff, participated in numerous meetings with representatives of DCOs, FCMs, trade associations, public interest groups, traders, and other interested parties. In addition, the Commission has consulted with other U.S. financial regulators including the Board of Governors of the Federal Reserve System and Securities and Exchange Commission (SEC).

The Commission is mindful of the benefits of harmonizing its regulatory framework with that of its counterparts in foreign countries. The Commission has therefore monitored global advisory, legislative, and regulatory proposals, and has consulted with foreign regulators in developing the proposed and final regulations for DCOs.

The Commission is of the view that each DCO should be afforded an appropriate level of discretion in determining how to operate its business within the legal framework established by the CEA, as amended by the Dodd-Frank Act. At the same time, the Commission recognizes that specific, bright-line regulations may be necessary to facilitate DCO compliance with a given core principle and, ultimately, to protect the integrity of the U.S. derivatives clearing system. Accordingly, in developing the proposed regulations and in finalizing the regulations adopted herein, taking into consideration public comments and views expressed by U.S. and foreign regulators, the Commission has endeavored to strike an appropriate balance between establishing general prudential standards and specific requirements.

In determining the scope and content of the final rules, the Commission has taken into account concerns raised by commenters regarding the implications of specific rules for smaller versus larger DCOs, DCOs that do not clear customer positions versus those with a traditional customer model, clearinghouses that are registered as both a DCO and a securities clearing agency, and clearinghouses that operate in foreign jurisdictions as well as in the United States. The Commission addresses these issues in its discussion of specific rule provisions, below.

The Commission has carefully considered the costs and benefits associated with each proposed rule, with particular attention to public comments. For the reasons discussed in this notice of final rulemaking, in the analyses of specific rule provisions as well as in the formal cost-benefit analysis, the Commission has determined that the final rules appropriately balance the costs and benefits associated with oversight and supervision of DCOs pursuant to the CEA, as amended by the Dodd-Frank Act.

The Commission is herein adopting regulations to implement the core principles applicable to DCOs, to implement CCO requirements established under the Dodd-Frank Act, and to update the regulatory framework for DCOs to reflect standards and practices that have evolved over the past decade since the enactment of the

[7] *See* 76 FR 44763 (July 27, 2011) (FSOC authority to designate financial market utilities as systemically important; final rule).

[8] The Commission is reserving for a future final rulemaking certain proposed amendments relating to participant and product eligibility. *See* 76 FR 13101 (Mar. 10, 2011) (requirements for processing, clearing, and transfer of customer positions (Straight-Through Processing)); and 76 FR 45730 (Aug. 1, 2011) (customer clearing documentation and timing of acceptance for clearing (Customer Clearing)).

[9] The Commission is reserving for a future final rulemaking regulations to implement DCO Core Principles O (Governance Fitness Standards) and Q (Composition of Governing Boards) (76 FR 722 (Jan. 6, 2011) (Governance)); and Core Principle P (Conflicts of Interest) (75 FR 63732 (Oct. 18, 2010) (Conflicts of Interest)).

[10] *See* Section 5b(i) of the CEA, 7 U.S.C 7a–1(i).

[11] *See* 76 FR 13101 (Mar. 10, 2011) (Straight-Through Processing); 76 FR 3698 (Jan. 20, 2011) (Core Principles C, D, E, F, G, and I (Risk Management)); 75 FR 78185 (Dec. 15, 2010) (Core Principles J, K, L, and M (Information Management)); 75 FR 77576 (Dec. 13, 2010) (Core Principles A, H, N, and R (General Regulations)); and 75 FR 63113 (Oct. 14, 2010) (Core Principle B (Financial Resources)).

[12] *See* 76 FR 25274 (May 4, 2011) (extending or re-opening comment periods for multiple Dodd-Frank proposed rulemakings); *see also* 76 FR 16587 (Mar. 24, 2011) (re-opening 30-day comment period for reporting requirement with clause omitted in the notice of proposed rulemaking).

[13] Comment files for each proposed rulemaking can be found on the Commission Web site, *www.cftc.gov.*

CFMA. The Commission is largely adopting final rules as proposed, although there are a number of proposed provisions that, upon further consideration in light of comments received, the Commission has determined to either revise or decline to adopt. In the discussion below, the Commission highlights topics of particular interest to commenters and discusses comment letters that are representative of the views expressed on those topics. The discussion does not explicitly respond to every comment submitted; rather, it addresses the most significant issues raised by the proposed rulemakings and it analyzes those issues in the context of specific comments.

The final rules include a number of technical revisions to the proposed rule text, intended variously to clarify certain provisions, standardize terminology within part 39, conform terminology to that used in other parts of the Commission's rules, and more precisely state regulatory standards and requirements. These are non-substantive changes. For example, the proposed DCO rules used the terms ''contract'' and ''product'' interchangeably, and some provisions used the statutory language ''contracts, agreements and transactions'' to refer to the products subject to Commission regulation. In the final rules adopted herein, the Commission has revised the terminology to uniformly refer to ''products,'' which encompasses contracts, agreements, and transactions, except where the language of the rule codifies statutory language. In those cases, the rule text is unchanged.

For easy reference and for purposes of clarification, in this notice of final rulemaking the Commission is publishing the complete part 39 as currently adopted. This means that certain longstanding rules that are not being amended (*e.g.,* § 39.8 (formerly designated as § 39.7, fraud in connection with the clearing of transactions of a DCO), and rules recently adopted (§ 39.5, review of swaps for Commission determination on clearing requirement) are being re-published along with the newly-adopted rules. Rules that have been proposed but not yet adopted in final form are identified in part 39 as ''reserved.''

II. Part 1 Amendments—Definitions

The Commission proposed to amend the definitions of ''clearing member,'' ''clearing organization,'' and ''customer'' found in § 1.3 of its regulations to conform the definitions with the terminology and substantive provisions of the CEA, as amended by the Dodd-Frank Act. The Commission also proposed to add to § 1.3, definitions for ''clearing initial margin,'' ''customer initial margin,'' ''initial margin,'' ''margin call,'' ''spread margin,'' and ''variation margin.''

ISDA commented that the margin definitions are appropriate for futures and cleared derivatives, but less readily applicable in the uncleared OTC derivatives context. It suggested that the definitions should expressly provide that they apply only to cleared transactions. The Commission notes that some of the definitions by their terms already apply only to cleared trades, *e.g.,* ''clearing initial margin.'' Other terms, however, have applicability to both cleared and uncleared trades, *e.g.,* ''initial margin.'' [14]

The Commission proposed to define ''spread margin'' as ''reduced initial margin that takes into account correlations between certain related positions held in a single account.'' Better Markets commented that the definition of ''spread margin'' omits key characteristics of netting initial margin which are needed to precisely define spread margin. Better Markets proposed to define it as ''initial margin relating to two positions in a single account that has been reduced from the aggregate initial margin otherwise applicable to the two positions by application of an algorithm that measures statistical correlations between the historic price movements of the two positions.'' The Commission is adopting the definition of ''spread margin'' as proposed because it believes that Better Markets' definition adds unnecessary details that could have the unintended effect of imposing substantive margin methodology requirements in a definition.

In light of proposed rulemakings issued after the Commission proposed the definition of ''customer; commodity customer; swap customer,'' the Commission is making certain technical modifications.[15] First, instead of placing the definition in § 1.3, which serves as the general definition section for all of the Commission's regulations, this definition is being moved to § 39.2, which sets forth definitions applicable only to regulations found in part 39 or as otherwise explicitly provided. This accommodates the need for further consideration of other proposals before a global definition is adopted, while satisfying the need for a definition for purposes of part 39 as adopted herein. Second, the Commission has made certain technical changes to the rule text in connection with the definition's redesignation in 39.2 and to conform phraseology when incorporating by reference definitions that appear in the CEA and § 1.3. These changes include limiting the term to ''customer,'' because the terms ''commodity customer'' and ''swap customer'' are not used in Part 39.

The Commission is adopting the other definitions as proposed.

III. Part 39 Amendments—General Provisions

A. Scope—§ 39.1

As originally proposed, § 39.1 included an updated statement of scope and definitions applicable to other provisions in part 39. The Commission later revised proposed § 39.1 to include only the statement of scope. The Commission did not receive any comments on the statement of scope, which was updated to include references to the definition of ''derivatives clearing organization'' in newly-renumbered Section 1(a)(15) of the CEA and § 1.3(d) of the Commission's regulations. The Commission is adopting § 39.1 as proposed.

B. Definitions—§ 39.2

The Commission proposed definitions of the terms ''back test,'' ''compliance policies and procedures,'' ''customer account '' or ''customer origin,'' ''house account'' or ''house origin,'' ''key personnel,'' ''stress test,'' and ''systemically important derivatives clearing organization.'' The definitions set forth in proposed § 39.2 would apply specifically to provisions contained in part 39 and such other rules as may explicitly cross-reference these definitions. The Commission is adopting the definitions as proposed, with the exceptions discussed below.

CME Group, Inc. (CME) commented that the proposed definition of ''compliance policies and procedures'' was too broad. That definition was proposed as an adjunct to the proposed rules for a DCO's CCO. The Commission is not adopting a definition of ''compliance policies and procedures,'' as it has concluded that a DCO's compliance policies and procedures will likely encompass a limited, self-evident body of documents, and a regulatory definition could invite more scrutiny than is necessary or helpful to the DCO or the Commission.

The Commission proposed to define ''stress test'' as ''a test that compares the impact of a potential price move, change

[14] *See* Section 4s of the CEA, 7 U.S.C. 6s.

[15] *See* 76 FR 33818 (June 9, 2011) (Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions); 76 FR 33066 (June 7, 2011) (Adaptation of Regulations to Incorporate Swaps).

in option volatility, or change in other inputs that affect the value of a position, to the financial resources of a [DCO], clearing member, or large trader to determine the adequacy of such financial resources.'' Better Markets, Inc. (Better Markets) expressed the view that a stress test can only be useful if it tests unprecedented circumstances of illiquidity, and that basing the test on historic price data would make it meaningless. In response to this comment, the Commission is modifying the definition in one respect. The word ''extreme'' is being inserted after the word ''potential'' to make clear that a stress test does not include typical events. The Commission further addresses Better Markets' concerns in its discussion of stress tests in § 39.13(h)(3).[16]

The Commission proposed to define the term ''systemically important derivatives clearing organization'' to mean ''a financial market utility that is a derivatives clearing organization registered under Section 5b of the Act (7 U.S.C. 7a–1), which has been designated by the Financial Stability Oversight Council to be systemically important.'' The Options Clearing Corporation (OCC) submitted a comment on this definition in connection with the Commission's proposed § 40.10 (special certification procedures for submission of certain risk-related rules by SIDCOs).[17] OCC pointed out that, under this proposed definition, a DCO could be a SIDCO even if the Commission were not its Supervisory Agency pursuant to Section 803(8) of the Dodd-Frank Act. The Commission, recognizing that some DCOs like OCC may be regulated by more than one federal agency, is adopting a revised definition to clarify that the term ''systemically important derivatives clearing organization'' means a ''financial market utility that is a derivatives clearing organization registered under Section 5b of the Act, which has been designated by the Financial Stability Oversight Council to be systemically important and for which the Commission acts as the Supervisory Agency pursuant to Section 803(8) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.'' [18]

The Commission also is making a technical change to the definition of ''customer account or customer origin.'' The proposed definition would provide, in part, that ''[a] customer account is also a futures account, as that term is defined by Sec. 1.3(vv) of this chapter.'' The Commission is removing this reference and defining ''customer account or customer origin'' to mean ''a clearing member account held on behalf of customers, as that term is defined in this section, and which is subject to section 4d(a) or section 4d(f) of the Act.'' This clarifies that the term encompasses both customer futures accounts and customer cleared swaps accounts, respectively.

Similarly, the Commission is making a technical revision to the term ''house account or house origin'' to delete the proposed reference to proprietary accounts, which are currently defined in § 1.3(y) only in terms of futures and options (not swaps). The term ''house account or house origin'' is now defined as a ''clearing member account which is not subject to section 4d(a) or 4d(f) of the Act.''

In connection with the proposal to adopt a definitions section designated as § 39.2, the Commission proposed to rescind the existing § 39.2, which exempted DCOs from all Commission regulations except those explicitly enumerated in the exemption. This action would result in clarifying the applicability of § 1.49 (denomination of customer funds and location of depositories) to DCOs and, insofar as the rule exempted DCOs from regulations relating to DCO governance and conflicts of interest, those regulations are expected to themselves be replaced by rules to implement DCO Core Principles O (Governance Fitness Standards), P (Conflicts of Interest), and Q (Composition of Governing Boards).[19] The Commission did not receive any comments on the proposed rescission of the exemption provided by existing § 39.2 and is herein rescinding that exemption, as proposed.

C. Procedures for Registration as a DCO—§ 39.3

The Commission proposed several revisions to its procedures for DCO registration, including the elimination of the 90-day expedited review period and the required use of an application form, proposed Form DCO. The Commission is adopting § 39.3 as proposed, and is adopting the Form DCO with the revisions discussed below.

1. Form DCO

The Commission proposed to revise appendix A to part 39, ''Application Guidance and Compliance with Core Principles,'' by removing the existing guidance and substituting the Form DCO in its place. An application for DCO registration would consist of the completed Form DCO, which would include all applicable exhibits, and any supplemental information submitted to the Commission.

CME commented that the proposed Form DCO would require the applicant to create and submit to the Commission a large number of documents. It questioned why certain documents were necessary and whether Commission staff would be able to meaningfully review all of the materials within the 180-day timeframe contemplated in the proposed regulations.

The Commission is adopting the Form DCO as proposed, except for the modifications discussed below. The Commission notes that the Form DCO standardizes and clarifies the information that the Commission has required from DCO applicants in the past and the Form DCO Exhibit Instructions, in an effort to reduce the burden on applicants, state that ''If any Exhibit requires information that is related to, or may be duplicative of, information required to be included in another Exhibit, Applicant may summarize such information and provide a cross-reference to the Exhibit that contains the required information.'' Based on the Commission's experience with the DCO registration process over the past decade, it believes that its staff can meaningfully review the required information within the 180-day time frame. In addition, the Commission believes that by standardizing informational requirements, the Form DCO will allow the Commission to process applications more quickly and efficiently. This will benefit applicants as well as free Commission staff to handle other regulatory matters.

CME specifically questioned whether, as part of the Form DCO cover sheet, applicants should be required to identify and list ''all outside service providers and consultants, including accountants and legal counsel.'' This comment mischaracterizes the information required by the Form DCO, which requires contact information for enumerated outside service providers (Certified Public Accountant, legal counsel, records storage or management, business continuity/disaster recovery) and ''other'' outside service providers ''such as consultants, providing services related to this application.'' Such contact information is helpful to the Commission staff in processing the application and making a determination as to whether the applicant has obtained the services it needs to effectively

[16] *See* discussion of stress tests in section IV.D.7.c, below.

[17] *See* 76 FR 44776 at 44783–84 (July 27, 2011) (Provisions Common to Registered Entities; final rule).

[18] *See id.* for further discussion of this topic.

[19] *See* 76 FR 722 (Jan. 6, 2011) (Governance); and 75 FR 63732 (Oct. 18, 2010) (Conflicts of Interest).

operate as a DCO.[20] Nonetheless, in response to CME's comments and in order to clarify the scope of requesting contact information for ''any other outside service providers,'' the Commission has decided to revise section 12.e. of the Form DCO cover sheet to provide for contact information for any ''Professional consultant providing services related to this application.''

CME commented that proposed exhibit A–1, which would require the applicant to produce a chart demonstrating in detail how its rules, procedures, and policies address each DCO core principle, is not necessary. The Commission believes exhibit A–1 is necessary because it will provide a clear picture of which rules, procedures, and policies address each DCO core principle. The chart will greatly assist Commission staff in tracking and evaluating the materials supplied by the applicant and should reduce the need for staff to seek follow-up clarifications from the applicant. Again, this will also reduce the costs to the applicant.

CME commented that the Commission has not explained its reasons for requiring an applicant to supply ''telephone numbers, mobile phone numbers and email addresses of all officers, managers, and directors of the DCO,'' as provided in proposed exhibit A–6. The Commission notes that the exhibit A–6 instructions request contact and other information for ''current officers, directors, governors, general partners, LLC managers, and members of all standing committees.'' The exhibit is not directed at ''all managers'' or ''all directors,'' but rather at those persons who are in key decision-making positions (for example, key personnel, directors serving on a board of directors and a manager or managing member of a DCO organized in the form of a limited liability corporation). The purpose of obtaining contact information is to enable the Commission to start building an emergency contact database.

[20] This requirement focuses on outside services ''related to this application.'' Similarly, if the applicant intends to use the services of an outside service provider (including services of its clearing members or market participants), to enable it to comply with any of the core principles, the applicant must submit as exhibit A–10 all agreements entered into or to be entered into between the applicant and the outside service provider, and identify: (1) The services that will be provided; (2) the staff who will provide the services; and (3) the core principles addressed by such arrangement. This exhibit does not require that the applicant submit information and documentation related to all outside service providers. Rather, the requirement is directed at contractual arrangements related to compliance with the core principles, *i.e.*, the DCO's core business functions.

CME commented that proposed exhibit A–7 would require the applicant to list all jurisdictions where the applicant and its affiliates are doing business, and the registration status of the applicant and its affiliates. CME questioned the Commission's need for such information with respect to affiliates of the applicant. The Commission believes that such information is necessary because it allows the Commission to develop a more complete understanding of the applicant's entire corporate organizational structure including potential financial commitments and regulatory obligations of the applicant's affiliates inclusive of its parent organization.

CME commented that proposed exhibit B–3, which would require the applicant to provide proof that each of its physical locations meets all building and fire codes, and that it has running water and a heating, ventilation and air conditioning system, and adequate office technology, is not necessary. The Commission believes that it is important for an applicant to demonstrate that it has a physical presence capable of supporting clearing and settlement services and is not a ''shoestring'' operation. Typically, Commission staff will conduct a site visit to an applicant's headquarters and other facilities, and one of the purposes of such visits is to evaluate the suitability of the applicant's physical facilities. Site visits, however, are conducted after a DCO application is deemed to be materially complete, and there are instances when it might not be feasible to conduct a site visit. Accordingly, at a minimum, a narrative statement discussing the applicant's physical facilities and office technology must be submitted to the Commission as part of the application package so that staff can complete its initial review for ''adequate * * * operational resources'' under Core Principle B.

In response to CME's comments, the Commission has decided to revise exhibit B–3 to require the following:

(3) A narrative statement demonstrating the adequacy of Applicant's physical infrastructure to carry out business operations, which includes a principal executive office (separate from any personal dwelling) with a U.S. street address (not merely a post office box number). For its principal executive office and other facilities Applicant plans to occupy in carrying out its DCO functions, a description of the space (*e.g.,* location and square footage), use of the space (*e.g.,* executive office, data center), and the basis for Applicant's right to occupy the space (*e.g.,* lease, agreement with parent company to share leased space).

(4) A narrative statement demonstrating the adequacy of the technological systems necessary to carry out Applicant's business operations, including a description of Applicant's information technology and telecommunications systems and a timetable for full operability.

CME questioned the value of proposed exhibits C–1(9) and C–2(5), which would, respectively, require an applicant to provide a list of current and prospective clearing members, and to forecast expected volumes and open interest at launch date, six months, and one year thereafter. The Commission believes that this information is important because it would enable the Commission to understand the nature and level of the DCO's expected start-up activities and to appropriately evaluate whether the applicant has adequate resources to manage the expected volume of business.

CME questioned the benefits of what it termed the ''incredibly burdensome'' requirements of proposed exhibit D–2(b)(3), which would require an applicant to explain why a particular margin methodology was chosen over other potentially suitable methodologies, and to include a comparison of margin levels that would have been generated by using such other potential methodologies. To address CME's comment, the Commission is revising exhibit D–2(b)(3) to require an explanation of whether other margining methodologies were considered and, if so, explain why they were not chosen. This information will be sufficient in the first instance and, when evaluating an applicant's proposed margin methodology, Commission staff can request additional information if needed to complete its review for compliance with Core Principle D and § 39.13 (risk management).

The Commission proposed to require use of the Form DCO by a registered DCO when requesting an amendment to its DCO registration order. CME and Minneapolis Grain Exchange, Inc. (MGEX) suggested that the Form DCO be modified so that a currently registered DCO would not have to expend as much time and resources to complete an amendment request as a new applicant for DCO registration, unless there are extenuating circumstances. In response to this suggestion, the Commission is revising the Form DCO General Instructions to clarify that if the Form DCO is being filed as an amendment to a pending application for registration or for the purpose of amending an existing registration order, the applicant need only submit the information and exhibits relevant to the application

amendment or request for an amended registration order.

CME also noted that a DCO applicant would be required to represent that its Form DCO submission is true, correct, and complete. It suggested that the Commission modify this language so that the applicant is required to certify that, ''to the best of its knowledge,'' its Form DCO submission is true, correct, and complete ''in all material respects.'' The Commission is revising the language as suggested by CME, in recognition of the fact that some of the information contained in the exhibits may have been provided by third parties and there is a limit to the reach of an applicant's due diligence with respect to such information.

In addition to the above changes, the Commission has made non-substantive editorial changes to the Form DCO for purposes of internal consistency and conformity with the Form SDR for swap data repositories (SDRs) and proposed Form DCM and Form SEF for designated contract markets (DCMs) and swap execution facilities (SEFs), respectively.[21] The Commission also has made changes to Form DCO to remove references to proposed regulations that remain pending.[22]

2. Request for Transfer of Registration and Open Interest—§ 39.3(h)

The Commission proposed § 39.3(h) to clarify the procedures that a DCO must follow when requesting the transfer of its DCO registration and positions comprising open interest for clearing and settlement, in anticipation of a corporation change.[23] The Commission received a comment from OCC suggesting that a request to transfer a DCO's registration and open interest should be published in the **Federal Register** for public comment.

The Commission recognizes the value of public comment, but it has determined not to formalize the public comment process through publication in the **Federal Register**. This procedure could unnecessarily delay the review process and completion of the transfer, and the Commission believes that posting the request on its Web site, which it currently does for DCO registration applications, will provide an opportunity for public comment without potential delay.

3. Technical Amendments

The Commission proposed a set of technical amendments to § 39.3 to update filing procedures, to conform various provisions to reflect the elimination of the 90-day expedited review period for DCO applications, and to correct terminology in the delegation provisions of § 39.3(g). The Commission did not receive any comments on the proposed technical amendments and the Commission is adopting the amendments as proposed.

D. Procedures for Implementing DCO Rules and Clearing New Products—§ 39.4

1. Acceptance of Certain New Products for Clearing—§ 39.4(c)(2)

The Commission proposed a technical amendment to existing § 39.4(c)(2), which would require a DCO to certify to the Commission the terms and conditions of new over-the-counter (OTC) products that it intended to clear. The Commission proposed removing the reference to new products ''not traded on a designated contract market or a registered derivatives transaction execution facility'' and inserting a reference to new products ''not traded on a designated contract market or a registered swap execution facility.'' The proposed provision would retain the reference to filing the terms and conditions of the new product ''pursuant to the procedures of § 40.2 of this chapter.''

Since proposing that technical amendment, the Commission has adopted a new § 39.5 (review of swaps for Commission determination on clearing requirement) [24] and revisions to § 40.2 (listing products for trading by certification).[25] As a result, a DCO seeking to clear new products that are not traded on a designated contract market or swap execution facility must submit to the Commission the terms and conditions of the product pursuant to the procedures of § 39.5, not § 40.2. The Commission is therefore adopting a technical revision to conform § 39.4(c)(2) to the current procedural requirements.

2. Holding Securities in a Futures Portfolio Margining Account—§ 39.4(e)

The CEA, as amended by Section 713 of the Dodd-Frank Act, permits, pursuant to an exemption, rule or regulation, futures and options on futures to be held in a portfolio margining account that is carried as a securities account and approved by the SEC.[26] Reciprocally, the Securities Exchange Act of 1934 (SEA), as amended by Section 713 of the Dodd-Frank Act, permits, pursuant to an exemption, rule, or regulation, cash and securities to be held in a portfolio margining account that is carried as a futures account and approved by the Commission.[27] Those provisions of the CEA and SEA further require consultation between the Commission and the SEC in drafting implementing regulations. As a first step toward meeting this goal, proposed § 39.4(e) would establish the procedural requirements applicable to a DCO seeking approval for a futures portfolio margining account program.

OCC, Newedge USA, LLC (Newedge), New York Portfolio Clearing, LLC (NYPC), and MetLife Inc. urged the Commission to propose rules that would permit portfolio margining, not just establish procedural requirements. The Commission agrees that it should propose substantive portfolio margining rules, but it must move forward on proposing substantive rules with the SEC's participation.

Accordingly, the Commission is adopting the procedural requirements as proposed and anticipates consulting with the SEC in the future to determine the substantive requirements it would impose in approving a futures portfolio margining program and, additionally, in granting an exemption under Section 4(c) of the CEA to permit futures and options on futures to be held in a securities portfolio margining account. The Dodd-Frank Act does not set a deadline for these actions, and the Commission believes that it is important to give this matter due consideration, both in terms of consultation with the SEC and, more broadly, in obtaining industry views on the topic before

[21] *See* 76 FR 54538 (Sept. 1, 2011) (SDRs: Registration Standards, Duties and Core Principles; final rule); 75 FR 80572 (Dec. 22, 2010) (Core Principles and Other Requirements for Designated Contract Markets); 76 FR 1214 (Jan. 7, 2011) (Core Principles and Other Requirements for Swap Execution Facilities).

[22] For example, the Commission has removed the specific cross-references located in exhibit P to Form DCO to the proposed conflicts of interest rules, 75 FR 63732 (Oct. 18, 2010) (Conflicts of Interest), and replaced such references with a description of the required information. When the Commission finalizes such proposed rules, the Commission intends to make technical changes to the Form DCO to include cross-references to such final rules where, in the opinion of the Commission, doing so will facilitate compliance with the Form DCO, the CEA and/or Commission regulations.

[23] As a technical matter, the Commission is removing proposed § 39.3(g)(1) and adopting proposed § 39.3(h) as § 39.3(f); proposed § 39.3(g)(1) was a typographical error which repeats a delegation of authority already provided by § 39.3(b)(2)(i).

[24] *See* 76 FR 44464, at 44473–44474 (July 26, 2011) (Process for Review of Swaps for Mandatory Clearing; final rule).

[25] *See* 76 FR 44776 (July 27, 2011) (Provisions Common to Registered Entities; final rule).

[26] Section 4d(h) of the CEA, 7 U.S.C. 6d(h).

[27] Section 15(c)(3)(C) of the SEA, 15 U.S.C. 78o(c)(3).

proposing substantive regulations or other guidance.

E. Reorganization of Part 39

With the adoption of regulations relating to implementation of the core principles and other provisions of the Dodd-Frank Act, the Commission is reorganizing part 39 of its regulations into two subparts, with a new appendix.

Subpart A, ''General Provisions Applicable to Derivatives Clearing Organizations'' contains §§ 39.1 through 39.8, which are general provisions including procedural requirements for DCO applications and other activities such as transfer of a DCO registration, clearing of new products, and submission of swaps for a mandatory clearing determination. Subpart A also includes pre-existing provisions regarding enforceability and fraud in connection with clearing transactions on a DCO.[28] Subpart B, ''Compliance with Core Principles,'' contains §§ 39.9 through 39.27, which are rules that implement the core principles under Section 5b of the CEA, as amended by the Dodd-Frank Act.

As discussed above, the Commission is replacing appendix A ''Application Guidance and Compliance with Core Principles,'' with a new appendix to part 39, ''Form DCO Derivatives Clearing Organization Application for Registration.''

F. Technical Amendments

With the objective of listing all DCO reporting requirements in a new § 39.19, the Commission proposed redesignating § 39.5(a) and (b) (information relating to DCOs) as proposed §§ 39.19(c)(5)(i) and (ii), respectively, in substantially the same form. The Commission also proposed removing § 39.5(c) (large trader reporting by DCOs), redesignating § 39.5(d) (special calls) as § 21.04 (and current § 21.04 as § 21.05), and adding § 21.06, which would delegate authority under § 21.04 to the Director of the Division of Clearing and Risk.

The Commission did not receive any comments on these proposals. Therefore, the Commission is adopting these revisions as proposed, except for non-substantive changes to §§ 39.19(c)(5)(i) and (c)(5)(ii) to clarify the language.[29]

IV. Part 39 Amendments—Compliance With Core Principles

Proposed § 39.9 would establish the scope of the rules contained in subpart B of part 39, stating that all provisions of subpart B apply to DCOs. The Commission did not receive any comments on the statement of scope, and the Commission is adopting § 39.9 as proposed.

A. Core Principle A—Compliance With Core Principles—§ 39.10

1. Core Principle A

Core Principle A,[30] as amended by the Dodd-Frank Act, requires a DCO to comply with each core principle set forth in Section 5b(c)(2) of the CEA and any requirement that the Commission may impose by rule or regulation pursuant to Section 8a(5) of the CEA. Core Principle A also provides a DCO with reasonable discretion to establish the manner by which it complies with each core principle. Proposed §§ 39.10(a) and 39.10(b) would codify these provisions, respectively. The Commission received no comments on these proposed rules and is adopting the rules as proposed.

2. Designation of a Chief Compliance Officer—§ 39.10(c)(1)

Section 725(b) of the Dodd-Frank Act added a new paragraph (i) to Section 5b of the CEA to require each DCO to designate an individual as its CCO, responsible for the DCO's compliance with the CEA and Commission regulations and the filing of an annual compliance report.[31] In proposed § 39.10(c), the Commission set forth implementing requirements that would largely track the language of Section 5b(i).

Under the introductory provision of proposed § 39.10(c)(1), each DCO would be required to appoint a CCO with ''the full responsibility and authority to develop and enforce in consultation with the board of directors or the senior officer, appropriate compliance policies and procedures, as defined in § 39.1(b), to fulfill the duties set forth in the Act and Commission regulations.'' As previously noted, the Commission is not adopting the definition of ''compliance policies and procedures'' included in proposed § 39.1(b).

CME commented that the text of the Dodd-Frank Act does not require a CCO to ''enforce'' compliance policies and procedures and it suggested that § 39.10 should not do so. According to CME, it is important to separate the functions of monitoring and advising on compliance issues from what it considers ''senior management functions'' of enforcing and supervising compliance policies.

The Commission believes that Congress intended that the CCO have the full responsibility and authority to enforce compliance in consultation with the board of directors or the senior officer. Given the specified duties of the CCO set forth in Section 5b(i)(2), the Commission finds ample support for this interpretation and is adopting the rule as proposed.

First, one definition of the term ''enforce'' is ''to ensure observance of laws and rules,'' [32] and among the CCO duties set forth by the Dodd-Frank Act is the requirement that the CCO ''ensure compliance.'' [33] Second, Section 5b(i)(2)(C) requires a CCO to ''resolve any conflicts of interest that may arise'' in consultation with the board of the DCO or the senior officer of the DCO. This duty clearly indicates that the CCO is more than just an advisor to management and must have the ability to enforce compliance with the CEA and Commission regulations. The authority to resolve conflicts of interest is more an enforcement function than an audit function. Finally, Section 5b(i)(2)(D) requires the CCO to ''be responsible for administering each policy.''

While the CEA does not explicitly use the word ''enforce,'' the Commission believes that the use of this word in § 39.10(c)(1) is appropriate to capture the meaning of Section 5b(i)(2)(C), *i.e.,* that CCOs must have the authority to fulfill their statutory and regulatory obligations. Moreover, it is consistent with the statutory directive for the CCO to ensure compliance with the CEA. These considerations are particularly important given that the CCO of a DCO has unique responsibilities in connection with the DCO's critical role in providing financial integrity to derivatives markets. In particular, a CCO must have the ability to effectively address rules and practices that could compromise compliance with fair and open access requirements (Core Principle C), risk management

[28] As part of the reorganization of Part 39, § 39.6 (Enforceability) is being redesignated as § 39.7 and § 39.7 (Fraud in connection with the clearing of transactions on a derivatives clearing organization) is being redesignated as § 39.8.

[29] After these technical amendments were proposed, the Commission adopted a final rule governing the process for review of swaps for mandatory clearing. That rule was designated as § 39.5, and the former § 39.5 was redesignated as § 39.8. *See* 76 FR at 44473 (July 26, 2011) (Process for Review of Swaps for Mandatory Clearing; final rule). In connection with adoption of the technical amendments described above, the provisions regarding fraud in connection with the clearing of transactions on a DCO (former § 39.7) are now redesignated as § 39.8.

[30] Section 5b(c)(2)(A) of the CEA, 7 U.S.C. 7a–1(c)(2)(A).

[31] *See* Section 5b(i) of the CEA; 7 U.S.C. 7a–1(b)(i).

[32] *See http://www.websters-online-dictionary.org/definitions/enforce.*

[33] *See* Section 5b(i)(2)(E) of the CEA, 7 U.S.C. 7a–1(b)(i)(2)(E), which requires the CCO to ''ensure compliance with this Act (including regulations) relating to agreements, contracts, or transactions, including each rule prescribed by the Commission under this section.''

requirements (Core Principle D), and financial resource requirements (Core Principle B).

The Commission, however, recognizes that the term ''enforce'' could imply that the DCO's CCO must have direct supervisory authority over employees not otherwise in his or her direct chain of command, or that the CCO has independent authority to discipline employees or terminate employment to facilitate compliance with the CEA and the Commission's regulations. To avoid confusion, the Commission herein clarifies that the term ''enforce,'' as used in § 39.10(c)(1), is not intended to include the authority to supervise employees not in the CCO's direct chain of command, or the authority to terminate employment or discipline employees for conduct that results in noncompliance. The Commission notes that a DCO is not precluded from conferring such authority on its CCO; however, such action would be at the DCO's discretion and is not required by § 39.10(c)(1).[34]

3. Individuals Qualifying To Serve as a CCO—§ 39.10(c)(1)(i)

Proposed § 39.10(c)(1)(i) would require a DCO to designate an individual with the background and skills appropriate for fulfilling the responsibilities of the CCO position. The Commission asked whether additional qualifications should be imposed and, in particular, whether the Commission should restrict the CCO position from being held by an attorney who represents the DCO or its board of directors, such as an in-house or general counsel. The Commission explained that the rationale for such a restriction would be based on concern that the interests of representing the DCO's board of directors or management could be in conflict with the duties of the CCO. Related to this, the Commission specifically sought comment on whether there is a need for a regulation requiring the DCO to insulate a CCO from undue pressure and coercion. It further asked if it is necessary to adopt rules to address the potential conflict between and among compliance interests, commercial interests, and ownership interests of a DCO and, if there is no need for such rules, requested comment on how such potential conflicts would be addressed.

CME, OCC, MGEX, and the Kansas City Board of Trade Clearing Corporation (KCC) commented that additional restrictions should not be imposed. MGEX commented that smaller DCOs will need to maximize the utility of each employee. It also argued that there is little risk if a CCO serves as in-house counsel because attorneys have additional ethical duties which can complement the duties and obligations of a CCO. According to MGEX, if a conflict arose, the attorney could step out of one or both of the roles.

Better Markets commented that there is potential conflict between a CCO and in-house counsel because in-house counsel is an advocate for the DCO or its board of directors regarding any controversy that may relate to regulatory compliance, while a CCO's duty is to ensure compliance. It suggested that the Commission prohibit a CCO from serving as in-house counsel.

The Commission is adopting § 39.10(c)(1)(i) as proposed. The Commission has considered prohibiting a CCO from working in the DCO's legal department or serving as general counsel, consistent with the Commission's approach to the CCO of an SDR.[35] However, in response to public comments and in light of the fact that all currently registered DCOs have some form of compliance program already in place, with one or more staff members assigned to carry out compliance officer functions, the Commission has determined that the potential costs of hiring additional staff to satisfy such requirement could result in imposing an unnecessary burden on DCOs, particularly smaller ones. The Commission recognizes, however, that a conflict of interest could compromise a CCO's ability to effectively fulfill his or her responsibilities as a CCO. The Commission therefore expects that as soon as any conflict of interest becomes apparent, a DCO would immediately implement a back-up plan for reassignment or other measures to address the conflict and ensure that the CCO's duties can be performed without compromise.

MGEX and KCC also recommended that the Commission should permit the Chief Regulatory Officer to function as the CCO. Presumably, the commenters are referring to circumstances in which a DCO (which typically would not have a Chief Regulatory Officer) is also registered as a DCM (which typically would have a Chief Regulatory Officer). The Commission notes that the rule does not prohibit the person serving as CCO from also serving as the Chief Regulatory Officer.

4. CCO Reporting Structure—§ 39.10(c)(1)(ii)

Section 5b(i)(2)(A) of the CEA requires that a CCO report directly to the board of directors or the senior officer of the DCO.[36] Proposed § 39.10(c)(1)(ii) would codify this requirement. The proposed rule also would require the board of directors or the senior officer to approve the compensation of the CCO.

In the notice of proposed rulemaking, the Commission sought comment as to the degree of flexibility that should be provided in the reporting structure of the CCO. Specifically, the Commission requested comment on: (i) Whether it would be more appropriate for a CCO to report to the senior officer or the board of directors; (ii) as between the senior officer or board of directors, which generally is a stronger advocate of compliance matters within an organization; and (iii) whether the proposed rules allow for sufficient flexibility with regard to a DCO's business structure.

CME, MGEX, and KCC commented that the proposed rules would provide DCOs with the appropriate degree of flexibility. CME, however, believes it would be ''logical'' for a CCO to report to the senior officer, and that the board of directors should oversee implementation of compliance policies and ensure that compliance issues are resolved effectively and expeditiously by the senior officer with the assistance of the CCO. MGEX noted that each DCO may have a different business and reporting structure and believes that rigid rules may hinder the effectiveness and independence of the CCO.

Better Markets observed that, in the past, businesses have placed financial interests over other considerations like risk management and have created a climate where people were unwilling to speak out against financial considerations for fear of being fired. Better Markets suggested that there should be a strong reporting and working relationship between the CCO and independent directors, and suggested that independent directors have sole responsibility to designate or terminate the CCO and to set compensation levels for the CCO.

The Commission is adopting § 39.10(c)(1)(ii) as proposed, declining to prescribe whether the CCO can only report to the board of directors or to the senior officer. The Commission appreciates Better Markets' concern that a CCO who reports to the senior officer may be swayed by financial

[34] *See* further discussion of a CCO's duties in section IV.A.7, below.

[35] *See* 76 FR 54538 (Sept. 1, 2011) (SDRs: Registration Standards, Duties and Core Principles; final rule).

[36] 7 U.S.C. 7a–1(i)(2)(A).

considerations. However, the Dodd-Frank Act permits alternative reporting structures and the Commission has not been presented with a compelling reason to conclude that the structure and operations of a DCO require the imposition of this limitation on the ability of a DCO's board and management to establish lines of authority appropriate to the particular DCO.

CME asked the Commission to clarify that the term ''senior officer'' may apply to the senior officer of a division that is engaged in clearing activities. The Commission notes that Section 5b(i)(2)(A) of the CEA requires a CCO to ''report directly to the board or to the senior officer of the derivatives clearing organization.'' If the division engaged in clearing activities is the registered DCO, then the senior officer of that division would be the ''senior officer'' for purposes of this provision.

Finally, Better Markets suggested that compliance should be addressed on an entire-group basis by a senior CCO. According to Better Markets, a single senior CCO should have overall responsibility for each affiliated and controlled entity, even if the individual entities within the group have CCOs. The final rules do not require a business organization to have a ''senior'' CCO as Better Markets suggested. The Commission believes this would be overly prescriptive and that a DCO should have the flexibility to manage compliance functions across divisions or affiliates to accommodate its particular organizational structure.

5. Annual Compliance Meeting—§ 39.10(c)(1)(iii)

Proposed § 39.10(c)(1)(iii) would require a CCO to meet with the board of directors or the senior officer at least once a year to discuss the effectiveness of the DCO's compliance policies and procedures, as well as the administration of those policies and procedures by the CCO. Better Markets suggested that a CCO meet with the board of directors at least quarterly. No comments were received on the proposed topics to be discussed at the annual meeting.

The Commission is adopting § 39.10(c)(1)(iii) in modified form. The final rule retains the requirement that the CCO meet with the board of directors or senior officer annually, but eliminates the required topics to be discussed at the meeting. As the Commission noted in the notice of proposed rulemaking, the requirement for an annual discussion would not preclude the board of directors or the senior officer from meeting with the CCO more frequently. While more frequent communication between the CCO and the DCO's board or senior officer may be desirable, the Commission has concluded that adopting requirements to that effect would be overly prescriptive. Similarly, upon further consideration, the Commission has concluded that the purpose of the meeting should be self-evident (*i.e.,* compliance) and it is not necessary for the Commission, by regulation, to prescribe the business that must be conducted at that meeting.

6. Change in the Designation of the CCO—§ 39.10(c)(1)(iv)

Proposed § 39.10(c)(1)(iv) would require that a change in the designation of the individual serving as the CCO be reported to the Commission, in accordance with the requirements of proposed § 39.19(c)(4)(xi). The Commission received no comments on the proposed rule and is adopting the provision as proposed.[37]

7. Duties of the CCO—§ 39.10(c)(2)

Section 5b(i)(2) of the CEA, added by Section 725(a) of the Dodd-Frank Act, sets forth the duties of a CCO,[38] and proposed § 39.10(c)(2) would codify those enumerated duties in paragraphs (c)(2)(i)–(vii).

The Commission received comments on the CCO's duties from CME, KCC, and OCC. In general, the commenters expressed the view that the proposed regulations are too broad because they improperly provide the CCO with what CME calls ''senior management functions'' like enforcing and supervising compliance policies. Instead, the commenters believe that the role of a CCO is only to serve as an auditor who monitors compliance and informs senior management of noncompliance. The Commission has carefully considered the comments and is adopting the rule as proposed, except as discussed below.

CME acknowledged that proposed § 39.10(c)(2)(ii) mirrors the language in the Dodd-Frank Act. However, CME believes that Congress did not intend to mean ''resolve'' in the executive or managerial sense such that the CCO alone would examine the facts and determine and affect the course of action. CME believes that Congress intended the CCO to identify, advise, and escalate, as appropriate, and to assist senior management in resolving conflicts of interest.

KCC also believes that the board of directors or senior officer should resolve any conflict of interest in consultation with the CCO. KCC commented that compliance policies and procedures should be administered by DCO staff and not by the CCO. According to KCC, a DCO's staff is most familiar with the day-to-day operations of the DCO and is in the best position to manage the policies and procedures. KCC believes that a CCO's role should be that of oversight of the DCO's compliance program and filing an annual report.

The Commission disagrees with assertions that a CCO should only assist senior management in resolving conflicts of interest or that the board or senior management should resolve conflicts of interest in consultation with the CCO. Section 5b(i)(2)(C) of the CEA states that a CCO shall ''in consultation with the board of the derivatives clearing organization, a body performing a function similar to the board of the derivatives clearing organization, or the senior officer of the derivatives clearing organization, resolve any conflicts of interest that may arise.'' Given this express statutory direction, the Commission is not revising the proposed rule.

The Commission points out that a CCO's duty to administer compliance policies and procedures is set forth in Section 5b(i)(2)(D) of the CEA. It requires a CCO to ''be responsible for administering each policy and procedure that is required to be established pursuant to this section.'' By administering compliance policies and procedures, a CCO is not required to perform staff functions that have compliance implications. Rather, the CCO is responsible for oversight of such functions.

The Commission is revising § 39.10(c)(2)(iii) to require a CCO to have the duty of ''[e]stablishing and administering written policies and procedures reasonably designed to prevent violation of the Act.'' This does not change the substance of the requirement or alter the implementation of the statutory standard, as it is consistent with § 39.10(c)(1) which requires a CCO to ''develop * * * appropriate policies and procedures * * * to fulfill the duties set forth in the Act and Commission regulations.'' The Commission believes that the revised language eliminates the possibility of ambiguity and prevents too narrow a reading of the reference to policies and procedures that are ''required'' under the CEA.

CME described as ''impracticable'' the proposed standard that a CCO must ''ensure'' a DCO's compliance and

[37] *See* discussion in section IV.J.5.h. (The Commission is adopting proposed § 39.19(c)(4)(xi) as a renumbered § 39.19(c)(4)(ix)).

[38] 7 U.S.C. 7a–1(i)(2).

suggested that an appropriate and ''achievable'' standard would be to require a CCO to put in place measures ''reasonably designed to ensure compliance'' with the CEA and Commission regulations.

The Commission is revising § 39.10(c)(2)(iv) in response to CME's comment. Although Section 5b(i)(2)(E) of the CEA requires a CCO to ''ensure'' compliance, the Commission agrees that a CCO cannot fully guarantee compliance because, as a practical matter, he or she will have to rely to some extent on information provided by other DCO employees or representatives of the DCO's service providers. Accordingly, § 39.10(c)(2)(iv) is being modified to include as a duty of the CCO, ''[*t]aking reasonable steps to ensure compliance* with the Act and Commission regulations * * *'' (added text in italics). The Commission believes that this revision addresses CME's concern while retaining the emphasis on the CCO's actions rather than focusing on the nature of measures put in place by the CCO.[39]

CME recommended that the Commission revise proposed § 39.10(c)(2)(vi) to require a CCO to ''[e]stablish[] appropriate procedures [for] the handling, management response, remediation, retesting, and closing of noncompliance issues,'' and to eliminate the requirement that a CCO ''follow[]'' such procedures. According to CME, this is a function of senior management and Congress did not intend for a CCO to exercise senior management functions. OCC agrees with CME.

Specifically, CME suggested that proposed § 39.10(c)(2)(vi) be modified to eliminate the requirement that a CCO ''follow'' appropriate procedures because following procedures is a function of senior management. However, a CCO's performance of this ''senior management'' function is explicitly set forth in Section 5b(i)(2)(G) of the CEA, which states that ''[t]he chief compliance officer shall * * * establish and follow appropriate procedures for the handling, management response, remediation, retesting, and closing of noncompliance issues.'' The Commission does not believe that CME has provided a persuasive basis for its suggested modification of § 39.10(c)(2)(vi), and the Commission is adopting the provision as proposed.

[39] *See also* 76 FR at 54584 (Sept. 1, 2011) (SDRs: Registration Standards, Duties and Core Principles; final rule) (adopting § 49.22(d)(4), which applies this standard to the CCO of an SDR).

Finally, the Commission, on its own initiative, is revising § 39.10(c)(2)(vii) to eliminate the requirement that a CCO establish a compliance manual. While having a compliance manual is a good practice, incorporating this requirement into a regulation may be overly prescriptive and the Commission has concluded that a DCO should have discretion as to the vehicles through which it will carry out its compliance program.

8. Annual Report—§ 39.10(c)(3)

Section 5b(i)(3) of the CEA, added by Section 725(b) of the Dodd-Frank Act, requires a CCO to prepare an annual report that describes the DCO's compliance with the CEA, regulations promulgated under the CEA, and each policy and procedure of the DCO, including the code of ethics and conflicts of interest policies.[40] Implementation of these statutory requirements was addressed at proposed § 39.10(c)(3)(i), (c)(3)(ii)(A), and (c)(3)(v) and (v).

With respect to proposed § 39.10(c)(3)(i), CME suggested that the Commission eliminate it and KCC commented that the requirement for a DCO to show compliance with respect to the CEA and Commission regulations is ambiguous and overreaching. KCC also suggested that the scope of the annual report should not go beyond reviewing the DCO core principles and identifying the compliance policies and procedures that are in place to satisfy the core principles.

Although paragraph (i) mirrors the language and requirements set forth in Section 5b(i)(3)(A)(i) of the CEA, to address CME's and KCC's comments, the Commission has decided to revise the language of §§ 39.10(c)(3)(i) and (ii) to avoid submission of duplicative information and to clarify the scope of the annual report content requirements without altering the nature of the information that must be included in the report pursuant to the CEA. Final § 39.10 (c)(3)(i) requires that the annual report ''[c]ontain a description of the derivatives clearing organization's written policies and procedures, including the code of ethics and conflict of interest policies.'' Final § 39.10 (c)(3)(ii) requires that the report '' [r]eview each core principle and applicable Commission regulations, and with respect to each: (A) Identify the compliance policies and procedures that are designed to ensure compliance with the core principle.'' The Commission notes that by specifying ''written'' policies and procedures, the rule more precisely establishes the scope of § 39.10(c)(3)(i).

Proposed §§ 39.10(c)(3)(iii) and (c)(3)(iv) would require that the annual report list any material changes to compliance policies and procedures since the last annual report and describe the DCO's financial, managerial, and operational resources for compliance with the Act and Commission regulations, respectively. The Commission did not receive any comments on these provisions and is adopting §§ 39.10(c)(3)(iii) and (c)(3)(iv) as proposed.

Proposed § 39.10(c)(3)(v) would require that the annual report ''[d]escribe any material compliance matters, including incidents of noncompliance, since the date of the last annual report and describe the corresponding action taken.'' CME suggested that the provision be revised to require that the annual report identify only material compliance issues that were not properly addressed by the DCO.

The Commission is adopting § 39.10(c)(3)(v) as proposed because receiving such information will enable the Commission to assess whether the DCO is addressing compliance matters effectively. It also will enable the Commission to become aware of possible future compliance issues across DCOs and to proactively identify best practices. An annual report that identifies only material compliance issues would not provide sufficient information.

Finally, the Commission on its own initiative is not adopting proposed § 39.10(c)(3)(vi) because information of this nature is not essential to the Commission's evaluation of the DCO's compliance program and, if it is relevant to a material compliance matter, it will be provided to the Commission pursuant to § 39.10(c)(3)(v).

9. Submission of Annual Report to the Commission—§ 39.10(c)(4)

Proposed § 39.10(c)(4) would set forth the requirements for submitting an annual report to the Commission. Except as noted below, the Commission is adopting the rule as proposed.

Better Markets suggested that the Commission change proposed § 39.10(c)(4)(i) to require a CCO to present the finalized annual report to the board of directors and executive management prior to its submission to the Commission. Better Markets also suggested that the independent directors as well as the entire board should be required to review and approve the report in its entirety and to detail any disagreement with any portion. In

[40] 7 U.S.C. 7a–1(i)(3).

addition, Better Markets commented that a CCO should be required to file the report with the Commission, either as approved or with statements of disagreement.

The Commission is not revising proposed § 39.10(c)(4)(i) per Better Markets' suggestion. The Commission believes that a DCO should have the flexibility to determine whether the annual report will be provided to the board of directors, the senior officer, or both. The Commission also is not requiring the board of directors to approve or submit comments on the report given that the board of directors might not have sufficient information to approve or disagree with the report. In addition, there is a risk that the board might try to influence the CCO to change the report if it were required to express approval. The Commission notes that the rules do not prohibit the board, any of its members, or the senior officer from approving or disagreeing with aspects of the annual report.

Proposed § 39.10(c)(4)(ii) would require that the annual report include a certification by the CCO that, to the best of his or her knowledge and reasonable belief, and under penalty of law, the annual report is accurate and complete. CME commented that the Commission should require the DCO's senior officer, and not the CCO, to make the necessary certification in the annual compliance report. According to CME, ''the best way to achieve the goal of a robust effective compliance program, and to close the loop on creating a culture of compliance, is to require the registrant's senior officer—and not the CCO—to complete the required certification.''

KCC commented that a CCO should not have to certify ''under penalty of law'' that the annual report is accurate and complete, and a CCO should certify instead that to the best of his or her knowledge and belief the annual report is accurate and complete.

The Commission is adopting § 39.10(c)(4)(ii) as proposed. The CEA requires (1) the CCO to sign the annual report and (2) that the annual report contain a certification that, under penalty of law, the compliance report is accurate and complete.[41] Accordingly, the Commission believes the regulation accurately reflects Congressional intent.

10. Annual Report Confidentiality

CME suggested that Commission regulations should expressly state that annual reports are confidential documents that are not subject to public disclosure by listing annual reports as a specifically exempt item in part 145 of the Commission's regulations. The Commission has not proposed and is not adopting CME's proposal, which would provide blanket confidentiality to all annual reports submitted by CCOs of DCOs, even though the Commission may determine that there is information contained in a report that should be public. Accordingly, a DCO must petition for confidential treatment of its annual report under § 145.9 if it wants the Commission to determine that a particular annual report should be subject to confidentiality.

11. Insulating the CCO From Undue Influence

The notice of proposed rulemaking solicited comments as to whether the Commission should adopt regulations that require a DCO to insulate its CCO from undue pressure and coercion. CME commented that the current regulations are sufficient to protect a CCO from undue influence and it does not believe additional regulations are necessary. The Commission agrees with CME and is not adopting such regulations.

12. Recordkeeping—§ 39.10(c)(5)

Proposed § 39.10(c)(5) would require a DCO to maintain: (i) A copy of the policies and procedures adopted in furtherance of compliance with the CEA and Commission regulations; (ii) copies of materials, including written reports provided to the board of directors or the senior officer in connection with review of the annual report; and (iii) any records relevant to the DCO's annual report, including work papers and financial data. The DCO would be required to maintain these records in accordance with § 1.31 and proposed § 39.20. The Commission did not receive any comment letters discussing proposed § 39.10(c)(5). The Commission has adopted § 39.10(c)(5) as proposed, except that the Commission has modified § 39.10(c)(5)(A) to refer to ''all compliance policies and procedures'' rather than ''the compliance policies and procedures, as defined in § 39.1(b)'' in light of the Commission's decision not to adopt a definition of compliance policies and procedures, as discussed in section III.B, above.

B. Core Principle B—Financial Resources—§ 39.11

Core Principle B,[42] as amended by the Dodd-Frank Act, requires a DCO to possess financial resources that, at a minimum, exceed the total amount that would enable the DCO to meet its financial obligations to its clearing members notwithstanding a default by the clearing member creating the largest financial exposure for the DCO in extreme but plausible market conditions and to cover its operating costs for a period one year, as calculated on a rolling basis. Proposed § 39.11 would codify these requirements. The Commission received a total of 18 comments on the proposed regulations. The Commission considered each of these comments in formulating the final regulations discussed below.

1. Amount of Financial Resources Required—§§ 39.11(a) and 39.11(b)(3)

Proposed § 39.11(a)(1) would require a DCO to maintain sufficient financial resources to meet its financial obligations to its clearing members notwithstanding a default by the clearing member creating the largest financial exposure for the DCO in extreme but plausible market conditions, and proposed § 39.11(a)(2) would require a DCO to maintain sufficient financial resources to cover its operating costs for at least one year, calculated on a rolling basis. Proposed § 39.11(b)(3) would allow a DCO to allocate a financial resource, in whole or in part, to satisfy the requirements of either proposed § 39.11(a)(1) or proposed § 39.11(a)(2), but not both, and only to the extent that use of that financial resource is not otherwise limited by the CEA, Commission regulations, the DCO's rules, or any contractual arrangements to which the DCO is a party.

The Futures Industry Association (FIA) recommended that all DCOs be required to maintain resources sufficient to withstand the default of the two clearing members representing the largest financial exposure to the DCO, but that the Commission give DCOs reasonable time to come into compliance with the enhanced requirement.

The International Swaps and Derivatives Association (ISDA) also suggested that, in the clearing of certain OTC derivatives such as eligible credit default swaps and interest rate swaps, a DCO should have sufficient financial resources that, at a minimum, enable it to withstand a potential default by two of its largest clearing members, as measured by the two clearing members with the largest obligations to the DCO in extreme but plausible market conditions. ISDA further suggested, however, that this heightened financial resource level may not be appropriate for all other OTC or other derivatives products, and offered to work with the Commission to determine the

[41] *See* Section 5b(i)(3)(B)(ii) of the CEA, 7 U.S.C. 7a–1(i)(3)(B)(ii).

[42] Section 5b(c)(2)(B) of the CEA, 7 U.S.C. 7a–1(c)(2)(B).

appropriate standard for derivatives in other asset classes.

Similarly, Mr. Chris Barnard recommended that consideration be given to differentiating risk, and therefore resource requirements by broad derivative/product class, or at least by exchange-traded and OTC derivative types.

Better Markets suggested that the default rate used in the stress test for DCOs should be the larger of (1) the member representing the largest exposure to the DCO, and (2) the members constituting at least 25 percent of the exposures in aggregate to the DCO. Americans for Financial Reform (AFR) stated that the calculation in proposed § 39.11(a)(1) should be based on risk exposure as well as number of defaults.

LCH.Clearnet Group Limited (LCH) concurred with all the provisions set forth by the Commission under proposed § 39.11(a). NYPC also expressed support for proposed §§ 39.11(a)(1) and 39.11(a)(2).

The Commission is adopting § 39.11(a) as proposed. Section 39.11(a) is consistent with Core Principle B as amended by the Dodd-Frank Act. As the Commission noted in its notice of proposed rulemaking, § 39.11(a)(1) is also consistent with the Bank for International Settlements' Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions (CPSS–IOSCO) Recommendations for Central Counterparties (CCPs), issued in 2004 (2004 CPSS–IOSCO Recommendations).[43] The Commission recognizes that those recommendations eventually will be replaced by the Principles for Financial Market Infrastructures (FMIs), which are currently being developed by CPSS and IOSCO and are expected to be finalized in 2012.[44] For financial resources requirements for CCPs, CPSS and IOSCO are considering three alternatives: (1) A ''cover one'' minimum requirement for all CCPs; (2) a ''cover two'' minimum requirement for all CCPs; and (3) either a ''cover one'' or a ''cover two'' minimum requirement for a particular CCP, depending upon the risk and other characteristics of the particular products it clears, the markets it serves, and the number and type of participants it has.[45] The Commission may reconsider § 39.11(a)(1) once CPSS and IOSCO have finished their work.

MGEX noted that proposed § 39.11(b)(3) would prohibit a DCO from using a financial resource for both default and operating cost purposes. While MGEX agreed this seems a logical approach to take to avoid counting an asset's value for two different purposes, MGEX stated that there are practical implications to consider. As a DCM and DCO, MGEX keeps one basic set of financial records that are compliant with various accounting standards. MGEX recommended that the Commission's proposal should not be interpreted to require a DCO to formally divide some assets and accounts. The Commission confirms that § 39.11(b)(3) does not require a DCO to formally divide its assets or accounts. The Commission is adopting § 39.11(b)(3) as proposed.

2. Treatment of Affiliated Clearing Members—§ 39.11(a)(1)

Proposed § 39.11(a) would state, in part: ''A [DCO] shall maintain financial resources sufficient to cover its exposures with a high degree of confidence and to enable it to perform its functions in compliance with the core principles set out in Section 5b of the [CEA] * * * Financial resources shall be considered sufficient if their value, at a minimum, exceeds the total amount that would: (1) Enable the [DCO] to meet its financial obligations to its clearing members notwithstanding a default by the clearing member creating the largest financial exposure for the [DCO] in extreme but plausible market conditions; *Provided that* if a clearing member controls another clearing member or is under common control with another clearing member, the affiliated clearing members shall be deemed to be a single clearing member for purposes of this provision * * *''

In the notice of proposed rulemaking, the Commission stated: ''There may be some instances in which one clearing member controls another clearing member or in which a clearing member is under common control with another clearing member. The Commission proposes to treat such affiliated clearing members as a single entity for purposes of determining the largest financial exposure because the default of one affiliate could have an impact on the ability of the other to meet its financial obligations to the DCO. However, to the extent that each affiliated clearing member is treated as a separate entity by the DCO, with separate capital requirements, separate guaranty fund obligations, and separate potential assessment liability, the Commission requests comment on whether a different approach might be warranted.''

CME noted that it treats affiliated clearing members as separate entities, with separate capital requirements, separate guaranty fund obligations, and separate potential assessment liability. While CME acknowledged that the default of one affiliate may impact the ability of another affiliated clearing member to meet its financial obligations to the DCO, CME suggested that circumstances may exist in which a clearing member is sufficiently independent to continue operating notwithstanding a default by an affiliate. CME rules allow, but do not require, emergency action to be taken against a clearing member based upon the financial or operational condition of an affiliate (whether or not that affiliate is also a clearing member). CME urged the Commission to take a similar approach by revising the language of proposed § 39.11(a) to state that ''if a clearing member controls another clearing member or is under common control with another clearing member, the affiliated clearing members may be deemed to be a single clearing member * * *.''

LCH agreed with the Commission's proposed requirement that the DCO must treat any clearing member, either controlled by another clearing member or under common control with another clearing member, as a single clearing member for the purposes of § 39.11(a)(1).

The Commission is adopting § 39.11(a)(1) as proposed. The Commission believes this treatment appropriately addresses the potential risks of affiliates. The Commission notes that aggregating the potential losses of affiliated clearing members for purposes of this calculation would provide more coverage in the event of a default.

3. Operating Costs—§ 39.11(a)(2)

Proposed § 39.11(a)(2) would require a DCO to maintain sufficient financial resources to cover its operating costs for at least one year, calculated on a rolling basis.

OCC commented that while the statutory requirement that a DCO have one year of operating costs, based on a rolling period, may be a reasonable

[43] *See* Bank for International Settlements' Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, ''Recommendations for Central Counterparties,'' CPSS Publ'n No. 64 (November 2004), available at *http://www.bis.org/publ/cpss64.pdf.*

[44] *See* Bank for International Settlements' Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, ''Principles for financial market infrastructures: Consultative report,'' CPSS Publ'n No. 94 (March 2011), available at *http://www.bis.org/publ/cpss94.pdf* (CPSS–IOSCO Consultative Report).

[45] CPSS–IOSCO Consultative Report, Principle 4: Credit Risk, at 30.

standard to ensure that a DCO is not forced out of business while there is still open interest in the contracts it clears, the requirement should be calculated based on essential operating expenses for the rolling period. According to OCC, an appropriate wind-down budget would include projected revenues during the wind-down and would not include expenses associated with activities having value only to a DCO that intends to remain in business (*e.g.,* product development, technological enhancements, lobbying activities, investor education, etc.).

ISDA stated that it is appropriate that a DCO hold equity capital sufficient to cover its operating costs and likely exit costs during any liquidation and this capital should be separate from any DCO equity contribution to the required default resources.

Eurex Clearing AG (Eurex) agreed that having a requirement for operating resources is reasonable, especially in view of the flexibility implied in the Commission's proposed rules for types of financial resources, but cautioned that the one-year time frame may be unnecessarily long.

FIA supported this aspect of the Commission's proposal, including the requirement that a DCO not be permitted to ''double-count'' its resources to cover both this and the default resources requirement.

The Commission is adopting § 39.11(a)(2) as proposed. The Commission notes that the language in § 39.11(a)(2) is virtually identical to that of Core Principle B.

4. Types of Financial Resources—§ 39.11(b)

Proposed § 39.11(b)(1) lists the types of financial resources that would be available to a DCO to satisfy the requirements of proposed § 39.11(a)(1): (1) The margin of the defaulting clearing member; (2) The DCO's own capital; (3) the guaranty fund deposits of the defaulting clearing member and non-defaulting clearing members; (4) default insurance; (5) if permitted by the DCO's rules, potential assessments for additional guaranty fund contributions on non-defaulting clearing members; and (6) any other financial resource deemed acceptable by the Commission. Proposed § 39.11(b)(2) lists the types of financial resources that would be available to a DCO to satisfy the requirements of proposed § 39.11(a)(2): (1) The DCO's own capital and (2) any other financial resource deemed acceptable by the Commission.

In the notice of proposed rulemaking, the Commission noted that a DCO would be able to request an informal interpretation from Commission staff on whether or not a particular financial resource may be acceptable to the Commission. The Commission also invited commenters to recommend particular financial resources for inclusion in the final regulation.

ISDA encouraged the Commission to give prudent consideration to the use of standby letters of credit as an additional financial resource, given that many letter-of-credit issuing banks will be an affiliate of a clearing member.

Natural Gas Exchange Inc. (NGX) requested that the Commission consider the acceptability of letters of credit as an asset of the guaranty fund and clarify in the final rule that letters of credit are acceptable as an asset of the guaranty fund if subject to certain safeguards. NGX also requested that the Commission make clear in the final regulation that it will interpret proposed §§ 39.11(b)(1)(vi) and 39.11(b)(2)(ii) broadly so as to permit a demonstration, on a case-by-case basis, that a DCO meets the overall policies of the regulation through a specific mix of financial resources.

Mr. Barnard recommended splitting the types of financial resources permitted under proposed § 39.11(b)(1) into two classes: Class A would consist of the financial resources listed in paragraphs (b)(i) through (b)(iii), and would be required to make up the significant part of the total financial resources, and class B would consist of the financial resources listed in paragraphs (b)(iv) through (b)(vi), on which larger prudential haircuts would be required. MGEX suggested that proposed § 39.11(b)(2) should retain the ability for a DCO to provide its explanation and methodology for including a particular financial resource. MGEX further suggested that the list of potential financial resources should be broad and not pruned too quickly, particularly by initial regulation.

Eurex commented that the Commission's proposed list of financial resources in proposed § 39.11(b)(1) is appropriate.

The Commission is adopting § 39.11(b) as proposed, except for a technical amendment to clarify the scope of the use of margin as a financial resource to cover a default. As proposed, the Commission is not including letters of credit as an acceptable financial resource because they are only a promise by a bank to pay and not an asset that can be sold.[46] However, both § 39.11(b)(1) and § 39.11(b)(2) permit ''any other financial resource deemed acceptable by the Commission,'' which means that the Commission could evaluate the use of letters of credit on a case-by-case basis.[47]

The Commission also received inquiries from a few DCOs as to whether the Commission would deem projected revenue an acceptable financial resource to satisfy the requirements of § 39.11(a)(2). The Commission expects that projected revenue generally would be deemed acceptable for established DCOs that can demonstrate a historical record of revenue, but not for DCO applicants or relatively new DCOs with no such record.

With respect to any financial resource that is not enumerated in § 39.11(b) and for which a DCO seeks a determination as to its acceptability based on the DCO's particular circumstances, DCO staff should contact Commission staff prior to submitting the DCO's quarterly financial resources report.

The Commission is modifying § 39.11(b)(1)(i) to more precisely reflect the fact that the use of margin as a financial resource available to satisfy the requirements of paragraph (a)(1) is subject to limitations imposed by the Commission and a DCO, *e.g.,* relating to the use of customer margin to cover a default. As proposed, § 39.11(b)(1)(i) would permit the use of ''[m]argin of a defaulting clearing member.'' The provision now refers to ''[m]argin to the extent permitted under parts 1, 22, and 190 of this chapter and under the rules of the derivatives clearing organization.''

5. Capital Requirement

Proposed §§ 39.11(b)(1) and (b)(2) list the DCO's own capital as a type of financial resource that would be available to a DCO to satisfy the requirements of proposed §§ 39.11(a)(1) and (a)(2), respectively. In the notice of proposed rulemaking, the Commission noted that Commission regulations do not prescribe capital requirements for DCOs. The Commission invited

[46] The Commission recognizes that assessment powers are also a promise to pay, but as the Commission noted in the notice of proposed rulemaking, a clearing member may have a strong financial incentive to pay an assessment. If a clearing member failed to pay its assessment obligation, that failure would be treated as a default and the clearing member would be subject to liquidation of its positions and forfeiture of the margin in its house account. Thus, in addition to a potential general interest in maintaining the viability of the DCO going forward, a non-defaulting clearing member may have a specific incentive to pay an assessment, depending on the size and profitability of its positions and the margin on deposit relative to the size of the assessment.

[47] *See* discussion of the prohibition on accepting letters of credit as initial margin in section IV.F.5, below.

comment on whether it should consider adopting such requirements and if so, what those requirements should be.

J.P. Morgan Chase & Co. (J.P. Morgan) commented that if a DCO enumerates its own capital as part of its waterfall, that DCO should be required to provide sufficient assurances that the capital will be available to meet those obligations and will not be reallocated to serve other purposes at the DCO's discretion. In a separate comment letter on the proposed risk management requirements for DCOs, J.P. Morgan offered its support for regulations that would require a DCO to retain in a segregated deposit account, on a rolling basis, 50 percent of its earnings from the previous 4 years. In addition, J.P. Morgan stated that it would be appropriate for at least 50 percent of the retained earnings to have a first loss position. J.P. Morgan also recommended that the DCO contribution be subject to a minimum floor of $50 million.

Mr. Michael Greenberger recommended that the Commission require DCOs to set aside a reasonable amount of capital, equal to an average size of one contract for that DCO, so that a DCO would have sufficient financial resources to absorb a default. In addition, Mr. Greenberger suggested that capital requirements for DCOs must require that the DCOs' capital be highly liquid so that a DCO can cure a default in a timely manner.

Eurex noted that clearing organizations exhibit a variety of organizational and capital structures and suggested the Commission should allow DCOs to determine their own mixes of protective measures, which might include the DCO's own capital. Nevertheless, Eurex expressed support for an initial capital requirement of $25 million for DCOs.

OCC commented that an equity capital requirement for DCOs is not appropriate because DCOs rely primarily on member-supplied resources, such as clearing fund deposits and margin, to meet their obligations. According to OCC, most, if not all, DCOs have little capital in relation to their obligations. OCC suggested that the critical question from a safeness and soundness standpoint is whether DCOs have adequate financial resources, not the form in which such resources are held.

CME stated that the financial resources requirements contained in Core Principle B are better suited to achieve the goal of ensuring adequate capitalization of DCOs, and that further capital requirements would be unnecessary and essentially duplicative.

KCC commented that, with proposed § 39.11(a)(1) requiring a DCO to maintain sufficient financial resources to meets its financial obligations, a separate capital requirement would be redundant. KCC also stated that onerous capital requirements placed on DCOs could have an anti-competitive effect.

NYPC cautioned that mandating that DCOs hold specific forms or amounts of capital could have a chilling effect on competition, at odds with the principles of the CEA by potentially shutting out various forms of organizational structures for DCOs. NYPC noted that Core Principle B requires that DCOs maintain sufficient financial resources to perform their functions as central counterparties in compliance with the CEA. NYPC suggested that whether such financial resources are derived from a DCO's own capital or other financial resources deemed acceptable to the Commission should be inconsequential to the extent such statutorily prescribed functions are fulfilled.

MGEX stated that it does not support adopting specific capital requirements for DCOs. MGEX noted that the proposed regulation already requires a DCO to be able to withstand the default of its largest clearing member in extreme but plausible market conditions. MGEX further noted that a DCO's capital is only one element of the financial resources necessary to cover that risk, and suggested that a DCO should be able to determine how it best needs to allocate that risk among its various financial resources.

The Commission is not adopting a capital requirement for DCOs at this time. The Commission believes that it is appropriate to provide flexibility to DCOs in designing their financial resources structure so long as the aggregate amount is sufficient. The Commission notes, however, that one of the principles in the CPSS–IOSCO Consultative Report would require an FMI to ''hold sufficiently liquid net assets funded by equity to cover potential general business losses so that it can continue providing services as a going concern.'' [48] CPSS and IOSCO are considering, and requesting comment on, the establishment of a specific minimum quantitative requirement for liquid net assets funded by equity. If such a requirement is established, the Commission may consider a similar requirement for DCOs at that time.

[48] *See* CPSS–IOSCO Consultative Report, Principle 15: General Business Risk, at 70.

6. Assessments—§§ 39.11(b)(1)(v) and 39.11(d)(2)

Proposed § 39.11(b)(1)(v) would list ''potential assessments for additional guaranty fund contributions, if permitted by the [DCO]'s rules'' as a type of financial resource that would be available to a DCO to satisfy the requirements of proposed § 39.11(a)(1). Proposed § 39.11(d)(2) would require a DCO: (i) To have rules requiring that its clearing members have the ability to meet an assessment within the time frame of a normal variation settlement cycle; (ii) to monitor, on a continual basis, the financial and operational capacity of its clearing members to meet potential assessments; (iii) to apply a 30 percent haircut to the value of potential assessments; and (iv) to only count the value of assessments, after the haircut, to meet up to 20 percent of its default resources requirement. The Commission requested comment on whether these limits and requirements are appropriate and, more generally, whether assessment powers should be considered to be a financial resource available to satisfy the requirements of proposed § 39.11(a)(1).

With regard to proposed §§ 39.11(d)(2)(i) and (ii), OCC commented that the requirement that clearing members be able to meet an assessment within the time frame of a normal variation settlement cycle is an aggressive but appropriate standard that its clearing members would be able to meet in most circumstances, but that DCOs should have discretion to extend this deadline on a case-by-case basis where appropriate to avoid severe strains on clearing member liquidity in unusual circumstances. OCC objected to the requirement that DCOs must monitor ''on a continual basis'' a clearing member's ability to meet potential assessments, which OCC claimed is overly burdensome and difficult to administer. OCC suggested that a monthly review is reasonable and adequate.

NYPC requested that the Commission clarify how the requirement of proposed § 39.11(d)(2)(i) would be imposed on DCOs that conduct both end-of-day and intraday settlements each business day. In order to ensure that a uniform standard is applied across clearing members of all DCOs, whether the DCO conducts one or two settlements per business day, NYPC recommended that the Commission clarify that a DCO's rules should require clearing members to have the ability to meet an assessment within one business day.

With regard to proposed § 39.11(d)(2)(ii), NYPC requested that

the Commission provide guidance as to how it expects DCOs to determine whether a clearing member has the capacity to meet a potential assessment. In addition, NYPC expressed concern that the ''continual'' monitoring of clearing members' ability to meet potential assessments, which NYPC believes implies daily or even real-time monitoring, would be extremely difficult, if not impossible, to administer. NYPC suggested that it would be reasonable and more practicable for the Commission to require that monitoring of clearing members' ability to meet potential assessments be included as a mandatory component of the periodic financial reviews of clearing members that DCOs already conduct in the ordinary course of business.

In response to these comments, the Commission is revising § 39.11(d)(2)(i) to read as follows (added text in italics): ''The derivatives clearing organization shall have rules requiring that its clearing members have the ability to meet an assessment within the time frame of a normal end-of-day variation settlement cycle.'' In response to OCC's comment, the Commission notes that § 39.11(d)(2)(i) requires a DCO to have rules requiring that its clearing members have the ability to meet an assessment within the time frame of a normal end-of-day variation settlement cycle, but would permit a DCO, in its discretion, to provide some flexibility to clearing members as to timing.

In addition, the requirement in § 39.11(d)(2)(ii) that a DCO must monitor the financial and operational capacity of its clearing members to meet potential assessments ''on a continual basis'' was intended to mean only that the DCO must perform such monitoring often enough to enable it to become aware of any potential problems in a timely manner. To eliminate possible ambiguity, the Commission is revising the final rule by removing the phrase ''on a continual basis.'' Thus, § 39.11(d)(2)(ii) establishes a standard whereby a DCO must monitor its clearing members, but the DCO can meet the standard through the exercise of its judgment in response to particular circumstances, *e.g.,* a DCO might have reason to evaluate certain clearing members on a daily basis and evaluate others only as part of routine, periodic financial reviews.

With regard to proposed §§ 39.11(d)(2)(iii), FIA commented that the 30 percent haircut and 20 percent cap are reasonable and prudent safeguards, sufficient to ensure that a DCO does not unduly rely on its assessment power. J.P. Morgan supported the proposal and also recommended that regulators adopt a risk-based analysis to determine the likelihood that a clearing member will be able to meet its assessment obligations across all DCOs. Mr. Greenberger, citing J.P. Morgan's comments, agreed that it is absolutely critical that the Commission promulgate rules that would determine a clearing member's risk of default and its availability of financial resources across all clearinghouses. Similarly, ISDA suggested that the Commission evaluate the potential impact of multiple assessments from different DCOs on the same clearing member or affiliate group in a short time-frame.

CME suggested that a DCO should be required to completely exclude the potential defaulting firm's assessment liability in calculating its available assessment resources. CME also commented that, in light of the requirements of proposed §§ 39.11(d)(2)(i) and (ii), and the fact that a clearing member that failed to pay an assessment would itself be in default to the DCO, it does not believe that a further haircut on assessments is necessary, and it is aware of no valid reason to cap the use of assessments at 20 percent as proposed.

KCC noted that the inclusion of assessment powers as financial resources is necessary for it to meet its obligations in the unlikely event of a default. KCC agreed that a reasonable haircut on the value of a DCO's assessment power may be a prudent measure, but stated that the proposed limits are unreasonable and excessive and seem arbitrary. KCC suggested that a better approach would be for the DCO to be allowed the latitude to determine clearing member assessment haircuts on an individual basis, based on each clearing member's financial capabilities.

MGEX recommended that the Commission allow each DCO to provide its methodology and support for why any assessment might be considered a financial resource and how much. MGEX stated that the 30 percent haircut and 20 percent cap seem arbitrary and prescriptive. MGEX stated that the DCO should have the discretion to determine an appropriate haircut based on the clearing member's liquidity.

Better Markets commented that the proposed haircuts for assessments are inadequate. According to Better Markets, it would be far more prudent to require funding of risk that can be anticipated in stress tests and rely on assessments as a financial resource only for conditions that are not anticipated in stress tests.

LCH recommended that potential assessments not be allowed to satisfy the requirements of proposed § 39.11(a)(1) because, in LCH's view, it is of the utmost importance that a DCO's resources following a clearing member default be immediately and unconditionally available. LCH suggested that assessments should be allowed as part of the DCO's ''waterfall'' of protections, but should not be taken into account to meet the specific test outlined under proposed § 39.11(a)(1).

AFR urged the Commission to prohibit DCOs from including assessment powers in their calculation of financial resources because it is unclear, in a time of broad market distress, whether a DCO's members would be willing and able to pay their assessments.

The Commission is adopting § 39.11(d)(2)(iii) as proposed. In view of the wide range of comments on this issue, the Commission believes the rule strikes an appropriate balance. The 30 percent haircut recognizes that the defaulting firm, which by definition will not be paying an assessment, might represent a significant segment of the DCO's total risk. The 20 percent cap recognizes that given the contingent nature of assessments, they should only be relied upon as a last resort. In response to ISDA's comment, the Commission expects that as part of the evaluation of a clearing member's risk profile, a DCO would take into consideration the potential exposure of the clearing member at other DCOs, to the extent that it is able to obtain such information, including the possibility of assessments. The Commission notes, in response to MGEX's and KCC's comments, that a DCO may determine clearing member assessment haircuts on an individual basis because § 39.11(d)(2)(iii) only requires a 30 percent haircut on an aggregate basis.

7. Computation of the Financial Resources Requirement—§ 39.11(c)(1)

Proposed § 39.11(c)(1) would require a DCO to perform stress testing on a monthly basis in order to make a reasonable calculation of the financial resources it needs to meet the requirements of proposed § 39.11(a)(1). The DCO would have reasonable discretion in determining the methodology used to make the calculation, but would be required to take into account both historical data and hypothetical situations. In the notice of proposed rulemaking, the Commission requested comment on whether monthly tests are appropriate.

MGEX commented that monthly reporting seems reasonable as it already

performs stress tests on a routine basis. MGEX further commented that allowing DCOs discretion in selecting stress test scenarios is appropriate.

CME suggested that annual stress testing would suffice for operating costs because operating costs are generally static. With regard to default coverage, CME suggested that stress testing should be done no less than monthly.

LCH expressed concern over the requirement that the DCO perform stress testing only on a monthly basis. In LCH's view, stress testing should be carried out by the DCO on at least a daily basis, and LCH strongly urged the Commission to amend its proposal accordingly. LCH suggested that monthly stress testing is inadequate, as experience has shown that market conditions and member positions can change rapidly during periods of market turmoil.

ISDA suggested that reverse stress tests [49] should be required for determining the size of the financial resources package and that there should be public disclosure of the stress tests and their results.

Mr. Barnard agreed that stress testing should be carried out at least monthly, and suggested that back testing should be carried out daily. Mr. Barnard also suggested that the Commission specifically refer to reverse stress testing in proposed § 39.11(c)(1) because, in his view, it is a useful tool for managing expectations and for helping the DCO to anticipate financial resources requirements in extreme conditions.

FIA recommended that the Commission make clear its expectation that the DCOs will, at a minimum: (1) Conduct a range of stress tests that reflect the DCO's product mix; (2) include the most volatile periods that have been experienced by the markets for which the DCO provides clearing services; (3) take into account the distribution of cleared positions between clearing members and their customers; and (4) test for unanticipated levels of volatility and for breakdowns in correlations within and across product classes.

Mr. Greenberger recommended that historical market data that led up to the passage of the Dodd-Frank Act be taken into account in determining market conditions that could be defined as extreme but plausible.

Better Markets commented that the passive role of the Commission in measuring the financial requirements for a DCO is inappropriate in light of the importance of this function. Better Markets proposed that the methodology, the historical data set, and the hypothetical scenarios be: (1) Jointly developed by the DCO and the Commission and (2) reviewed whenever ordered by the Commission, but no less frequently than quarterly. Better Markets also recommended that the Commission explicitly recognize the importance of illiquidity in developing hypothetical scenarios.

AFR stated that it is critical that the Commission play a central role in establishing the standards by which DCOs will measure their exposure to future risks. AFR urged the Commission to define minimal standards that will ensure that DCO stress tests are stringent and incorporate realistic metrics of worst-case scenarios that DCOs may experience.

The Commission is adopting § 39.11(c)(1) as proposed. The Commission believes it is appropriate to allow the DCO discretion in designing stress tests because stress testing is an exercise that inherently entails the exercise of judgment at various stages. Furthermore, § 39.11(c)(1) allows the Commission to evaluate the testing and require changes as appropriate. In response to the LCH comment, the Commission notes that there is a distinction between the type of stress testing carried out under this rule for the purpose of sizing the overall financial resource package and the type of stress testing carried out under § 39.13(h)(3) for the purpose of ascertaining the risks that may be posed to the DCO by individual traders and clearing members. The former is a comprehensive test across all clearing members and all products with the goal of identifying the firms posing the greatest risk to the DCO and quantifying that risk. The regulations would require such testing to be completed monthly. The latter is targeted testing addressing the specific risks of specific positions at specific firms. The regulations would require such testing to be completed on either a daily or weekly basis, as described in § 39.13(h)(3).[50]

8. Valuation of Financial Resources—§ 39.11(d)(1)

Proposed § 39.11(d)(1) would require a DCO, no less frequently than monthly, to calculate the current market value of each financial resource used to meet its obligations under proposed § 39.11(a). When valuing a financial resource, a DCO would be required to reduce the value, as appropriate, to reflect any market or credit risk specific to that particular resource, *i.e.,* apply a haircut. The Commission would permit each DCO to exercise its discretion in determining the applicable haircuts. However, the haircuts would have to be evaluated on a monthly basis, would be subject to Commission review, and would have to be acceptable to the Commission.

OCC suggested that the proposed regulations should be modified or interpreted to accommodate the use of a true portfolio margining model that values collateral based on its relationship to an overall portfolio in lieu of applying fixed haircuts on margin collateral.

ISDA stated that it would support an appropriate haircut for default insurance, potential assessments, and possibly other financial resources deemed acceptable by the Commission, as determined by the Commission upon review of the relevant DCO.

FIA expressed reservations about the ability of a DCO to be paid promptly under the terms of a default insurance policy. FIA therefore recommended that default insurance coverage be subjected to a 30 percent haircut and a 20 percent cap, similar to the policies that the Commission has proposed to apply to a DCO's assessment power.

In discussions with Commission staff, Federal Reserve and Federal Reserve Bank of New York staff suggested that the liquidity of a financial resource should be an additional factor in determining an appropriate haircut. Considerations should include whether it is easy to value the financial resource (*e.g.,* whether the pricing is transparent) and whether the financial resource could be divested in a short time period under normal market conditions. The Commission agrees that liquidity is an important factor in valuing financial resources.

Accordingly, the Commission is revising § 39.11(d)(1) to read as follows (added text in italics): ''At appropriate intervals, but not less than monthly, a derivatives clearing organization shall compute the current market value of each financial resource used to meet its obligations under paragraph (a) of this section. Reductions in value to reflect

[49] Reverse stress tests are stress tests that require a firm to assess scenarios and circumstances that would render its business model unviable, thereby identifying potential business vulnerabilities. Reverse stress testing starts from an outcome of business failure and identifies circumstances where this might occur. This is different from general stress testing, which tests for outcomes arising from changes in circumstances. *See http://www.fsa.gov.uk/pages/About/What/International/stress_testing/firm_s/reverse_stress_testing/index.shtml.*

[50] *See* discussion of § 39.13(h)(3) in section IV.D.7.c, below.

credit, market, and *liquidity* risks (haircuts) shall be applied as appropriate and evaluated on a monthly basis.'' In response to OCC's comments, the Commission notes that § 39.11(d)(1) does not prohibit the valuation method described by OCC in its comment letter.

The Commission believes § 39.11(d)(1) takes a balanced approach by permitting a DCO to exercise its discretion in determining applicable haircuts for each of its financial resources but making those haircuts subject to Commission review and approval. Section 39.11(d)(1) requires a DCO to perform such valuations no less frequently than monthly, which means the Commission would expect a DCO to perform such valuations more frequently when appropriate, such as during periods of market volatility.

9. Liquidity of Financial Resources—§ 39.11(e)

Proposed § 39.11(e)(1) would require a DCO to have financial resources sufficiently liquid to enable the DCO to fulfill its obligations as a central counterparty during a one-day settlement cycle, including sufficient capital in the form of cash to meet the average daily settlement variation pay per clearing member over the last fiscal quarter. The DCO would be permitted to take into account a committed line of credit or similar facility for the purpose of meeting the remainder of the liquidity requirement. In the notice of proposed rulemaking, the Commission requested comment on whether the liquidity requirement should cover more than a one-day cycle. The Commission also requested comment on what standards might be applicable to lines of credit—*e.g.,* should the Commission require that there be a diversified set of providers, or that a line of credit have same-day drawing rights?

Proposed § 39.11(e)(2) would require a DCO to maintain unencumbered liquid financial assets in the form of cash or highly liquid securities, equal to six months' operating costs. The DCO would be permitted to take into account a committed line of credit or similar facility to satisfy this requirement.

Proposed § 39.11(e)(3) would require that: (i) Assets in a guaranty fund have minimal credit, market, and liquidity risks and be readily accessible on a same-day basis, (ii) cash balances be invested or placed in safekeeping in a manner that bears little or no principal risk, and (iii) letters of credit not be a permissible asset for a guaranty fund.

OCC recommended that the proposed regulations be modified or interpreted to provide DCOs some flexibility in determining the means of managing their ''cash'' liquidity needs by allowing DCOs to use secured credit facilities and tri-party repo facilities in addition to cash held in demand deposit accounts to satisfy the cash requirement. OCC observed that permitting these alternatives would allow a DCO to hold a significant portion of its financial resources in the form of U.S. Treasuries, with the ability to convert the Treasuries to cash as needed. According to OCC, cash must generally be held at banks, which presents a credit risk.

NGX suggested that immediately accessible bank lines of credit should be acceptable to cover the cash requirement where the underlying commodity is itself traded in a liquid market.

CME suggested the phrase ''average daily settlement variation pay per clearing member over the last fiscal quarter'' in proposed § 39.11(e)(1) is somewhat ambiguous. CME assumed that the Commission intended to refer to the average daily variation pay for a single clearing member, not the average daily settlement variation pay for all clearing members.

CME also commented that the Commission's approach is not warranted given the potential amount of cash at issue and the reliability of liquidity facilities for short-term cash needs. CME suggested that the Commission revise the last sentence of proposed § 39.11(e)(1) to read as follows: ''If any portion of such financial resources is not sufficiently liquid, the derivatives clearing organization may take into account a committed line of credit or similar facility for purposes of meeting these requirements.''

In response to the Commission's request for comment on what standards might be applicable to a liquidity facility, CME stated that reviews and evaluations by Commission staff during regular DCO audits are a sufficient check on the adequacy and soundness of a committed line of credit, and that the Commission should not attempt to prescribe the terms and conditions of a DCO's liquidity facility.

KCC found the language in proposed § 39.11(e) to be ambiguous. KCC interpreted the average daily settlement variation pay per clearing member over the last fiscal quarter to mean the cumulative average of the pay-ins per each clearing member divided by the number of clearing members. In KCC's view, a line of credit with same-day drawing rights should be considered as liquid as cash and therefore should be allowed to be used by the DCO to fulfill its financial obligations during a one-day settlement cycle. KCC commented that the liquidity requirement should cover no more than one day of market price movement.

LCH was unclear on what the Commission intends to mean in proposed § 39.11(e)(1) by requiring that the DCO should allocate financial resources to meet the requirements of § 39.11(a)(1) and fulfill its arising obligations during a ''one-day settlement cycle.'' LCH suggested that the requirement instead should be that the DCO is obliged to fulfill its arising obligations ''as they fall due.'' Additionally, LCH suggested that the requirement that the DCO must have ''sufficient capital in the form of cash to meet the average daily settlement variation pay per clearing member over the last fiscal quarter'' is insufficient. LCH recommended that this requirement be replaced by a test that the DCO can meet its liquidity requirements ''following the default of the clearing member(s) creating the largest liquidity requirement under stressed market conditions over the quarter.''

Mr. Greenberger suggested that the standards for a committed line of credit or similar facility must be narrowly and strictly defined, so that the party can easily use such highly liquid line of credit or similar facility. Mr. Greenberger further suggested that greater participation by clearing members in a committed line of credit or a similar instrument at times of market distress would not provide necessary liquidity but rather would increase systemic risk.

Eurex noted that proposed § 39.11(e) requires DCOs to monitor the liquidity of assets and agreed that low-credit risk, highly liquid assets should comprise guaranty funds and that this rule would serve important purposes.

FIA recommended that the Commission clarify that the cash requirement is intended to measure the average (and not the aggregate) clearing member variation margin requirement. FIA further recommended that the Commission permit a DCO to satisfy this requirement through the use of cash or cash equivalents, including U.S. government securities and repurchase agreements involving highly liquid securities if such repurchase agreement matures within one business day or is reversible upon demand. FIA additionally recommended that this aspect of the Commission's proposal be modified to clarify that DCOs are permitted to satisfy the liquidity requirement through the establishment of committed repo facilities. FIA supported allowing a DCO to obtain a

committed line of credit or similar credit facility to cover the remainder of its default resources requirement, but recommended that this proposal be strengthened by the diversification of credit providers, with concentration limits of 25 percent per provider.

MGEX commented that proposed § 39.11(e)(1) requires some clarity. MGEX interpreted it to mean that a DCO must have cash that will cover the average of all the clearing members' average daily settlement variation pays, which to MGEX would seem a logical and practical application. Rather than adopting multiple liquidity requirements (*i.e.,* cash, clearing member default coverage, six months' worth of operating expenses), MGEX suggested the process could be simplified to address the most relevant, which appeared to MGEX to be the clearing member default coverage. In addition, MGEX recommended that proposed § 39.11(e) should permit combining and then totaling its liquidity of financial resources as a single-entity DCO/DCM.

AFR stated that DCOs should be required to have sufficient cash to fulfill their obligations for 10 business days and that lines of credit should not count toward liquidity requirements.

NYPC commented that, to the extent the proposed requirement is intended to exclude cash equivalents, such as U.S. Treasury securities, the standard is inappropriate. NYPC recommended that the Commission allow DCOs to satisfy their liquidity needs through the use of any combination of cash held in demand deposit accounts, bank accounts meeting the requirements of CFTC Interpretative Letter 03–31,[51] and secured credit facilities and repurchase agreements that allow DCOs to convert U.S. Treasury securities and other high quality collateral into cash on a same-day basis.

In response to the comments, the Commission is revising § 39.11(e)(1) to provide greater clarity. In addition, the Commission is modifying the ''cash'' requirement to include ''U.S. Treasury obligations and high quality, liquid, general obligations of a sovereign nation.'' This conforms the requirement to existing liquidity practices and, in particular, it accommodates acceptable practices of foreign-based DCOs. However, the Commission is not including bank lines of credit as an acceptable financial resource for meeting the ''cash'' requirement because they are only a promise by the bank to pay and not an asset that can be sold. The Commission is revising § 39.11(e)(1) by deleting the following language: ''The derivatives clearing organization shall have sufficient capital in the form of cash to meet the average daily settlement pay per clearing member over the last fiscal quarter. If any portion of the remainder of the financial resources is not sufficiently liquid, the derivatives clearing organization may take into account a committed line of credit or similar facility for the purpose of meeting this requirement.''

The Commission is replacing the deleted language with the following: ''[(ii)] The derivatives clearing organization shall maintain cash, U.S. Treasury obligations, or high quality, liquid, general obligations of a sovereign nation, in an amount greater than or equal to an amount calculated as follows: (A) Calculate the average daily settlement pay for each clearing member over the last fiscal quarter; (B) Calculate the sum of those average daily settlement pays; and (C) Using that sum, calculate the average of its clearing members' average pays. (iii) The derivatives clearing organization may take into account a committed line of credit or similar facility for the purpose of meeting the remainder of the requirement under paragraph (e)(1)(ii) of this section.''

The Commission notes that, in the CPSS–IOSCO Consultative Report, CPSS and IOSCO are considering a minimum liquidity requirement for CCPs that would be either: (1) A ''cover one'' minimum requirement for all CCPs; (2) a ''cover two'' minimum requirement for all CCPs; or (3) a ''cover one'' or ''cover two'' minimum requirement for an individual CCP, depending on the particular risk and other characteristics of the particular products that it clears, the markets it serves, and the number and type of participants it has.[52] The Commission might revisit the issue after CPSS and IOSCO determine what standard they will adopt.

10. Reporting Requirements—§ 39.11(f)

Proposed § 39.11(f) would require a DCO to report to the Commission, at the end of each fiscal quarter or at any time upon Commission request: (i) The amount of financial resources necessary to meet the requirements set forth in the regulation; and (ii) the value of each financial resource available to meet those requirements. The DCO would be required to include with its report a financial statement (including the balance sheet, income statement, and statement of cash flows) of the DCO or its parent company. A DCO would have 17 business days from the end of the fiscal quarter to file its report, but would also be able to request an extension of time from the Commission.

NYPC suggested that, in light of the scope of information required to be submitted in the quarterly report (*i.e.,* information regarding default risk financial resources and operating financial resources), the Commission should require that such reports be filed not later than 30 calendar days, rather than 17 business days, following the end of the DCO's fiscal quarter.

ISDA suggested that a DCO seeking an extension of the 17-day reporting deadline should be required to request the extension at least seven business days before the deadline.

KCC noted that it does not prepare a statement of cash flows on a monthly basis, only on an annual basis as part of its audited financial statements. KCC commented that a monthly profit/loss statement is sufficient for determining its financial operating needs.

MGEX suggested the Commission should consider a DCO's privacy concerns when permitting reasonable discretion in the data the DCO provides in the monthly reports required by the proposed regulations. MGEX stated that some detail as to projected revenue and expenses must remain proprietary if it involves potential business opportunities or other strategic business decisions, and that DCOs have a legitimate concern that confidential financial information could be subject to Freedom of Information Act requests.

The Commission is adopting § 39.11(f) as proposed. The Commission notes that the 17-business-day filing deadline is consistent with the deadline imposed on FCMs for the filing of monthly financial reports under § 1.10(b). Moreover, a DCO may request an extension if it is unable to meet the deadline. The Commission does not believe it is appropriate to require a DCO to request an extension at least seven business days before the deadline, because a DCO may not know that far in advance that it will be unable to meet the deadline. With regard to the confidentiality of the information contained in the reports, the Commission notes that Core Principle L

[51] CFTC Interpretative Letter 03–31 concerned a bank that requested an interpretation that a trust deposit account product it developed would be acceptable for the deposit of customer segregated funds in accordance with Commission Regulation 1.20. Based on an analysis of the account, staff of the Commission's Division of Clearing and Intermediary Oversight issued an interpretation that the account would be acceptable as a deposit location because the account would be properly titled and covered by appropriate acknowledgements by the bank, and the funds in the account would at all times be immediately available for withdrawal on demand.

[52] *See* CPSS–IOSCO Consultative Report, Principle 7: Liquidity Risk, at 46.

and § 39.21(c)(4) require a DCO to publicly disclose the size and composition of the financial resources package available in the event of a clearing member default. A DCO may request confidential treatment under § 145.9 for other information submitted to the Commission under these regulations.

11. SIDCOs—§ 39.29

Proposed § 39.29(a) would require a SIDCO to maintain sufficient financial resources to meet its financial obligations to its clearing members notwithstanding a default by the two clearing members creating the largest combined financial exposure for the SIDCO in extreme but plausible market conditions. Proposed § 39.29(b) would require that a SIDCO not count the value of assessments to meet the obligations arising from a default by the clearing member creating the single largest financial exposure and only count the value of assessments, after a 30 percent haircut, to meet up to 20 percent of the obligations arising from a default by the clearing member creating the second largest financial exposure. The Commission believes that it would be premature to take action regarding § 39.29 at this time. The FSOC has not yet designated any DCOs as systemically important. As previously noted, the CPSS–IOSCO Principles for Financial Market Infrastructures, which are expected to be finalized in 2012, will address minimum financial resources requirements for CCPs. Similarly, certain foreign regulators, including the European Union, are also considering requirements in this area for the CCPs they regulate. The Commission is concerned that SIDCOs would be put at a competitive disadvantage if they are forced to comply with these requirements before non-U.S. CCPs are subject to comparable standards. The Commission is closely monitoring developments on this issue and is prepared to revisit the issue if the European Union or other foreign regulators move closer to implementation. Moreover, because it may be some time before any DCO is designated a SIDCO, the Commission believes it would be prudent to reconsider the regulation of SIDCOs in light of developments that may occur in the interim. The Commission expects to consider all the proposed rules relating to SIDCOs together.

C. Core Principle C—Participant and Product Eligibility—§ 39.12

1. Participant Eligibility

Core Principle C,[53] as amended by the Dodd-Frank Act, requires each DCO to establish appropriate admission and continuing eligibility standards for members of, and participants in, the DCO,[54] including sufficient financial resources and operational capacity to meet the obligations arising from participation. Core Principle C further requires that such participation and membership requirements be objective, be publicly disclosed, and permit fair and open access. Core Principle C also requires that each DCO establish and implement procedures to verify compliance with each participation and membership requirement, on an ongoing basis. Proposed § 39.12(a) would codify these requirements and establish the minimum requirements that a DCO would have to meet in order to comply with Core Principle C.

Although there is potential tension between the goals of ''fair and open access'' and ''sufficient financial resources and operational capacity to meet obligations arising from participation in the derivatives clearing organization,'' the Commission believes the rules that it is adopting herein strike an appropriate balance. The Commission has crafted the provisions of § 39.12 and related rules, *e.g.,* the risk management requirements, to establish a regulatory framework that it believes can ensure that a DCO's participation requirements do not unreasonably restrict any entity from becoming a clearing member while, at the same time, limiting risk to the DCO and its clearing members. The Commission expects that more widespread participation will reduce the concentration of clearing member portfolios, thereby diversifying risk, increasing market liquidity, and increasing competition among clearing members.

[53] Section 5b(c)(2)(C) of the CEA, 7 U.S.C. 7a–1(c)(2)(C).

[54] Core Principle C, as well as the other core principles that are discussed herein, refer to ''members of, and participants in'' a DCO. The Commission interprets this phrase to mean persons with clearing privileges, and has used the term ''clearing member'' in describing the requirements of each core principle and in the text of the proposed regulations described herein. The Commission is also amending the definition of ''clearing member'' in § 1.3(c), adopted herein, to mean ''any person that has clearing privileges such that it can process, clear and settle trades through a derivatives clearing organization on behalf of itself or others. The derivatives clearing organization need not be organized as a membership organization.''

a. Fair and Open Access—§ 39.12(a)(1)

Proposed § 39.12(a) would require a DCO to establish appropriate admission and continuing participation requirements for clearing members of the DCO, which are objective, publicly disclosed, and risk-based. Proposed § 39.12(a)(1) would require a DCO to have participation requirements that permit fair and open access, setting forth specific standards.

The Managed Funds Association (MFA), BlackRock, Inc. (BlackRock), State Street Corporation (State Street), and the Committee on Capital Markets Regulation (CCMR) supported the proposed rules. J.P. Morgan, ISDA, and FIA expressed support for the fair and open access provisions as long as there is prudent risk management.

According to MFA, more inclusive DCO participation requirements would benefit DCOs and the markets by: (1) Reducing DCO concentration risk; (2) increasing diversity of market participants involved in DCO governance; (3) enhancing competition in the provision of clearing services; and (4) lowering overall costs for non-clearing members. State Street agreed that more widespread participation could increase competition by allowing more entities to become clearing members. Blackrock commented that the proposed rule would allow a diverse group of entities to become clearing members, which would increase competition, promote more inclusive DCO participation requirements, and lower costs to customers of clearing members.

Each of the provisions of § 39.12(a)(1) are discussed below.

b. Less Restrictive Standards—§ 39.12(a)(1)(i)

To achieve fair and open access, proposed § 39.12(a)(1)(i) would prohibit a DCO from adopting a particular restrictive participation requirement if it could adopt a less restrictive requirement that would not materially increase risk to the DCO or its clearing members. BlackRock, the Swaps & Derivatives Market Association (SDMA), CME, LCH, Citadel, and CCMR supported the proposed rule. CCMR commented that the proposed rule would help to encourage an open marketplace.

KCC, ICE, and MGEX did not support the proposed rule. According to KCC, the test is highly subjective and would be difficult to implement in practice. ICE commented that the proposal would require a DCO to dilute current prudent risk management practices. MGEX commented that the proposed rule

would require DCOs to consider only objective, hard number risk factors, which would force DCOs to bear other risks such as financial fraud convictions. MGEX suggested that the Commission should provide DCOs with latitude when determining the risks to which it will expose itself.

The Commission is adopting § 39.12(a)(1)(i) as proposed, except for the addition of clarifying language to provide that a DCO shall not adopt restrictive clearing member standards if less restrictive requirements ''that achieve the same objective and'' that would not materially increase risk to the derivatives clearing organization or clearing members could be adopted. The rule balances the dual Congressional mandate to provide for fair and open access while ensuring that such increased access does not materially increase risk. Because the rule does not require a DCO to provide access that materially increases risk to the DCO or clearing members, the Commission does not agree with ICE that the rule will subject a DCO to increased risk.

The Commission does not agree with KCC that the rule will be highly subjective or difficult to implement in practice. The rule provides a DCO with discretion to balance restrictions on participation with legitimate risk management concerns and, in this regard, a DCO is in the best position in the first instance to determine the optimal balance. Only in circumstances where there is a question as to the impact of the rule would the Commission ask a DCO to justify the balance that the DCO has struck.

In response to MGEX's comment, the Commission notes that the rule does not require a DCO to rely solely on objective, hard number risk factors. The rule permits a DCO to rely on both qualitative and quantitative analyses, providing each DCO with latitude to determine how it can facilitate open access while determining the risks to which it will expose itself.

Except for certain bright-line participation requirements (*e.g.,* capital requirements for clearing members), the Commission has not provided more specific guidance as to what participant eligibility requirements are permissible under Core Principle C. Such a clarification would only serve to limit a DCO's flexibility to formulate participation requirements.

The Commission encourages each DCO to conduct a self-assessment to make sure that it can provide reasoned support to justify a conclusion that its rules do not violate the ''less restrictive'' standard contained in § 39.12(a)(1)(i). Such an analysis should take into consideration the interaction of this provision with the other provisions of § 39.12(a).

c. Clearing Member Qualification—§ 39.12(a)(1)(ii)

Proposed § 39.12(a)(1)(ii) would require a DCO to permit a market participant to become a clearing member if it meets the DCO's participation requirements. SDMA, LCH, and CCMR supported the proposed rule. According to CCMR, the proposed rule would help to encourage an open marketplace.

KCC commented that the proposed rule is not workable because a DCO may not have the operational capacity to admit all applicants that satisfy the DCO's membership requirements. KCC proposed that the regulation clarify that a DCO may set limits on the number of market participants that may be admitted in light of the DCO's own operational constraints.

The Commission is adopting § 39.12(a)(1)(ii) as proposed. The Commission is concerned that permitting a DCO to set a limit on the number of market participants that may become clearing members could enable a DCO to evade the open access requirement imposed by Core Principle C. If a DCO were able to demonstrate that operational constraints prevented it from admitting additional clearing members, the DCO could petition the Commission for an exemption.

d. Non-Discriminatory Treatment—§ 39.12(a)(1)(iii)

Proposed § 39.12(a)(1)(iii) would prohibit participation requirements that have the effect of excluding or limiting clearing membership of certain types of market participants unless the DCO can demonstrate that the restriction is necessary to address credit risk or deficiencies in the participants' operational capabilities that would prevent them from fulfilling their obligations as clearing members. LCH and SDMA supported the proposed rule. CME commented that in addition to credit risk and deficiencies in operational capabilities, legal risk should be included in the text of this regulation as a basis upon which a DCO may exclude or limit clearing membership of certain types of participants.

KCC did not support the proposed rule, commenting that a DCO's right to exclude or place limitation on certain clearing members should not be subject to ex-post determinations as to the necessity of such restrictions, as the DCO itself is in the best position to monitor the risks posed by the activities of its clearing members. According to KCC, the proposed rule would limit the risk management capabilities of a DCO, and DCOs should be accorded flexibility in their assessments of the operational capabilities of potential clearing members.

The Commission is adopting § 39.12(a)(1)(iii) as proposed. CME's concerns regarding heightened legal risk, such as the inability to attach property of a foreign clearing member under foreign law, are encompassed within the ''credit risk'' consideration. The Commission expects that most, if not all, bases for membership exclusion or limitation will fall within either financial or operational considerations. In addition, the Commission does not believe the rule would limit a DCO's risk management capabilities as KCC suggested because it would not prevent a DCO from excluding or limiting certain types of market participants from clearing if such participation would introduce genuine risk that cannot be adequately managed by the DCO. The Commission expects that DCOs will review their existing participation requirements for compliance with this rule.

e. Prohibition of Swap Dealer Requirement—§ 39.12(a)(1)(iv)

Proposed § 39.12(a)(1)(iv) would prohibit a DCO from requiring that clearing members be swap dealers. LCH commented that, in the event of default, it relies on non-defaulting clearing members to hedge the defaulting member's swap portfolio; to provide liquidity for such hedging; to bid on hedged portfolios; and, in extreme circumstances, to accept a forced allocation of swaps, which could be a risky, unhedged swaps portfolio. LCH commented that a clearing member who is not a swap dealer may not be able to participate in a DCO's default management process.

The Commission is adopting § 39.12(a)(1)(iv) as proposed. It is important to note that the regulation would not preclude participation by swap dealers (on which LCH currently relies). It simply requires that a DCO provide clearing access to other entities that could also participate in a DCO's default management process, even if to a lesser extent. Broader access is supported by other Commission regulations, *e.g.,* § 39.12(a)(3), which mandates that a DCO require its clearing members to have adequate operational capacity to participate in default management activities; § 39.12(b)(5), which requires a DCO to select contract units for clearing purposes that maximize liquidity, facilitate

transparency in pricing, promote open access, and allow for effective risk management; and § 39.16(c)(2)(iii), which permits a DCO to require its clearing members to accept an allocation, provided that any allocation must be proportional to the size of the clearing member's positions at the DCO. Thus, a DCO should be able to establish participation requirements that allow it to rely on non-defaulting clearing members to hedge a defaulting member's swap portfolio, to provide liquidity for such hedging, to bid on hedged portfolios, and to accept a forced allocation of swaps.

f. Prohibition of Swap Portfolio or Swap Transaction Volume Requirements—§ 39.12(a)(1)(v)

Proposed § 39.12(a)(1)(v) would prohibit a DCO from requiring clearing members to maintain a swap portfolio of any particular size, or that clearing members meet a swap transaction volume threshold.

According to State Street, such requirements are intended to systematically favor membership for financial institutions that are also substantial dealers in swaps. They do not take into account the risk management capabilities of many DCO members such as State Street, which are able to closely monitor risk exposures and effectively liquidate exposures through networks of interdealer relationships. The Commission believes that such requirements would have the effect of permitting only large swap dealers to provide clearing services. This would be inconsistent with Core Principle C. Accordingly, the Commission is adopting § 39.12(a)(1)(v) as proposed.

g. Financial Resources—§ 39.12(a)(2)(i)

Core Principle C mandates that each DCO must ensure that its clearing members have ''sufficient financial resources and operational capacity to meet obligations arising from participation in the [DCO].'' [55] Proposed § 39.12(a)(2)(i) would require a DCO to establish participation requirements that require clearing members to have access to sufficient financial resources to meet obligations arising from participation in the DCO in extreme but plausible market conditions. The financial resources could include a clearing member's capital, a guarantee from a clearing member's parent, or a credit facility funding arrangement.

CME commented that it supports the inclusion of parent guarantees and credit facility funding arrangements as acceptable financial resources for clearing members, provided that each DCO retains the flexibility to determine the particular terms and conditions of such arrangements. LCH, however, commented that credit facilities or funding arrangements should not be allowed for the purposes of fulfilling financial participation requirements. According to LCH, all clearing members' resources should be immediately and unconditionally available. ISDA also commented that a credit facility funding arrangement from an unaffiliated entity should not be available to satisfy clearing member financial resource requirements. ISDA did not believe that such funding would be reliable.

MGEX commented that testing for extreme but plausible market conditions would have minimal value because the test would be based on historical records or it would be based on future assumptions that are based on static conditions. MGEX believes that the proposed rule would require a DCO to devise tests for clearing members to use and would require a DCO to conduct the tests and provide the results to clearing members. MGEX commented that this specific rule seems unnecessary because DCOs have other methods to address risk, like increasing and decreasing margin. It noted further that it already requires clearing members to be in good financial standing, which includes minimum capital requirements and a requirement to provide a parent guarantee in certain circumstances.

The Commission is adopting § 39.12(a)(2)(i) with the modification described below. Per CME's comment, the rule provides a DCO with the flexibility to determine what constitutes sufficient financial resources to meet obligations arising from participation in the DCO in extreme but plausible market conditions, and to determine what financial resources are available to a clearing member to satisfy this requirement.

Regarding the comments of LCH and ISDA, the rule does not require a DCO to allow clearing members to use a credit facility funding arrangement to meet financial resource requirements. Because such arrangements can serve as an important source of liquidity for clearing members, the Commission has not prohibited their possible use to satisfy clearing member financial resource requirements. The Commission is modifying § 39.12(a)(2)(i) to clarify a DCO's discretion, by rephrasing the second sentence to read as follows: ''A derivatives clearing organization may permit such financial resources to include, without limitation, a clearing member's capital, a guarantee from the clearing member's parent, or a credit facility funding arrangement.'' To address concerns about reliability, a DCO can consider requiring that a credit facility funding arrangement be supported by multiple lenders.

Finally, the Commission does not believe that MGEX's comment provides a basis for revising the proposed rule. As an initial matter, Core Principle C requires each DCO to establish participation standards that require a clearing member to have sufficient financial resources to meet obligations arising from participation in the DCO. Core Principle B requires a DCO to maintain financial resources that would enable it to meet its financial obligations in ''extreme but plausible'' market conditions. The Commission believes that it is appropriate for a DCO to subject its clearing members to a comparable financial standard to support its own compliance with statutory requirements. A DCO would have discretion in setting the terms of any tests to determine whether clearing members' financial resources are sufficient to meet their obligations in extreme but plausible market conditions.

h. Capital Requirements Must Match Capital to Risk—§ 39.12(a)(2)(ii)

Proposed § 39.12(a)(2)(ii) would require a DCO to establish capital requirements that are based on objective, transparent, and commonly accepted standards, which appropriately match capital to risk. The capital requirements also would have to be scalable so that they are proportional to the risks posed by clearing members.

J.P. Morgan, MFA, ISDA, State Street, SDMA, Citadel LLC (Citadel), Better Markets, and FIA supported the proposed rule. According to Better Markets, the proposed rule is an important change of practices that will open DCO membership to more market participants while protecting the risk management system. FIA commented that a DCO, when it sets capital requirements, should take into account a clearing member's risk-derived exposures and its potential assessment obligations at each clearing organization of which it is a member. FIA recommended that a DCO should allow an FCM to clear positions in proportion to its capital net of those other risk-derived exposures and assessment obligations.

The Commission is adopting § 39.12(a)(2)(ii) as proposed, with one modification. In response to a comment from staff of the Federal Reserve and the Federal Reserve Bank of New York, the

[55] Section 5b(c)(2)(C)(i)(I) of the CEA; 7 U.S.C. 7a–1(c)(2)(C)(i)(I).

Commission is deleting the phrase ''so that they are proportional'' from the rule. This is to make clear that a DCO should take into account nonlinear risk. In response to FIA's comment, the Commission notes that in setting scalable requirements, a DCO should take into consideration risks that a clearing member carries as a result of positions cleared at other DCOs, to the extent that it is able to obtain such information.

i. Minimum Capital Requirement—§ 39.12(a)(2)(iii)

Proposed § 39.12(a)(2)(iii) would prohibit a DCO from setting a minimum capital requirement of more than $50 million for any person that seeks to become a clearing member in order to clear swaps. Pierpont Securities LLC (Pierpont), Better Markets, SDMA, Newedge, MFA, Citadel, and Jefferies & Company (Jefferies) supported the proposed rule.

Jefferies commented that the proposed rule would allow it to participate more actively in the swap market. Jefferies believes that taken together, the provisions of proposed § 39.12(a) provide a DCO with more than sufficient authority to assure the financial integrity and efficient operation of its swaps clearing activities.

Newedge commented that the proposed rule should not increase risk to a DCO because a DCO can mitigate risk by, among other things, imposing position limits, stricter margin requirements, or stricter default deposit requirements on lesser capitalized clearing members. Newedge proposed that the Commission prohibit DCOs from imposing a requirement that clearing members have an internal trading desk capable of liquidating or hedging a defaulting clearing member's positions. It said that there is no need for such a requirement because a non-defaulting member can handle a default event in a variety of ways, including having a contingent default manager. Newedge noted that under proposed § 39.16(c)(2)(iii), any obligation of a clearing member to participate in an auction, or to accept the allocation of a defaulting clearing member's positions, would be proportionate to the size of the clearing member's own position at the DCO. Thus, a clearing member should be able to hedge an allocated position and carry the position over time without having to take a substantial charge to its capital.

MFA commented that the threshold should not impose additional risk on a DCO because a DCO could ensure the safety of itself and clearing members by scaling each clearing member's net capital obligation in proportion to that clearing member's risk exposure. MFA expressed concern that a DCO could comply with the $50 million net capital requirement but impose a non-risk-based and excessive threshold guaranty fund contribution requirement that would unnecessarily exclude clearing members. MFA proposed that the regulations require that such scaling be determined by objective, risk-based methodologies that are based on reasonable stress and default scenarios, and the tests be consistently applied to all clearing members, without use of ''tiers'' that could have discriminatory or anti-competitive effects.

J.P. Morgan, the U.K. Financial Services Authority (FSA), CME, KCC, ISDA, IntercontinentalExchange, Inc. (ICE), State Street, Federal Home Loan Banks (FHLBanks), the Securities Industry and Financial Markets Association (SIFMA), and LCH expressed the view that the proposed rule could increase risk and the probability of default, and require DCOs to accept members who might not be able to participate in the default management process. FSA, KCC, and CME commented that a DCO must have reasonable discretion to determine the appropriate capital requirements for its clearing members based upon the DCO's analysis of the particular characteristics of the swaps that it clears.

J.P. Morgan, however, commented that a cap on a member's minimum capital requirement would not impact the systemic stability of a DCO as long as: (1) Clearing members clear house and client business in proportion to their available capital; (2) DCOs employ real-time risk management processes to ensure compliance with this principle; (3) DCOs hold a sufficient amount of margin and funded default guarantee funds; and (4) the Commission monitors clearing members to ensure that they are able to meet their financial obligations with respect to all DCOs of which they are members.

LCH and ISDA commented that the lower threshold could increase risk because a $50 million threshold would allow a clearing member to meet the eligibility requirements of multiple DCOs.

LCH, CME, and FSA commented that the smaller firms may be unable to participate in the default management process. LCH and ISDA also commented that members should not be able to outsource default management to third parties because they may not be sufficiently reliable in times of stress.

In addition, according to ISDA, there could be conflict-of-interest issues because the unaffiliated third party would not have ''skin in the game.'' As a result, through the actions of the unaffiliated third party, a clearing member could be assigned an unsuitable part of a defaulting clearing member's proprietary portfolio and/or at a sub-optimal valuation and/or wrongly accept customer positions from the defaulting clearing member. This conflict-of-interest concern is exacerbated where the entity to whom the default management obligations are outsourced is a ''competing'' clearing member in the same DCO.

State Street and SDMA, however, commented that clearing members should be permitted to enter into committed arrangements with non-affiliated firms to perform default management functions. According to SDMA, there is no evidence to suggest that a legal arrangement with a third-party dealer somehow lessens the integrity to the system. Assuming the legal and financial arrangements between such firms are sufficiently strong to ensure performance when needed, State Street commented that there is no appreciable difference between the default management capacity of the traditional dealer-affiliated clearing member and a non-dealer clearing member outsourcing certain functions to a non-affiliate.

Finally, SIFMA commented that the appropriate minimum capital requirement would be $300 million, while ISDA commented that if the Commission cannot monitor risk across all DCOs, a $1 billion capital requirement would be appropriate.

After carefully considering the comments, the Commission is adopting § 39.12(a)(2)(iii) as proposed. The Commission believes, as noted in numerous comments, that the rule will increase the number of firms clearing swaps, which will make markets more competitive, increase liquidity, reduce concentration, and reduce systemic risk. The Commission also believes that, as explained below, the $50 million threshold will not significantly increase risk or lead to admission of clearing members who are unable to meaningfully and responsibly participate in the clearing process.

As an initial matter, the Commission emphasizes that the $50 million threshold is not arbitrary. That number was arrived at by reviewing the capital of registered FCMs.[56] This amount

[56] *See* transcript of December 16, 2010 Commission meeting at 77–81 available at *www.cftc.gov* (discussing $50 million threshold; Commission staff stating that of 126 FCMs, 63 currently have capital above $50 million and most

Continued

captures firms that the Commission believes have the financial, operational, and staffing resources to participate in clearing swaps without posing an unacceptable level of risk to a DCO. This capital threshold is considered to be appropriate, particularly in light of other proposed rules (such as scaling capital and risk exposure and breaking down large swap positions into smaller units for more diversified allocation in the event of a clearing member default).

The Commission considered whether to increase the capital threshold to $300 million as proposed by SIFMA or $1 billion as proposed by ISDA. The Commission analyzed the reduction in the number of firms that would be eligible to clear at CME, ICE Clear US, KCC, MGEX, and OCC using these thresholds. As set forth in the table below, depending on the basis used to measure capital, a capital threshold of $300 million would reduce the number of firms able to clear by 38–51 percent. A capital threshold of $1 billion would reduce the number of firms able to clear by 62–65 percent. The Commission believes that this reduction in participation would be contrary to the Congressional mandate for open access to clearing.[57]

	Ownership Equity			Adjusted Net Capital				Excess Net Capital			
	FCM	Non-clearing FCMs	Δ	FCM	Non-clearing FCMs	Clearing non-FCMs	Δ	FCM	Non-clearing FCMs	Clearing Non-FCMs	Δ
$50 Million	40	32		38	27	12		31	25	10	
$300 Million	26	13	-46%	21	10	7	-51%	24	10	7	-38%
$1 Billion	17	8	-65%	18	5	5	-64%	15	5	5	-62%

The Commission does not believe that the rule will increase risk. Section 39.12(a)(2)(ii) requires DCOs to impose capital requirements that are scalable to the risks posed by clearing members. Accordingly, a small clearing member should not be able to expose a DCO to significant risk even if it is able to clear at multiple DCOs because its exposure at each DCO would be limited. DCOs that participate in the Shared Market Information System (SHAMIS) will be able to see a clearing member's pays and collects across participating DCOs, and a DCO also could on its own initiative require clearing members to directly report their clearing activity at other DCOs. The Commission also will be able to monitor clearing member exposure by means of DCO end-of-day reporting under the reporting requirements of § 39.19(c)(1)(i), which the Commission is adopting herein. It will also be able to monitor the financial strength of clearing members that are registrants pursuant to financial reporting requirements.

In addition, the Commission is adopting other rules that will reinforce a DCO's oversight of its clearing members. In this regard, § 39.12(a)(4) requires a DCO to verify, on an ongoing basis, the compliance of each clearing member with each participation requirement; § 39.12(a)(5) requires a DCO to require all clearing members to file periodic financial statements and timely information that concerns any financial or business developments that may materially affect the clearing members' ability to continue to comply with participation requirements; and § 39.13(h)(5) further requires a DCO to adopt rules that require clearing members to maintain current risk management policies and procedures and requires a DCO to review such policies and procedures on a periodic basis. The Commission also has proposed requirements for clearing member risk management.[58]

The Commission does not believe that the $50 million threshold would lead to a DCO having to admit clearing members that are unable to participate in the default management process. As discussed above, the regulation does not preclude highly-capitalized entities (such as swap dealers) from participating in a DCO as clearing members. Thus, the addition of smaller clearing members does not eliminate the role that larger clearing members can play in default management—it merely spreads the risk.

The Commission wishes to emphasize that it will review DCO membership rules as a package in light of all of the provisions of § 39.12(a). Thus, a DCO may not circumvent § 39.12(a)(2)(iii) by enacting some additional financial requirement that effectively renders the $50 million threshold meaningless for some potential clearing members. Such an arrangement would violate § 39.12(a)(1)(i) (less restrictive alternatives), or § 39.12(a)(1)(iii) (exclusion of certain types of firms).

As discussed below, under § 39.12(a)(3), a DCO's participation requirements must include provisions for adequate operational capacity. This requirement should be read in conjunction with § 39.12(a)(1)(i), which prohibits restrictive clearing member standards if less restrictive standards could be adopted; § 39.12(a)(1)(iii), which prohibits DCOs from excluding certain types of market participants from clearing membership if they can fulfill the obligations of clearing membership; and § 39.16(c)(2)(iii), which permits a DCO to require a clearing member to participate in an auction or to accept allocations of a defaulting clearing member's customer or house positions, provided the allocated positions are proportional to the size of the clearing member's positions at the DCO and are permitted to be outsourced to a qualified third party subject to safeguards imposed by the DCO.

Several commenters discussed the use of outsourcing to satisfy default management obligations. The Commission believes that open access to clearing and effective risk management need not be viewed as conflicting goals. Subject to appropriate safeguards, outsourcing of certain obligations can be an effective means of harmonizing these goals. For example, a small clearing member might have less ability to contribute meaningfully to a DCO's

FCMs with capital below that amount are not clearing members).

[57] Clearing FCM and non-clearing FCM data for adjusted net capital and excess net capital was provided by FCM registrants and is available on the Commission Web site. The other data is non-public. Ownership equity data was provided by FCM registrants through the monthly financial statements that are submitted to the Commission. The data from the monthly financial statements reside in the Commission's RSR Express system, and all data for clearing non-FCMs was provided by the DCOs to the Commission's Risk Surveillance Group during the course of its routine oversight activities.

[58] *See* 76 FR 45724 (Aug. 1, 2011) (Clearing Member Risk Management).

auction process acting on its own than if an entity with greater expertise in the relevant markets acted in its place.

Therefore, the Commission believes that it would be inconsistent with § 39.12(a)(1)(i) and § 39.12(a)(1)(iii) for a DCO to prohibit outsourcing. Accordingly, as discussed below, the Commission is adopting revised default procedure rules to require a DCO to permit outsourcing to qualified third parties of obligations to participate in auctions or in allocations, subject to appropriate safeguards imposed by the DCO.[59]

Finally, the Commission has determined that it will not permit a DCO to require members to post a minimum amount of liquid margin or default guarantee contributions, or to participate in a liquidity facility per J.P. Morgan's suggestion. The Commission believes that the rules are sufficient to ensure that each member has adequate resources to withstand another member's default and such requirements could be used by a DCO to evade the open access to clearing intended by the Dodd-Frank Act.

j. Operational Requirements—§ 39.12(a)(3)

Proposed § 39.12(a)(3) would require a DCO to require its clearing members to have adequate operational capacity to meet their obligations arising from participation in the DCO. The requirements would include, but not be limited to: The ability to process expected volumes and values of transactions cleared by a clearing member within required time frames, including at peak times and on peak days; the ability to fulfill collateral, payment, and delivery obligations imposed by the DCO; and the ability to participate in default management activities under the rules of the DCO and in accordance with proposed § 39.16.

LCH, FIA, Jefferies, and SDMA commented that the Commission has correctly identified the operational requirements. Jefferies commented that demonstrating sufficient operational capacity is more important than capital considerations. According to SDMA, these operational requirements are directly related to the core business of the clearing member and provide the services needed and relied upon by the DCO to clear trades. SDMA also believes that DCOs should be prohibited from imposing operational requirements that are not part of a clearing member's core business because they create discriminatory barriers to clearing, and it points to the following as examples of discriminatory operational eligibility requirements: Clearing members must (1) Have both execution and clearing capabilities; (2) provide end-of-day prices to mark its positions; and (3) have extensive experience in clearing swaps or ''sophistication.''

J.P. Morgan and FIA commented that a DCO must ensure that each member has risk management resources to assist the DCO in its risk management process, and FIA suggested that the final rules add appropriate risk management requirements as a participant eligibility criterion, or make clear that nothing in the proposed rules is intended to prevent a DCO from adopting such requirements.

ISDA commented that the ability to bid for portfolios of other clearing members of the DCO is critically important. According to ISDA, an appropriate risk management framework for a clearing member may be broadly categorized as follows: (1) Board and senior management oversight; (2) organizational structure; and (3) strong systems and procedures for controlling, monitoring and reporting risk.

Finally, State Street commented that a clearing member must be able to demonstrate it can carry out its obligations to a DCO under a default scenario. That demonstration could include having the capacity to trade swaps using experienced swap traders, and the ability to execute transactions in the market by having appropriate trading relationships. A clearing member must also demonstrate an ability to monitor positions, calculate potential losses and market risk, perform stress tests, and maintain liquidity, among numerous other requirements.

The Commission is adopting § 39.12(a)(3) as proposed. The Commission believes that the rule correctly identifies the necessary operational requirements and is concerned that the heightened operational requirements suggested by some commenters could allow a DCO to evade the open access to DCO clearing intended by the Dodd-Frank Act. The Commission emphasizes that under the rule, any operational requirements must be necessary to meet clearing obligations. In addition, the Commission is adopting § 39.13(h)(5) herein, which requires a DCO to adopt rules requiring clearing members to maintain current written risk management policies and procedures.[60] The Commission has also proposed rules requiring clearing members that are FCMs (proposed § 1.73) and swap dealers and major swap participants (proposed § 23.609) to engage in specific risk management activities.[61]

k. Monitoring, Reporting, and Enforcement—§ 39.12(a)(4)

Core Principle C requires each DCO to ''establish and implement procedures to verify, on an ongoing basis, the compliance of each clearing member with each participation requirement of the derivatives clearing organization.'' [62] Proposed § 39.12(a)(4) would codify these requirements.

OCC supported the proposed rule ''if interpreted reasonably.'' J.P. Morgan commented that a clearing member may have committed to additional unfunded assessments at more than one clearinghouse and proposes that the Commission and DCOs monitor clearing members to ensure that they have sufficient liquid resources to support the business they clear at each DCO. According to J.P. Morgan, a DCO should monitor exposures against risk-based position limits on a real-time basis.

The Commission is adopting § 39.12(a)(4) as proposed. In response to J.P. Morgan's comments, the Commission notes that in monitoring firms, a DCO should take into consideration risks that the firm faces outside of that DCO. The Commission further notes that it is not prescribing the means by which DCOs should monitor compliance.

l. Reporting Requirements—§ 39.12(a)(5)

Proposed § 39.12(a)(5)(i) would mandate that a DCO require all clearing members, including those that are not FCMs, to file with the DCO periodic financial reports containing any financial information that the DCO determines is necessary to assess whether participation requirements are met on an ongoing basis. The proposed rule also would mandate that a DCO require clearing members that are FCMs to file the financial reports that are specified in § 1.10 of the Commission's regulations with the DCO, and would require the DCO to review all such financial reports for risk management purposes. Proposed § 39.12(a)(5)(i) would also require a DCO to require its clearing members that are not FCMs to make the periodic financial reports that they file with the DCO available to the Commission upon the Commission's

[59] *See* discussion of revised § 39.16(c)(2)(iii) in section IV.G.4, below.

[60] *See* discussion of § 39.13(h)(5) in section IV.D.7.e, below.

[61] *See* 76 FR at 45729–45730 (Aug. 1, 2011) (Clearing Member Risk Management).

[62] *See* Section 5b(c)(2)(C)(ii) of the CEA; 7 U.S.C. 7a–1(c)(2)(C)(ii).

request. Proposed § 39.12(a)(5)(ii) would mandate that a DCO adopt rules that require clearing members to provide to the DCO, in a timely manner, information that concerns any financial or business developments that may materially affect the clearing members' ability to continue to comply with participation requirements.

LCH commented that a DCO based outside the U.S. may have clearing members that are not subject to the Commission's jurisdiction and would be regulated in their home jurisdiction. LCH proposed this provision be revised such that only FCMs and U.S.-based members that are not FCMs are required to provide this information to the Commission upon request. According to LCH, all other members should be required to submit the information to the DCO only or to their equivalent local regulator.

LCH and MGEX commented that proposed § 39.12(a)(5)(ii) would be more appropriately imposed on clearing members themselves, rather than on the DCO. KCC suggested that the Commission should evaluate its statutory authority to enact the proposed rule. MGEX commented that the proposed rules appear to require clearing members to report to each DCO with which they clear, which would create an additional, duplicative burden on clearing members. MGEX suggested that the Commission regulate the clearing members directly. As an alternative, MGEX proposed a new industry group similar to the Joint Audit Committee (JAC) in which each DCO would be represented and participate in developing an overall risk management program that would be used in fulfilling the new proposed requirements.

The Commission is adopting § 39.12(a)(5) with modifications to (1) provide that the financial information provided by non-FCM clearing members may be submitted by the clearing members to the Commission pursuant to DCO rules or may be submitted to the Commission by the DCO, in either case, upon the Commission's request; and (2) eliminate the proposed requirement that the DCO must review clearing members' financial reports for risk management purposes.

The rule is intended to address circumstances where the Commission must obtain information in the possession of a clearing member. The Commission anticipates such requests will be few in number. However, when those occasions arise, the Commission must be able to obtain the information as expeditiously as possible. The rule addresses this need by allowing the Commission to obtain the information directly from the source and to minimize the burden on DCOs. In response to the comments, the Commission is revising the rule to provide that a DCO may either provide the requested information directly to the Commission or require clearing members to provide the information to the Commission.

The Commission is eliminating the requirement that the DCO must review clearing members' financial reports for risk management purposes. Upon further consideration, the Commission has concluded that although a DCO may review such financial reports for several reasons, including risk management and to ensure that clearing members continue to meet participation requirements, it is not necessary to be prescriptive in this regard.

In response to MGEX suggestion of a new industry group, Commission staff is considering such a step.

The Commission is making certain technical revisions to § 39.12(a)(5) in connection with these changes.

m. Enforcement of Participation Requirements—§ 39.12(a)(6)

Proposed § 39.12(a)(6) would require a DCO to enforce compliance with its participation requirements and establish procedures for the suspension and orderly removal of clearing members that no longer meet the requirements. MGEX commented that the proposed rule goes beyond the language of the Dodd-Frank Act.

The Commission is adopting § 39.12(a)(6) as proposed. A DCO must have the ability to enforce compliance with its participation requirements or its clearing members may not satisfy these requirements. A DCO also must have procedures for the suspension and orderly removal of clearing members that no longer meet the requirements. Otherwise, the enforcement process may not be orderly and could introduce additional risk to the DCO. This requirement complements § 39.17, adopted herein, which implements Core Principle H (Rule Enforcement).[63]

2. Product Eligibility

Core Principle C requires that each DCO establish appropriate standards for determining the eligibility of agreements, contracts, or transactions submitted to the DCO for clearing. Proposed § 39.12(b) would codify these requirements.

a. General Comments

Citadel and MFA supported the proposed rules. To ensure non-discriminatory clearing, Citadel and MFA recommended the Commission make explicit that a DCO must provide highly standardized mechanisms and procedures for establishing connectivity with SEFs and any other permitted trading venue. According to Citadel, these mechanisms and procedures must be objective, commercially reasonable, publicly available, and treat all applicant execution facilities in an unbiased manner. Citadel and MFA also proposed that the rules mandate that a DCO keep the clearing acceptance process anonymous (*i.e.,* without the customer's clearing member knowing the identity of the customer's executing counterparty).

The Commission agrees that a DCO must provide mechanisms for establishing connectivity with SEFs and DCMs, which would provide executing counterparties with fair and open access. The Commission has proposed rules addressing this issue.[64] The Commission also has proposed rules that address the anonymity issue.[65]

b. Products Eligible for Clearing—§ 39.12(b)(1)

Proposed § 39.12(b)(1) would require a DCO to establish appropriate requirements for determining the eligibility of agreements, contracts, or transactions submitted to the DCO for clearing, taking into account the DCO's ability to manage the risks associated with such agreements, contracts, or transactions. Factors to be considered in determining product eligibility would include but would not be limited to: (1) Trading volume; (2) liquidity; (3) availability of reliable prices; (4) ability of market participants to use portfolio compression with respect to a particular swap product; (5) ability of the DCO and clearing members to gain access to the relevant market for purposes of creating and liquidating positions; (6) ability of the DCO to measure risk for purposes of setting margin requirements; and (7) operational capacity of the DCO and clearing members to address any unique risk characteristics of a product.[66]

OCC noted that the factors to be considered are already among the factors that a DCO would naturally consider and that OCC in fact considers, and it suggested that the application of

[63] *See* discussion of § 39.17 in section IV.H, below.

[64] *See* 76 FR 13101 (Mar. 10, 2011) (Straight-Through Processing).

[65] *See* 76 FR 45730 (Aug. 1, 2011) (Customer Clearing).

[66] As proposed, § 39.12(b)(1)(vii) referred to addressing any ''unique'' risk characteristics of a product. The Commission is revising this provision in the final rule to refer to any ''unusual'' risk characteristics to clarify that such characteristics are not limited to those that are one of a kind.

this new rule be limited to swaps. OCC also noted that the trading volume of new products is often unknown and unpredictable and suggested that factor not be a barrier to accepting a product for clearing.

MGEX commented that the proposed rule considers legitimate factors, but mandating that a DCO establish eligibility requirements is not necessary, other than requirements for the contract size of swaps. Like OCC, MGEX noted that DCOs already use these factors as part of their sound business judgment in making these types of decisions. MGEX recommended that the Commission issue suggested guidelines or core principles and, on an as-needed basis, request that a DCO file with the Commission the rationale supporting its conclusion that a contract qualifies for clearing.

LCH expressed concerns with proposed § 39.12(b)(1)(iv) and commented that compression services have been developed only when swap markets are relatively large and well-established, and the introduction of cleared facilities has largely pre-dated the introduction of compression services. According to LCH, making swap clearing contingent on swap portfolio compression may have the effect of permitting fewer swaps to be cleared. LCH proposed that the Commission encourage the use of compression services where suitable and available, but not constrain the ability of a DCO to clear a given swap based on the availability of such services.

LCH also commented that it is imperative that a DCO have the ability to ''transfer,'' ''auction,'' or ''allocate'' cleared swaps. LCH proposed that the factor listed in proposed § 39.12(b)(1)(v), the ''[a]bility of the [DCO] and clearing members to gain access to the relevant market for purposes of creating and liquidating positions'' be modified to reflect these additional actions.

The Commission agrees with LCH that a DCO must have the ability to ''transfer,'' ''auction,'' or ''allocate'' cleared swaps and it is revising § 39.12(b)(1)(v) to incorporate LCH's suggestion.[67] The Commission is otherwise adopting Section 39.12(b)(1) as proposed. The Commission believes that setting forth the minimum factors that all DCOs must consider when determining contract eligibility is necessary to prevent a DCO from seeking to clear transactions that present an unacceptable level of risk. The Commission also believes that OCC's and LCH's concerns are unfounded. The rule provides factors to be considered and does not prohibit a DCO from accepting a product for clearing if it does not satisfy one of the factors. Finally, the Commission is declining to limit the rule to swaps because it believes the eligibility factors are applicable to all products cleared by a DCO. The Commission is also declining to issue suggested guidelines or core principles, or to request that a DCO file with the Commission the rationale for why a contract qualifies for clearing. The Commission believes that § 39.12(b)(1) is not burdensome because, as MGEX and OCC commented, these factors are already considered by DCOs. In contrast, filing rationales on an as-needed basis could be burdensome to the DCO and the Commission, and would not serve to mitigate risk more effectively.

c. Economic Equivalence—§ 39.12(b)(2)

Proposed § 39.12(b)(2) would require a DCO to adopt rules providing that all swaps with the same terms and conditions (as defined by templates established under DCO rules) submitted to the DCO for clearing are economically equivalent within the DCO and may be offset with each other within the DCO.

ISDA, CME, and FIA commented that the term ''template'' is inappropriate. According to ISDA, ''template'' has no clear meaning, and it assumes that the term refers to the contract specifications currently used by a variety of futures facilities. ISDA noted that the development of specific templates for swap transactions is a mixed business/technological project that requires significant discussion involving each DCO and its market participants. It suggested that the Commission's regulations guide the meaning of ''template'' to achieve as much individual transactional variability as possible within the transaction or range of transactions that a template may cover.

CME commented that references to ''templates'' are confusing because swap dealers generally maintain standard templates for documenting their trading relationships, and their counterparties frequently negotiate changes to those templates. According to CME, a DCO does not define the templates used by OTC participants, and DCO rules do not function as templates from which counterparties may negotiate. Rather, a DCO sets forth in its rulebook the product specifications of each contract it accepts for clearing, including swaps. CME suggested that the Commission revise § 39.12(b)(2) to state as follows (change in italics): ''A [DCO] shall adopt rules providing that all swaps with the same terms and conditions, as defined by product specifications established under [DCO] rules, submitted to the [DCO] for clearing are economically equivalent within the [DCO] and may be offset with each other within the [DCO].''

FIA requested that Commission confirm that economically equivalent swaps must have the same cash flows, values, and liquidation dates. FIA also suggested that terms and conditions of such templates—for example, events of default—should also be consistent with market practice.

Finally, KCC commented that the proposed rule is redundant because Chapter 21 of the KCC rulebook already defines the terms and conditions for swaps that KCC will clear.

The Commission is revising § 39.12(b)(2) as suggested by CME to substitute the phrase ''product specifications'' for the word ''templates.'' As noted above, some commenters found the use of the word ''templates'' confusing. The Commission's intent was to ensure that a DCO sets the specifications for cleared products. The Commission is otherwise adopting the rule as proposed.

In response to FIA, the Commission confirms that it regards cash flows, values, and liquidation dates as terms and conditions encompassed by this rule. The Commission, however, declines to require that terms and conditions be consistent with market practice. The Commission believes that a DCO should have the flexibility to determine whether to conform terms and conditions to market practice.

d. Non-Discriminatory Treatment of Swaps—§ 39.12(b)(3)

Proposed § 39.12(b)(3) would require a DCO to provide for non-discriminatory clearing of a swap executed bilaterally or on or subject to the rules of an unaffiliated SEF or DCM. FIA and MFA commented in support of the proposed rule.

OCC suggested that it should not be deemed a violation of § 39.12(b)(3) for a DCO to require a SEF or DCM desiring to transmit swaps to the DCO for clearing to enter into a non-exclusive clearing agreement on non-discriminatory terms similar to those offered by the DCO to other SEFs or DCMs for clearing of similar products. OCC believes that such agreements are

[67] This is also consistent with § 39.16(c)(2)(ii), adopted herein and discussed in section IV.G.4, below, which requires a DCO to adopt rules that set forth the actions that a DCO may take in the event of a default, which must include the prompt transfer, liquidation, or hedging of the defaulting clearing member's positions, and which may include the auctioning or allocation of such positions to other clearing members.

necessary and appropriate for purposes of addressing matters between the parties such as information sharing and furnishing price data by the exchange to the DCO.

LCH suggested that the Commission clarify that ''non-discriminatory'' includes costs, technology, and other related considerations. LCH also suggested that the Commission impose the reverse requirements on execution venues such as DCMs and SEFs, so that those venues are also required to provide trade feeds to DCOs on a non-discriminatory basis.

The Commission is adopting § 39.12(b)(3) as proposed. In response to OCC, the Commission notes that the rule does not prohibit a DCO from requiring a SEF or DCM desiring to transmit swaps to the DCO for clearing to enter into a non-exclusive clearing agreement on non-discriminatory terms similar to those offered by the DCO to other SEFs or DCMs for clearing of similar products. The Commission agrees that such agreements are necessary and appropriate for purposes of addressing matters between the parties such as information sharing and furnishing price data by the exchange to the DCO. The Commission notes that it expects DCOs to review clearing agreements for compliance with § 39.12(b)(3), the open access requirements of Core Principle C, and any relevant requirements of other core principles.

In response to LCH's comment, the Commission notes that the requirement applies to the factors LCH enumerated. The Commission also notes that LCH's suggestion regarding trading venues is outside the scope of this rulemaking

e. Prohibition on Requirement That Executing Party Is a Clearing Member—§ 39.12(b)(4)

Proposed § 39.12(b)(4) would prohibit a DCO from requiring one of the original executing parties to be a clearing member in order for a contract, agreement, or transaction to be eligible for clearing.

CME concurred with the Commission's analysis and fully supported the proposed regulation. FIA, Citadel, and MFA also supported the proposed regulation.

MFA suggested strengthening the proposed rule. According to MFA, when a non-clearing member trades with another non-clearing member, the clearing process should be identical and as prompt as when one of the parties is a clearing member, so long as the transaction satisfies the relevant DCO's rules, requirements, and standards otherwise applicable to such trades. MFA believes that providing this parity would allow new liquidity providers to efficiently and effectively enter into and compete within the market.

MFA also suggested that the Commission revise the proposed rule to prohibit a DCO from adopting rules or engaging in conduct that is prejudicial to non-clearing members as compared to clearing members with respect to eligibility or the timing of clearing or processing of trades generally. The Commission has addressed this issue in the recently proposed rules on clearing documentation.[68]

ISDA commented that rules barring trades that don't involve a clearing member as a party are inappropriate in established DCOs, but new DCOs may need to roll out products and procedures in a contained way. According to ISDA, ''initial decisions on which market constituencies should have access to clearing must be the subject of legitimate, reasoned decision-making by each DCO with regard to its ability to properly serve each constituency and each constituency's readiness to participate in a cleared market.''

Finally, NGX commented that if the proposed rule were applied to a non-intermediated DCO such as NGX, the rule would require a fundamental restructuring of the manner in which the DCO admits members, guarantees trades, and provides risk management. DCOs like NGX require all participants to become clearing participants at the DCO, and they do not clear contracts that involve non-clearing participants.

The Commission is adopting § 39.12(b)(4) as proposed. In response to the comments of ISDA and NGX, the Commission notes that some DCOs currently have only direct participants, *i.e.,* participants that do not offer client clearing. NGX, for example, provides direct access to commercial end users who clear for themselves. The Commission notes that, consistent with principles of open access, a DCO must have rules in place to offer client clearing promptly if an FCM or a customer requests access. However, from a cost-benefit perspective, the Commission would expect that any DCO investment in building systems would be proportionate to evidence of demand for the service.

Finally, in a separate rulemaking, the Commission has proposed rules that address MFA's suggestion that trades between indirect clearing members should have parity with trades between clearing members.[69]

f. Product Standardization—§ 39.12(b)(5)

Proposed § 39.12(b)(5) would require a DCO to select contract unit sizes and other product terms and conditions that maximize liquidity, facilitate transparency in pricing, promote open access, and allow for effective risk management.[70] To the extent appropriate to further these objectives, a DCO would be required to select contract units for clearing purposes that were smaller than the contract units in which trades submitted for clearing were executed. [71]

ISDA supported the goals identified by the Commission; however, it commented that ''unit size'' is not a meaningful concept in swap transactions because contract size is not standardized. According to ISDA, the only meaningful size limit is the smallest unit of relevant currency or relevant underlying. ISDA suggested that the Commission avoid focusing on ''unit size'' and instead articulate its ultimate objectives, as it has, leaving DCOs with the discretion to set suitable terms and conditions to further those objectives.

FIA did not support the requirement that a DCO select contract unit sizes because FIA does not believe that the swap market has evolved to the point where DCOs can do this. FIA also does not believe the market is at a point where it would be appropriate for a DCO to establish templates regarding the terms and conditions of standardized swaps eligible for clearing. FIA believes that requiring swaps to fit within artificial, prescribed templates would be disruptive to the market and would not benefit customers. FIA, however, would support a requirement that DCOs study this matter and submit a report to the Commission on the feasibility of establishing templates regarding the terms and conditions of standardized swaps as soon as practicable.

Finally, LCH commented that it is not appropriate to require a DCO to select contract units for clearing purposes that are smaller than the contract units in which trades submitted for clearing were executed. According to LCH, a DCO clearing swaps should be able to accept such swaps in any size, and swaps submitted for clearing should not

[68] *See* 76 FR 45730 (Aug. 1, 2011) (Customer Clearing).

[69] *See* 76 FR 45730 (Aug. 1, 2011) (Customer Clearing).

[70] *See* 76 FR 13101 (Mar. 10, 2011) (Straight-Through Processing).

[71] *Id.*

be broken down into sub-units. LCH suggested that the Commission strike § 39.12(b)(5) and that any rules addressing average size of exposure traded in the swap markets be addressed in rules pertaining to trading and execution venues.

The Commission is adopting § 39.12(b)(5) as proposed. The Commission believes that standardizing products, including swaps, by requiring a DCO to determine product terms and conditions, including product size, will increase liquidity, lower prices, and increase participation. In addition, standardized products should make it easier for members to accept a forced allocation in the event of bankruptcy.

The Commission recognizes that standardized products may create basis risk for some hedge positions. However, this circumstance has long existed in the futures markets. The Commission believes that the benefits of standardization, such as competitive pricing, liquid markets, and open access, outweigh the costs of imperfect hedging.

In response to LCH, the Commission notes that the product unit size of a particular swap executed bilaterally may reflect the immediate circumstances of the two parties to the transaction. Once submitted for clearing, it may be possible to split the trade into smaller units without compromising the interests of the two original parties. Smaller units can promote liquidity by permitting more parties to trade the product, facilitate open access by permitting more clearing members to clear the product, and aid risk management by enabling a DCO, in the event of a default, to have more potential counterparties for liquidation. The Commission notes that under the rule, DCOs retain some discretion in determining how best to promote liquidity, facilitate open access, and aid risk management.

g. Novation—§ 39.12(b)(6)

Proposed § 39.12(b)(6) would require a DCO that clears swaps to have rules providing that upon acceptance of a swap: (i) The original swap is extinguished; (ii) the original swap is replaced by equal and opposite swaps between clearing members and the DCO; (iii) the terms of the cleared swaps conform to templates established under DCO rules; and (iv) if a swap is cleared by a clearing member on behalf of a customer, all terms of the swap, as carried in the customer account on the books of the clearing member, must conform to the terms of the cleared swap established under the DCO's rules.

Newedge supported this rule, in particular, the requirement for standardization.

CME, FIA, and ICE commented that the proposed rule appears to presume the use of a ''principal'' model for all cleared swaps, even those swaps cleared on behalf of customers. CME noted that at CME, an FCM clearing customer business acts as an agent for undisclosed principals (*i.e.,* the FCM's customers) vis-a-vis CME and guarantees its customers' performance to CME. CME suggested that in order to preserve the agency model for customer-cleared swaps, the Commission should adopt a revised § 39.12(b)(6)(ii) to provide that, upon acceptance of a swap for clearing, ''the original swap is replaced by equal and opposite swaps *with* the DCO.'' As previously noted, CME also commented that the use of the term ''template'' is confusing. It suggested that the Commission revise § 39.12(b)(6)(iii) to state: ''All terms of the cleared swaps must conform to product specifications established under [DCO] rules.''

FIA commented that the proposed rule would conflict with the FCMs' position that, with respect to customer positions, FCMs are acting as agent, and not as principal, for customers in executing and clearing swaps (and futures) on behalf of customers. FIA suggested that the proposed rule be revised to confirm that, in clearing swaps on behalf of customers, a clearing member shall be deemed a guarantor and agent of a cleared swap and not a principal.

ICE noted that U.S. futures markets may clear on an open offer basis, which allows straight-through processing. ICE commented that the Commission should not preclude open offer clearing of swaps by requiring the underlying swap to be novated.

Finally, LCH suggested that the Commission revise the rule so that the obligation would fall on the clearing member rather than the DCO because the provisions relate to the clearing member's books and records, not the DCO's.

The Commission is adopting § 39.12(b)(6) with modifications to clarify its intended meaning. In response to the comments from CME, FIA, and ICE, the Commission is revising § 39.12(b)(6)(ii) to provide that a DCO that clears swaps must have rules providing that, upon acceptance of a swap by the DCO for clearing, ''[t]he original swap is replaced by an equal and opposite swap between the derivatives clearing organization and each clearing member acting as principal for a house trade or acting as agent for a customer trade.''

In response to the comment from CME, the Commission is revising § 39.12(b)(6)(iii) to substitute the phrase ''product specifications'' for the word ''templates.'' This is consistent with the change to § 39.12(b)(2), discussed above.

In response to the comment by ICE, the Commission notes that ''open offer'' systems are acceptable under the rule. Effectively, under an open offer system there is no ''original'' swap between executing parties that needs to be novated; the swap that is created upon execution is between the DCO and the clearing member, acting either as principal or agent.

Finally, with regard to LCH's comment, the Commission believes that it is proper for the requirement to fall on the DCO. The DCO is the central counterparty and is responsible for the transaction going forward.

h. Confirmation of Terms—§ 39.12(b)(8)

Proposed § 39.12(b)(8) would require a DCO to have rules that provide that all swaps submitted to the DCO for clearing must include written documentation that memorializes all of the terms of the transaction and legally supersedes any previous agreement.[72] The confirmation of all terms of the transaction would be required to take place at the same time as the swap is accepted for clearing.

CME suggested that the Commission revise the proposed regulation to require a DCO to ''provide each clearing member carrying a cleared swap with a definitive record of the terms of the agreement, which will serve as a confirmation of the swap.''

ISDA commented that it is not clear what efficiencies the proposed rule would achieve for the parties to the swap in confirming through a DCO. It suggested that the Commission be less prescriptive and recognize that the act of clearing a swap transaction through a DCO in and of itself should produce a definitive written record, tailored to the particular category of swap transaction by the DCO and its market constituency, which fulfills the Commission's objective of facilitating the timely processing and confirmation of swaps not executed on a SEF or a DCM.

FIA requested that the Commission clarify the obligations of the parties under this proposed rule. According to FIA, the rule appears to place

[72] This provision was originally designated as § 39.12(b)(7)(v) in 76 FR 13101 (Mar. 10, 2011) (Straight-Through Processing). It was later proposed to be renumbered as § 39.12(b)(8) in 76 FR 45730 (Aug. 1, 2011) (Customer Clearing). Section 39.12(b)(7), as currently proposed (76 FR at 13110), will be addressed in a separate final rulemaking.

responsibility on the parties to the swap to submit a written confirmation of the terms of the transaction to the DCO, which, upon acceptance by the DCO, will supersede any prior documents and serve as the confirmation of the trade. However, the notice of proposed rulemaking places responsibility on the DCO, explaining that the proposed rule ''would require that DCOs accepting a swap for clearing provide the counterparties with a definitive written record of the terms of their agreement, which will serve as a confirmation of the swap.'' Further, the proposed rule appears to apply to all swaps submitted for clearing, but the notice of proposed rulemaking appears to limit the requirement to swaps not executed on a SEF or DCM, noting that swaps executed on a SEF or DCM are confirmed upon execution.[73]

OCC commented that the terms and conditions applicable to a cleared swap would already be specified in the DCO rules or product specifications, and it does not think it is necessary for a DCO to provide a confirmation that is similar in form to detailed trade documentation such as an ISDA Master Agreement. OCC believes that the term ''written documentation'' should be interpreted broadly to mean any documentation that sufficiently memorialized the agreement of the counterparties with respect to the terms of a swap, which may consist of a confirmation (electronic or otherwise) that confirms the values agreed upon for terms that can be varied by the parties.

MarkitSERV noted that the proposed rule would require a confirmation of all terms of the transaction at the time the swap is accepted for clearing, and commented that the rule is unclear as to whether, when a swap is to be submitted for clearing, confirmation would ever be required of the pre-clearing initial transaction between the original counterparties. In contrast, the Commission has elsewhere stated that it expects a DCO to require pre-clearing transactions to be confirmed before clearing.[74] MarkitSERV also noted that when a transaction is not rapidly accepted for clearing the parties will still be responsible for confirming the transaction under Commission regulations. It recommended that the Commission clarify that when a transaction is not accepted for clearing within the time frame established for mandatory confirmation the parties should be permitted to satisfy their confirmation obligations by confirming the transaction prior to clearing.

The Commission is adopting § 39.12(b)(8) in modified form to read as set forth in the regulatory text of this final rule.

The change to the heading is responsive to the comment by FIA that it was unclear whether the rule applied to all cleared swaps or only to those that are executed bilaterally. Regardless of the execution venue, confirmation of a cleared swap is ultimately provided by the DCO. In the case of a trading facility with a central limit order book, execution and acceptance for clearing are simultaneous and confirmation occurs at that time. In all other cases, there is an interim time between execution and acceptance, or rejection, for clearing.

The Commission notes that applicable confirmation requirements may depend on the length of time between execution and acceptance or rejection for clearing. For example, if a trade executed on a SEF is accepted for clearing within seconds, the DCO notification would serve as the single confirmation. But, if a trade is executed bilaterally and later submitted for clearing, there may need to be an initial bilateral confirmation that is later superseded by the clearing confirmation.

The changes to the text are responsive to the comments of FIA, CME, ISDA, OCC, and MarkitSERV. As FIA pointed out, the proposed rule text seems to place the confirmation obligation on the submitting parties, while the discussion in the notice of proposed rulemaking places it on the DCO. Consistent with the language in the discussion and the recommendations of FIA, CME, and ISDA, the revised rule clarifies that DCOs provide confirmations of cleared trades. This interpretation was implicit in the proposal given that the second sentence of the rule provides that confirmation takes place when the trade ''is accepted'' for clearing.

D. Core Principle D—Risk Management—§ 39.13

Core Principle D, [75] as amended by the Dodd-Frank Act, requires each DCO to ensure that it possesses the ability to manage the risks associated with discharging the responsibilities of the DCO through the use of appropriate tools and procedures. It further requires each DCO to measure its credit exposures to each clearing member not less than once during each business day and to monitor each such exposure periodically during the business day. Core Principle D also requires each DCO to limit its exposure to potential losses from defaults by clearing members, through margin requirements and other risk control mechanisms, to ensure that its operations would not be disrupted and that non-defaulting clearing members would not be exposed to losses that non-defaulting clearing members cannot anticipate or control. Finally, Core Principle D provides that a DCO must require margin from each clearing member sufficient to cover potential exposures in normal market conditions and that each model and parameter used in setting such margin requirements must be risk-based and reviewed on a regular basis. The Commission proposed to adopt § 39.13 to establish requirements that a DCO would have to meet in order to comply with Core Principle D.

1. General—§ 39.13(a)

Proposed § 39.13(a) would require a DCO to ensure that it possesses the ability to manage the risks associated with discharging its responsibilities through the use of appropriate tools and procedures. The Commission did not receive any comments on proposed § 39.13(a) and is adopting § 39.13(a) as proposed.

2. Risk Management Framework—§ 39.13(b)

Proposed § 39.13(b) would require a DCO to establish and maintain written policies, procedures, and controls, approved by its board of directors, which establish an appropriate risk management framework that, at a minimum, clearly identifies and documents the range of risks to which the DCO is exposed, addresses the monitoring and management of the entirety of those risks, and provides a mechanism for internal audit. In addition, proposed § 39.13(b) would require a DCO to regularly review its risk management framework and update it as necessary.

Mr. Barnard recommended that the Commission comprehensively and explicitly address all elements that make up a risk management framework, including organizational structure, governance, risk functions, internal controls, compliance, internal audit,

[73] The notice of proposed rulemaking states: ''Proposed § 39.12(b)(7)(v) would require that DCOs accepting a swap for clearing provide the counterparties with a definitive written record of the terms of their agreement, which will serve as a confirmation of the swap.'' 76 FR at 13105–13106 (Mar. 10, 2011) (Straight-Through Processing).

[74] *See* 75 FR 81519, at 81521 (Dec. 28, 2010) (Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants) (''if a swap is executed bilaterally, but subsequently submitted to a DCO for clearing, the DCO will require a definitive written record of all terms to the counterparties' agreement prior to novation by the DCO'').

[75] Section 5b(c)(2)(D) of the CEA, 7 U.S.C. 7a–1(c)(2)(D).

and legal functions.[76] In particular, with respect to organizational structure, Mr. Barnard noted that reporting lines and the allocation of responsibilities and authority within a DCO should be clear, complete, well-defined and enforced.

The Commission believes that a DCO should adopt a comprehensive and documented risk management framework that addresses all of the various types of risks to which it is exposed and the manner in which they may relate to each other. The Commission believes that a written risk policy is important because it will help to ensure the DCO has carefully considered its risk management framework, and it will provide guidance to DCO management, staff, and market participants. It will also allow the Commission to assess the DCO's risk management framework more efficiently. The risks to be addressed may include, but are not limited to, legal risk, credit risk, liquidity risk, custody and investment risk, concentration risk, default risk, operational risk, market risk, and business risk. However, the Commission does not believe that it is necessary to explicitly list such risks in the final rule.

MGEX commented that the documentary and procedural requirements of proposed § 39.13(b) would impose heavy costs and turn the goal of practical risk management into one of paperwork compliance, and that while having a framework containing all the various policies can be beneficial for DCOs, the development and implementation of such policies must be flexible and left to each DCO. The Commission notes that DCOs generally already have certain written risk management policies, procedures and controls, although the substance, level of detail, and integration of each DCO's documentation of such policies, procedures and controls may vary. The Commission believes that § 39.13(b) provides DCOs with the appropriate amount of flexibility with regard to the documentation of their risk management frameworks, without imposing significant additional costs upon DCOs.

OCC noted that its risk management policies are highly complex and are embodied in multiple separate written documents, and much of its day-to-day operations are related to risk management. OCC stated that the Commission should make it clear that the proposal would not require the board to approve every document related to risk management, as it would be burdensome and would inappropriately require the board to micro-manage the day-to-day functions of a DCO. OCC indicated that it does not believe that the function of the committee that is responsible for the oversight of its risk management activities would be enhanced by the creation of additional written policies, procedures, and controls.

The Commission recognizes that many of the day-to-day functions of a DCO are related to risk management, and § 39.13(b) is not intended to require that a DCO's board must approve every document at a DCO that addresses risk management issues nor is it intended to require that a DCO's board must approve every day-to-day decision regarding the implementation of the DCO's risk management framework.

CME and ICE took the position that a DCO's Risk Management Committee should have the authority to approve the written policies, procedures, and controls that establish a DCO's risk management framework, noting that this would be consistent with proposed § 39.13(c), which would require a DCO's Chief Risk Officer to make appropriate recommendations to the DCO's Risk Management Committee or board of directors, as applicable, regarding the DCO's risk management function.

The Commission believes that a DCO's risk management framework should be subject to the approval of its board of directors. The Commission recognizes that a DCO's Risk Management Committee may play a crucial role in the development of the risk management policies of a DCO. However, the board has the ultimate responsibility for the management of the DCO's risks. Requiring board approval of a DCO's risk management framework is also consistent with proposed international standards.[77]

In addition, a requirement that a DCO's board approve its risk management framework is consistent with § 39.13(c), which permits a DCO's Chief Risk Officer to make appropriate recommendations to the DCO's Risk Management Committee regarding the DCO's risk management functions. Although the board would approve the framework, it could delegate defined decision-making authority to the Risk Management Committee in connection with the implementation of the framework. The Commission is adopting § 39.13(b) as proposed.

3. Chief Risk Officer—§ 39.13(c)

Proposed § 39.13(c) would require a DCO to have a Chief Risk Officer (CRO) who would be responsible for the implementation of the risk management framework and for making appropriate recommendations regarding the DCO's risk management functions to the DCO's Risk Management Committee or board of directors, as applicable. In a separate rulemaking, the Commission has proposed to adopt § 39.13(d) to require DCOs to have a Risk Management Committee with defined composition requirements and specified minimum functions.[78]

Better Markets commented that the proposal should provide substantive parameters for a CRO and that the CRO rules applicable to FCMs should be applied to DCOs. Mr. Greenberger indicated that the CRO of a DCO should be subject to the same rules regarding reporting and independence as the CROs of other registered entities.

The Commission does not believe that it is necessary to further define the responsibilities of a DCO's CRO in the final rule. The Commission notes that it has not proposed any rules regarding a CRO for FCMs or any other registered entities, as suggested by Better Markets and Mr. Greenberger.[79]

As noted in the notice of proposed rulemaking, given the importance of the risk management function and the comprehensive nature of the responsibilities of a DCO's CCO, which are governed by § 39.10, as adopted in this rulemaking, the Commission expects that a DCO's CRO and its CCO would be two different individuals. The Commission is adopting § 39.13(c) as proposed.

4. Measurement of Credit Exposure—§ 39.13(e)

Proposed § 39.13(e) would require a DCO to: (1) Measure its credit exposure to each clearing member and mark to market such clearing member's open positions at least once each business

[76] Mr. Barnard also recommended that the Commission focus more on operational risk and the role of reporting and public disclosures. With respect to operational risk, the Commission notes that it is adopting § 39.18 herein, which addresses system safeguards, and which is discussed in section I, below. Reporting and public information are addressed in §§ 39.19 and 39.21, respectively, also adopted herein, which are discussed in sections J and L, respectively, below.

[77] *See* CPSS–IOSCO Consultative Report, Principle 2: Governance, Key Consideration 5, at 23.

[78] *See* 75 FR at 63750 (Oct. 18, 2010) (Conflicts of Interest). In that proposed rulemaking, the provisions relating to the Risk Management Committee were designated as § 39.13(g). In the final rulemaking with respect to that proposal, those provisions will be redesignated as § 39.13(d).

[79] However, the Commission has proposed rules regarding a CCO for futures commission merchants, swap dealers, and major swap participants, at 75 FR 70881 (Nov. 19, 2010) (Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a Futures Commission Merchant, Swap Dealer, or Major Swap Participant), with respect to which Better Markets filed a comment letter.

day; and (2) monitor its credit exposure to each clearing member periodically during each business day. Proposed § 39.13(e) was a prerequisite for proposed § 39.14(b), which would address daily settlements based on a DCO's measurement of its credit exposures to its clearing members.

LCH commented that a DCO should be required to measure its credit exposures ''several times each business day'' and that a DCO should be obliged to recalculate initial and variation margin requirements more than once each business day. By contrast, OCC requested that the Commission clarify that the proposed requirement that a DCO monitor its credit exposure to each clearing member periodically during each business day would not require a DCO to update clearing member positions on an intra-day basis for purposes of monitoring risk, which would not be practical, and that intra-day monitoring of credit exposures based on periodic revaluation of beginning-of-day positions would be sufficient to comply with the proposed rule.

The Commission does not believe that a DCO should be required to mark each clearing member's open positions to market and recalculate initial and variation margin requirements more than once each business day, and notes that the requirement that a DCO monitor its credit exposure to each clearing member periodically during each business day could be satisfied through intra-day monitoring of credit exposures based on periodic revaluation of beginning-of-day positions as suggested by OCC.

However, as discussed in section IV.E.2, below, § 39.14(b) requires a DCO to effect a settlement with each clearing member at least once each business day, and to have the authority and operational capacity to effect a settlement with each clearing member, on an intraday basis, either routinely, when thresholds specified by the DCO are breached, or in times of extreme market volatility. Therefore, in order to comply with § 39.14(b), a DCO would be required to have the authority and operational capacity to mark each clearing member's open positions to market and recalculate initial and variation margin requirements, on an intraday basis, under the circumstances defined in § 39.14(b).

The Commission is adopting § 39.13(e) as proposed, except that the Commission is making a technical revision by replacing the phrase ''such clearing member's open positions'' with the phrase ''such clearing member's open house and customer positions'' to eliminate possible ambiguity and to clarify the Commission's intent to reflect current industry practice and include both house and customer positions, not just house positions. The Commission notes that § 39.13(e) is consistent with international recommendations.[80]

5. Limitation of Exposure to Potential Losses From Defaults—§ 39.13(f)

Proposed § 39.13(f) would require a DCO, through margin requirements and other risk control mechanisms, to limit its exposure to potential losses from defaults by its clearing members to ensure that: (1) Its operations would not be disrupted; and (2) non-defaulting clearing members would not be exposed to losses that nondefaulting clearing members cannot anticipate or control. The language of proposed § 39.13(f) is virtually identical to the language in Section 5b(c)(2)(D)(iii) of the CEA, as amended by the Dodd-Frank Act.

FIA supported the proposal and MGEX stated that it appeared reasonable if applied appropriately. FIA acknowledged that clearing members understand and accept that they are subject to losses in the event of a default of another clearing member but noted that these potential losses must be measurable and subject to a reasonable cap over a period of simultaneous or multiple defaults. MGEX suggested that the Commission adopt an interpretation that each clearing member, by becoming a clearing member, can reasonably anticipate that another clearing member may potentially default and that a DCO can apply its rules accordingly.

The Commission believes that every clearing member is aware that another clearing member may default. The Commission also notes that the potential losses resulting from such a default will be mitigated to the extent that a DCO is bound to comply with the CEA, Commission regulations, and its own rules, particularly with regard to financial resources and default rules and procedures.

KCC commented that there would appear to be little cost/benefit justification for duplicating the statutory language of the core principle in the form of a rule.[81] The Commission believes that codifying provisions of the CEA does not impose an additional cost on a DCO because a DCO must satisfy such requirements to comply with the law. At the same time, the Commission believes that codifying this statutory provision provides a DCO with a single location in which to identify the minimum standards necessary to fulfill the requirements of Core Principle D. The Commission is adopting § 39.13(f) as proposed.

6. Margin Requirements—§ 39.13(g)

a. General

Several commenters made general comments about margin requirements that did not address specific provisions of proposed § 39.13(g). The Commission has summarized those comments, and responded to those comments, below.

KCC expressed its belief that the Commission's detailed proposed margin requirements are not consistent with the Dodd-Frank Act's changes to the CEA, which simply require that a DCO's margin models and parameters must be ''risk-based.'' The Commission notes that Section 5b(c)(2) of the CEA, as amended by the Dodd-Frank Act, requires a DCO to comply with the statutory core principles ''and any requirement that the Commission may impose by rule or regulation pursuant to section 8a(5).'' As noted in section I.A, above, legally enforceable standards set forth in regulations serve to increase legal certainty, prevent DCOs from lowering risk management standards for competitive reasons, and increase market confidence. These goals are especially important with respect to margin, which is one of the key tools used by DCOs in managing risk. Therefore, the Commission believes it is appropriate to impose more detailed margin requirements than those contained in the statutory language of Core Principle D.

ISDA urged the Commission to adopt rules requiring DCOs to adopt risk methodologies that would reduce the impact that customer account risk has on the size of default fund contributions. ISDA noted that this would enable DCOs to better guaranty the portability of client portfolios, but would increase risk to the DCO; however, ISDA stated that this increased risk could be addressed by increasing the risk margin of the customer account. The Commission has not proposed and is not adopting such rules. The Commission believes that a DCO should have reasonable discretion to determine how it will calculate the amounts of any default fund contributions that it may require from its clearing members, and the extent to which customer risk will be a factor in such calculations.

MFA and Citadel stated that it is important that a DCO's process for setting initial margin be transparent in order to give all market participants

[80] *See* CPSS–IOSCO Consultative Report, Principle 6: Margin, Key Consideration 4, at 40.

[81] *See* Section 5b(c)(2)(D)(iii) of the CEA, 7 U.S.C. 7a–1(c)(2)(D)(iii).

certainty as to the margin they can expect the DCO to assess. Therefore, MFA and Citadel urged the Commission to adopt final rules that would require a DCO to make available to all market participants, at no cost, a margin calculation utility, so that they would be able to replicate the calculation of the margin that the DCO would assess.

The Commission notes that it is adopting §§ 39.21(c)(3) and (d) herein, which require a DCO to disclose information concerning its margin-setting methodology on its Web site. However, the Commission is not requiring a DCO to provide a margin calculation utility to market participants free of cost, although the Commission notes that some DCOs have chosen to do so.[82] The Commission believes that whether a DCO will provide a margin calculation utility to market participants, and whether and how much it might charge for such a utility, is a business decision that should be left to the discretion of a DCO.

The FHLBanks indicated that it may be appropriate, in some circumstances, for a DCO to waive its initial margin requirements with respect to certain highly creditworthy customers of a clearing member. Therefore, the FHLBanks urged the Commission to grant DCOs discretion to waive initial margin requirements when doing so would not pose risk to the DCO or its clearing members. In light of the fact that the Dodd-Frank Act requires the removal of reliance on credit ratings, the FHLBanks recommended that the Commission adopt alternative criteria by which a DCO could exercise such discretionary waivers, or alternatively grant DCOs discretion to establish their own criteria, subject to Commission approval, or to guidelines established by the Commission in the final rule.

The Commission has not proposed a rule that would permit it to grant DCOs the discretion to waive initial margin requirements and it is not adopting such a rule, as requested by the FHLBanks. Even if there were an objective way to define highly creditworthy customers, the Commission does not believe that permitting such waivers would constitute prudent risk management.

b. Amount of Initial Margin Required—§ 39.13(g)(1)

Proposed § 39.13(g)(1) would require that the initial margin [83] that a DCO requires from each clearing member must be sufficient to cover potential exposures in normal market conditions and that each model and parameter used in setting initial margin requirements must be risk-based and reviewed on a regular basis. The Commission invited comment regarding whether a definition of ''normal market conditions'' should be included in the proposed regulation and, if so, how normal market conditions should be defined.

MFA, BlackRock, and Citadel expressed their support for the proposal. CME and OCC commented that the Commission should not define normal market conditions, while ISDA stated that the Commission should define normal market conditions. The Commission noted in the notice of proposed rulemaking that the 2004 CPSS–IOSCO Recommendations defined ''normal market conditions'' as ''price movements that produce changes in exposures that are expected to breach margin requirements or other risk control mechanisms only 1 percent of the time, that is, on average on only one trading day out of 100.'' [84] The CPSS–IOSCO Consultative Report was published subsequent to the issuance of proposed § 39.13(g)(1). The CPSS–IOSCO Consultative Report replaced the concept of ''normal market conditions'' with a proposed requirement that ''[i]nitial margin should meet an established single-tailed confidence level of at least 99 percent for each product that is margined on a product basis, each spread within or between products for which portfolio margining is permitted, and for each clearing member's portfolio losses.'' [85] The Commission had also proposed similar requirements for a 99 percent confidence level in proposed § 39.13(g)(2)(iii), discussed below. Therefore, in adopting § 39.13(g)(1), the Commission is declining to adopt the proposed explicit requirement that initial margin must be sufficient to cover potential exposures in normal market conditions, in order to avoid any ambiguity over the meaning of ''normal market conditions.''

FIA recommended that parameters used in setting initial margin requirements should be reviewed monthly and models should be reviewed annually and on an ad hoc basis if substantive changes are made, whereas OCC took the position that the Commission should permit a DCO to use its reasonable discretion in determining what constitutes a ''regular basis'' for reviewing margin models and parameters. The Commission has determined not to specify the appropriate frequency of review, as it may differ based on the characteristics of particular products and markets, and the nature of the margin models and parameters that apply to those products and markets. However, although § 39.13(g)(1) would permit a DCO to exercise its discretion in determining how often it should review its margin models and parameters, the Commission would apply a reasonableness standard in determining whether the frequency of reviews conducted by a particular DCO was appropriate.

Moreover, as discussed in section IV.D.6.d, below, § 39.13(g)(3) requires that a DCO's systems for generating initial margin requirements, including the DCO's theoretical models, must be reviewed and validated by a qualified and independent party, on a regular basis. As the Commission noted in the notice of proposed rulemaking, the Commission would expect a DCO to obtain an independent validation prior to implementation of a new margin model and when making any significant change to a model that is in use by the DCO. This express expectation would address FIA's suggestion that a DCO should be required to review its margin models on an ad hoc basis if substantive changes are made. For the reasons discussed, the Commission is adopting § 39.13(g)(1) with the modification described above.

c. Methodology and Coverage

(1) General—§ 39.13(g)(2)(i)

Proposed § 39.13(g)(2)(i) would require a DCO to establish initial margin requirements that are commensurate with the risks of each product and portfolio, including any unique characteristics of, or risks associated with, particular products or portfolios.[86] In particular, proposed § 39.13(g)(2)(i) would require a DCO that clears credit default swaps (CDS) to appropriately address jump-to-default risk in setting initial margins.[87] The Commission

[82] *See e.g., http://www.cmegroup.com/clearing/cme-core-cme-clearing-online-risk-engine.html* and *https://www.theice.com/publicdocs/ice_trust/ICE_Margin_Simulation_Calculator_Training_Presentation.pdf.*

[83] The term ''initial margin'' is now defined in § 1.3(lll), adopted herein.

[84] *See* 2004 CPSS–IOSCO Recommendations at 21.

[85] *See* CPSS–IOSCO Consultative Report, Principle 6: Margin, Key Consideration 3, at 40.

[86] As proposed, § 39.13(g)(2)(i) referred to addressing any ''unique'' characteristics of, or risks associated with, particular products or portfolios. The Commission is revising this provision in the final rule to refer to any ''unusual'' characteristics of, or risks associated with, particular products or portfolios to clarify that such characteristics or risks are not limited to those that are one of a kind. *See* also n. 66, above.

[87] In the notice of proposed rulemaking, the Commission defined jump-to-default risk as referring to the possibility that a CDS portfolio with large net sales of protection on an underlying reference entity could experience significant losses

Continued

invited comment regarding whether there are specific risks that should be identified and addressed in the proposed regulation in addition to jump-to-default risk.

CME and Nadex, Inc. (Nadex) expressed the opinion that it would not be beneficial to attempt to identify additional specific risks that a DCO must address in determining initial margins and LCH commented that the reference to jump-to-default risk should either be removed or amended to cover all other products that are subject to jump-to-default risk. The Commission agrees with CME and Nadex that it is not necessary to identify additional specific risks in the regulation, and also agrees with LCH that the reference to jump-to-default risk should generally apply to any product that may be subject to such risk. Therefore, the Commission is adopting a revised § 39.13(g)(2)(i) that eliminates the specific reference to CDS. The Commission has also added the phrase ''or similar jump risk.'' This is intended to address the possibility of a large payment obligation in a product accumulating in a very short period of time following an extreme market event.

(2) Liquidation Time—§ 39.13(g)(2)(ii)

Proposed § 39.13(g)(2)(ii) would require a DCO to use margin models that generate initial margin requirements sufficient to cover the DCO's potential future exposures to clearing members based on price movements in the interval between the last collection of variation margin [88] and the time within which the DCO estimates that it would be able to liquidate a defaulting clearing member's positions (liquidation time). As proposed, a DCO would have to use a liquidation time that is a minimum of five business days for cleared swaps that were not executed on a DCM, and a liquidation time that is a minimum of one business day for all other products that it clears, although it would be required to use longer liquidation times, if appropriate, based on the unique characteristics of particular products or portfolios. The Commission invited comment regarding whether the minimum liquidation times specified in proposed § 39.13(g)(2)(ii) were appropriate, or whether there were minimum liquidation times that were more appropriate.

LCH suggested that ''or transfer'' should be inserted after ''liquidate'' in the proposed rule and that an appropriate liquidation period should be a period that would be sufficient to enable a DCO to adequately hedge or close out a defaulting member's risk. The Commission does not believe that it is appropriate to add ''or transfer,'' or to interpret the liquidation period to include the time that would be sufficient to hedge a defaulting clearing member's positions. In a worst-case scenario, a DCO would need to liquidate a defaulting clearing member's positions, and the time it would take to do so should be the relevant consideration in setting initial margin requirements.

ISDA commented that a DCO should continually monitor the risk associated with concentration in participants' positions, and if a DCO determines that a participant's cleared portfolio is so large that it could not be liquidated within the liquidation period assumed in the DCO's default management plan, the DCO should have the discretion to include an extra charge for concentration risk in the initial margin requirements of that participant. FIA made similar comments but suggested that prudent risk management should require the imposition of concentration margin in appropriate circumstances. FIA further noted that when a DCO imposes concentration margin on a clearing member, the additional margin should be included in the DCO's minimum margin calculations for any customers of the clearing member that generate the increased risk.

Although the regulations adopted by the Commission herein do not specifically address concentration margin as described by ISDA and FIA, they do not limit a DCO's discretion to impose extra charges on its clearing members for concentration risk. It should also be noted that § 39.13(h)(6), adopted herein,[89] requires a DCO to take additional actions with respect to particular clearing members, when appropriate, based on the application of objective and prudent risk management standards, which actions may include imposing enhanced margin requirements.

Numerous commenters objected to the proposed difference in requirements that would subject swaps that were either executed bilaterally or executed on a SEF to a minimum five-day liquidation time, while permitting equivalent swaps that were executed on a DCM to be subject to a minimum one-day liquidation time. Commenters variously argued that the proposed one-day/five-day distinction for swap transactions depending on the venue of execution would: (1) Be inconsistent with the open access provisions of Section 2(h)(1)(B) of the CEA [90] and/or proposed § 39.12(b)(2) [91] (GFI Group Inc. (GFI), VMAC, LCC (VMAC), BlackRock, Wholesale Markets Brokers' Association, Americas (WMBAA), and FX Alliance Inc. (FXall)); (2) be inconsistent with Congressional intent, expressed in Section 731 of the Dodd-Frank Act,[92] which recognizes a difference in risk between cleared and uncleared swaps that could be addressed by differential margin requirements, but does not differentiate between the risk of swaps executed on a DCM and those executed on a SEF (Asset Management Group of the Securities Industry and Financial Markets Association (AMG)); (3) discriminate against trades not executed on DCMs by requiring DCOs to impose higher margin requirements for swaps that are executed on SEFs than for swaps that are executed on DCMs (GFI, VMAC, MarketAxess Corporation (MarketAxess), WMBAA, Tradeweb Markets LLC (Tradeweb), Nodal Exchange, LLC (Nodal), and FXall); (4) raise the cost of clearing for swaps traded on a SEF (National Energy Marketers Association (NEM), NGX, and BlackRock); [93] (5) put SEFs at a competitive disadvantage to DCMs (GFI, MarketAxess, and BlackRock); (6) artificially restrict the ability of market participants, including asset managers, to select the best means of execution for their swap transactions (BlackRock); (7) penalize market participants that desire to effect swap transactions on a SEF rather than a DCM (WMBAA and Tradeweb); (8) undermine the goal of the Dodd-Frank Act to promote trading of swaps on SEFs (Tradeweb and FXall); (9) potentially create detrimental arbitrage between standardized swaps traded on a SEF and futures contracts with the same terms and conditions traded on a DCM (Nodal); (10) impose onerous and unnecessary administrative costs on DCOs, which would likely be passed on to clearing members and their customers (VMAC and BlackRock); (11) create a disincentive for DCOs to practice appropriate default management ''drills'' to reduce the

over a very short period of time following an unexpected event of default by the reference entity.

[88] The term ''variation margin'' is now defined in § 1.3(ooo), adopted herein.

[89] *See* discussion of § 39.13(h)(6)(ii) in section IV.D.7.f, below.

[90] *See* Section 2(h)(1)(B) of the CEA, 7 U.S.C. 2(h)(1)(B).

[91] *See* discussion of § 39.12(b)(2) in section IV.C.2.c, above.

[92] Section 731 of the Dodd-Frank Act amended the CEA to insert Section 4s. *See* Section 4s(e)(3)(A)(ii) of the CEA, 7 U.S.C. 6s(e)(3)(A)(ii).

[93] NGX estimated that the impact of transitioning from its current two-day requirement to a five-day requirement for all of the energy products that it clears would lead to an approximate 60 percent increase in initial margins.

liquidation time of portfolios of swaps (ISDA); (12) remove the incentive for DCOs to detail, practice and leverage clearing member expertise in default management (FIA); (13) discourage voluntary clearing (NGX); and (14) require DCOs and clearing members to manage margin calls and netting based on the execution platform for the relevant swaps (VMAC and BlackRock).

In addition, a number of commenters argued that there was no basis for concluding that swaps executed on a SEF would be less liquid than swaps executed on a DCM (GFI, WMBAA, NGX, MarketAxess, AMG, and FXall).

BlackRock recommended that the Commission require a DCO to use a consistent liquidation time for cleared swaps that are executed on SEFs and DCMs.

Commenters variously contended that a liquidation time of five business days may be excessive for some swaps (CME and Citadel [94]), a one-day liquidation period is too short (LCH), a one-day liquidation period is appropriate for swaps executed on a DCM or a SEF (AMG), and a two-day liquidation period is appropriate for cleared swaps (NGX).

Various commenters encouraged the Commission to permit a DCO to determine the appropriate liquidation time for all products that it clears based on the unique characteristics and liquidity of each relevant product or portfolio (CME, MFA, ISDA, LCH, NYPC, NGX, FIA,[95] Nadex, Citadel, and FXall) or to grant DCOs such discretion subject to a one-day minimum for all products, including cleared swaps (GFI, VMAC, MarketAxess, Nodal, WMBAA, and Tradeweb).

FIA and ISDA commented that the appropriate liquidation time should be derived from a DCO's default management plan and the results of its periodic testing of such plan. FIA further stated that a DCO should adjust its minimum margin requirements if its periodic testing of its default management plan demonstrates that a defaulting clearing member's positions could be resolved in a shorter period of time. Similarly, NGX stated that the Commission should permit a DCO to demonstrate through back testing and stress testing that a particular type of cleared transaction should be subject to a shorter liquidation time.

MFA and Citadel recommended that if the Commission were to mandate minimum liquidation times in the final rules, it should allow DCOs to apply for exemptions for specific groups of swaps if market conditions prove that such minimum liquidation times are excessive. Citadel further recommended that the Commission make it explicit that the Commission may re-evaluate and, if necessary, re-calibrate such minimum liquidation times as markets evolve.

The Commission is persuaded by the views expressed by numerous commenters that requiring different minimum liquidation times for cleared swaps that are executed on a DCM and equivalent cleared swaps that are executed on a SEF could have negative consequences. Therefore, after further consideration, the Commission has determined not to mandate different minimum liquidation times for cleared swaps based on their venue of execution, and has further determined that the same minimum liquidation time should be used with respect to cleared swaps that are executed bilaterally. This approach is consistent with the open access requirements of Section 2(h)(1)(B) of the CEA and § 39.12(b)(2), adopted herein.

The Commission also acknowledges the concerns expressed by commenters that a five-day liquidation period may be excessive for some swaps. For example, for a number of years, CME and ICE have successfully cleared swaps based on physical commodities using a one-day liquidation time.[96] By contrast, as noted in the notice of proposed rulemaking, several DCOs currently use a five-day liquidation time in determining margin requirements for certain swaps based on financial instruments.[97] These differences reflect differences in the risk characteristics of the products.

The Commission has carefully considered whether it should prescribe any liquidation time or, alternatively, permit each DCO to exercise its discretion in applying liquidation times based on the risk profile of particular products or portfolios. In this regard, the Commission notes that even without a specified minimum liquidation time, under Sections 5b(c)(2)(D) and 8a(7)(D) of the CEA, the Commission can require a DCO to adjust its margin methodology if it determines that the current margin levels for a product or portfolio are inadequate based on back testing or current market volatility.

Weighing the advantages and drawbacks of the alternatives, the Commission believes that a bright-line requirement, with a provision for making exceptions, will best serve the public interest. While a DCO will still have considerable latitude in setting risk-based margin levels, the Commission has determined that establishing a minimum liquidation time will provide legal certainty for an evolving marketplace, will offer a practical means for assuring that the thousands of different swaps that are going to be cleared subject to the Commission's oversight will have prudent minimum margin requirements, and will prevent a potential ''race to the bottom'' by competing DCOs. Moreover, given the large number of swaps already cleared, this alleviates the need for the Commission, with its limited staff resources, to evaluate immediately the liquidation time for each swap that is cleared.[98]

Taking into account these considerations, and in response to the comments, the Commission is adopting § 39.13(g)(2)(ii) with a number of modifications. First, the final rule requires a DCO to use the same liquidation time for a product whether it is executed on a DCM, a SEF, or bilaterally. This addresses the competitive concerns raised by numerous commenters and recognizes that once a swap is cleared, its risk profile is not affected by the method by which it was executed.[99]

Second, the final rule provides that the minimum liquidation time for swaps based on certain physical commodities, *i.e.,* agricultural commodities,[100] energy, and metals, is one day. For all other swaps, the minimum liquidation time is five days. This distinction is based on the differing risk characteristics of these product groups and is consistent with existing requirements that reflect the risk assessments DCOs have made over the course of their experience clearing these types of swaps. The longer liquidation time, currently five days for credit default swaps at ICE Clear Credit, LLC, and CME, and for interest rate

[94] Citadel further commented that excessive margin requirements relative to risk exposure could adversely affect market liquidity and deter clearing.

[95] FIA also commented that liquidation times should be set at times appropriate to manage the liquidation of the vast majority of the portfolios carried by a DCO's clearing members, and not necessarily that of the largest clearing member.

[96] NYMEX, now CME, has cleared OTC swaps generally with a one day liquidation time since 2002. CME currently offers more than 1,000 products for clearing through its ClearPort system.

[97] In particular, ICE Clear Credit LLC and CME use a five-day liquidation time for credit default swaps and LCH and CME use a five-day liquidation time for interest rate swaps.

[98] *E.g.,* the 950,000 trades in LCH's SwapClear have an aggregate notional principal amount of over $295 trillion. *Source: http://www.lch.com/swaps/swapclear_for_clearing_members/.*

[99] *See* Section 2(h)(1)(B) of the CEA and § 39.12(b)(2), adopted herein (swaps submitted to a DCO with the same terms and conditions are economically equivalent within the DCO and may be offset with each other within the DCO).

[100] *See* 76 FR 41048 (July 13, 2011) (Agricultural Commodity Definition; final rule).

swaps at LCH and CME, is based on their assessment of the higher risk associated with these products.[101] Contributing factors include a concentration of positions among clearing members, the number and variety of products listed, the complexity of the portfolios, the long-dated expiration time for many swaps, and the challenges of the liquidation process in the event of a default.[102]

Third, to provide further flexibility, the Commission is adding a provision specifying that, by order, the Commission may provide for a different minimum liquidation time for particular products or portfolios. As markets evolve, it may become appropriate to ease the requirement for certain swaps subject to the five-day minimum. Conversely, analysis may reveal that for other products or portfolios the five-day or one-day minimum is insufficient. The Commission believes that in light of the novelty, complexity, and potential magnitude of the risk posed by financial swaps, prudential considerations dictate that this type of fine-tuning should be used in appropriate circumstances. Such an order could be granted upon the Commission's initiative or in response to a petition from a DCO.

In this regard, the Commission emphasizes that it is retaining the proposed requirement that a DCO must use longer liquidation times, if appropriate, based on the specific characteristics of particular products or portfolios.[103] Such longer liquidation times may be based on a DCO's testing of its default management plan. If a DCO determines that a longer liquidation time is appropriate for a particular swap, the Commission would expect that the DCO would use the same longer liquidation time for the equivalent swaps that it clears, whether the swaps are executed on a DCM, a SEF, or bilaterally. Among the factors that DCOs should consider in establishing minimum liquidation times are: (i) Average daily trading volume in a product; (ii) average daily open interest in a product; (iii) concentration of open interest; (iv) availability of a predictable basis relationship with a highly liquid product; and (v) availability of multiple market participants in related markets to take on positions in the market in question. The Commission would also consider these factors in determining whether a particular liquidation time was appropriate.

The Commission is adopting § 39.13(g)(2)(ii) revised to read as set forth in the regulatory text of this final rule.[104]

(3) Confidence Level—§ 39.13(g)(2)(iii)

Proposed § 39.13(g)(2)(iii) would require that the actual coverage of the initial margin requirements produced by a DCO's margin models, along with projected measures of the models' performance, would have to meet a confidence level of at least 99 percent, based on data from an appropriate historic time period with respect to: (A) each product that is margined on a product basis; (B) each spread within or between products for which there is a defined spread margin rate, as described in proposed § 39.13(g)(3); (C) each account held by a clearing member at the DCO, by customer origin and house origin,[105] and (D) each swap portfolio, by beneficial owner. The Commission invited comment regarding whether a confidence level of 99 percent is appropriate with respect to all applicable products, spreads, accounts, and swap portfolios.

Alice Corporation supported the proposed 99 percent confidence level, especially for new swaps and swaps with non-linear characteristics. ISDA commented that the proposed 99 percent confidence level is appropriate given current levels of mutualization in a DCO default fund and mutualization in omnibus client accounts.[106] MGEX stated that it did not oppose the proposed 99 percent confidence level for each account held by a clearing member at a DCO, by customer origin and house origin.[107]

FIA opposed the proposed 99 percent requirement because it sets an artificial floor that may remove the incentive for DCOs to conduct the rigorous analysis necessary to establish an appropriate confidence level. FIA further stated that if a different regulatory scheme than loss mutualization for the protection of customer funds were to be adopted for cleared swaps, a much higher level of confidence may be required.

CME, Nadex, KCC,[108] and Citadel took the position that the Commission should not prescribe a specific confidence level, but should instead continue to give each DCO the discretion to determine the appropriate confidence levels. CME and Nadex noted that one or more of the following factors could be considered by a DCO in determining the appropriate confidence levels: the particular characteristics of the products and portfolios it clears, the depth of the underlying markets, the existence of multiple venues trading similar products on which a defaulting clearing member's portfolio could be liquidated or hedged, the duration of the products, the size of the DCO and its systemic importance, its customer base, or its other risk management tools.

The Commission does not agree such discretion is appropriate and has

[101] *See e.g., Cleared OTC Interest Rate Swaps* at 7 (Aug. 2011), available at *http://www.cmegroup.com/clearing/cme-core-cme-clearing-online-risk-engine.html; ICE Clear Credit Clearing Rules,* Schedule 401 (Jul. 16, 2011) available at *https://www.theice.com/publicdocs/clear_credit/ICE_Clear_Credit_Rules.pdf.*

[102] The liquidation of the Lehman interest rate swap portfolio in the fall of 2008 demonstrates that the actual liquidation time for a swap portfolio could be longer than 5 days. Between September 15, 2008 (the day Lehman Bros. Holdings declared bankruptcy) and October 3, 2008, LCH and ''OTCDerivnet,'' an interest rate derivatives forum of major market dealers, wound down the cleared OTC interest rate swap positions of Lehman Bros. Special Financing Inc. (LBSFI). This portfolio had a notional value of $9 trillion and consisted of 66,390 trades across 5 major currencies. LCH and OTCDerivnet competitively auctioned off LBSFI's five hedge currency portfolios to their members between September 24 and October 3, 2008. The margin held by LCH proved sufficient to cover the costs incurred. *Source:* LCH Press Release of October 8, 2008, available at: *http://www.lchclearnet.com/Images/2008-10-08%20SwapClear%20default_tcm6–46506.pdf.*

[103] As proposed, § 39.13(g)(2)(ii) referred to the ''unique'' characteristics of particular products or portfolios. The Commission is revising this phrase in the final rule to refer to the ''specific'' characteristics of a particular product or portfolio to clarify that such characteristics are not limited to those that are one of a kind.

[104] In a technical revision, the Commission has eliminated the phrase, ''whether the swaps are carried in a customer account subject to Section 4d(a) or 4d(f) of the Act, or carried in a house account,'' because it is superfluous.

[105] The terms ''customer account or customer origin'' and ''house account or house origin'' are now defined in § 39.2, adopted herein.

[106] ISDA contended that if there were a requirement to have individualized client accounts, the appropriate confidence level should be higher than 99 percent because the funds available to a DCO to manage a client account default would be reduced.

[107] MGEX requested that the Commission clarify that this proposed requirement applies to the net account of each clearing member and not the underlying accounts at each clearing member. The Commission did not intend proposed § 39.13(g)(2)(iii)(C), which would refer to ''[e]ach account held by a clearing member at the DCO, by customer origin and house origin * * *, '' to apply to individual customer accounts by beneficial owner. However, the Commission notes that § 39.13(g)(2)(iii)(D), as proposed and as adopted herein, applies the 99 percent confidence level requirement to ''[e]ach swap portfolio, by beneficial owner.''

[108] KCC also expressed its belief that ultra-high confidence level modeling does not protect against risk as well as direct margin intervention by the DCO in the case of significant market movements, such as retaining the right to review recent price movements to re-establish margins at a higher level and retaining the right to demand special margin from certain clearing members. The Commission believes that a DCO should retain the right to take such actions in addition to, rather than instead of, using a 99 percent confidence level, as required by § 39.13(g)(2)(iii). For example, § 39.13(h)(6)(ii), discussed below, requires a DCO to take additional actions with respect to particular clearing members, when appropriate, including imposing enhanced margin requirements.

determined to establish a minimum confidence level. The Commission believes that a minimum confidence level will provide legal certainty for an evolving marketplace, will offer a practical means for assuring market participants that the thousands of different products that are going to be cleared subject to the Commission's oversight will have prudent minimum margin requirements, and will prevent a potential ''race to the bottom'' by competing DCOs. Moreover, given the large number of products already cleared, this alleviates the need for the Commission, with its limited staff resources, to evaluate immediately the confidence level requirements for each product that is cleared.

The Commission is adopting the proposed minimum 99 percent confidence level. This is consistent with proposed international standards.[109] Moreover, given the potential costs of default, the Commission agrees with those commenters who stated that a 99 percent level is appropriate. An individual DCO may determine to set a higher confidence level, in its discretion.

NASDAQ OMX Commodities Clearing Company (NOCC) supported an approach that would allow DCOs to set margin requirements for new and low-volume products at a lower coverage level if the potential losses resulting from such products are minimal. According to NOCC, this would allow DCOs to include more products and market participants by attracting them at an early stage without materially increasing the risk of the DCO.

VMAC suggested that the Commission add to the requirement that initial margin levels must be based upon ''an established confidence level of at least 99 percent,'' language that states ''or, subject to specific authorization from the CFTC, a lower confidence level.'' In particular, VMAC commented that although a DCO should be required to demonstrate that the given confidence level results in an initial margin amount which is sufficient to allow the DCO to fully discharge its obligations upon a clearing member default, a DCO should not be required to collect margin substantially in excess of its obligations to clearing members in a default scenario.

The Commission is not modifying the language of § 39.13(g)(2)(iii) in a manner that would permit DCOs to set margin requirements at a lower coverage level for new and low-volume products, as recommended by NOCC, or provide for a lower confidence level subject to specific Commission authorization, as suggested by VMAC. In the notice of proposed rulemaking, the Commission noted that the 2004 CPSS–IOSCO Recommendations stated that ''[m]argin requirements for new and low-volume products might be set at a lower coverage level [than the major products cleared by a CCP] if the potential losses resulting from such products are minimal.'' [110] However, the CPSS–IOSCO Consultative Report, which was issued subsequent to the Commission's proposed rules, does not contain similar language. The Commission believes that it is prudent to apply the same standard to all products.

OCC and NYPC encouraged the Commission to modify its proposal to make clear that, when swaps are commingled in either a Section 4d(a) futures account or a Section 4d(f) cleared swaps account, pursuant to § 39.15(b)(2),[111] the 99 percent test need not be separately applied to the swaps positions alone. The Commission agrees with OCC and NYPC that if swaps and futures are held in the same customer account pursuant to rules approved by the Commission or a 4d order issued by the Commission, as specified in § 39.15(b)(2), the 99 percent test would apply to the entire commingled account, and not just the swap positions, under § 39.13(g)(2)(iii)(D). Therefore, the Commission is modifying § 39.13(g)(2)(iii)(D) to add ''including any portfolio containing futures and/or options and held in a commingled account pursuant to § 39.15(b)(2) of this part,'' after ''[e]ach swap portfolio.'' The Commission is making similar modifications in § 39.13(g)(7) with respect to back testing requirements, which are discussed in section IV.D.6.g, below.

OCC also requested that the Commission clarify that, in the case of a margin system that calculates margin for all positions in an account on the basis of the net risk of those positions based upon historical price correlations rather than on a product or a pre-defined spread basis, the 99 percent confidence level would be applied only on an account-by-account basis, and not to individual products, product groups, or specified spread positions. NYPC made a similar request, stating that its historical Value at Risk (VaR)-based margin model calculates initial margin requirements at the portfolio level, rather than on a product or spread basis.

The Commission notes that, as proposed, § 39.13(g)(2)(iii)(A) would require the application of the 99 percent confidence level to ''[e]ach product (that is margined on a product basis)'' and § 39.13(g)(2)(iii)(B) would require the application of the 99 percent confidence level to ''[e]ach spread within or between products for which there is a defined spread margin rate * * *.'' The Commission's intent was that §§ 39.13(g)(2)(iii)(A) and (B) would apply to products and pre-defined spreads under margin models that calculate initial margin requirements on a product and pre-defined spread basis, respectively. Further, with respect to margin models that do not calculate margin on a product or pre-defined spread basis, the 99 percent requirement would apply with respect to each account held by a clearing member at the DCO by house origin and by each customer origin, and to each swap portfolio, by beneficial owner, pursuant to §§ 39.13(g)(2)(iii)(C) and (D), respectively.[112]

In order to clarify the Commission's intent, the Commission is adopting § 39.13(g)(2)(iii)(A) to read as follows: ''[e]ach product for which the derivatives clearing organization uses a product-based margin methodology,'' while striking ''(that is margined on a product basis).'' In addition, the Commission is adopting § 39.13(g)(2)(iii)(B) to read as follows: ''[e]ach spread within or between products for which there is a defined spread margin rate,'' while striking ''as described in paragraph (g)(4) of this section.''

LCH commented that the Commission's approach to setting margin based on products and spreads, while appropriate for futures, is not

[109] *See* CPSS–IOSCO Consultative Report, Principle 6: Margin, Key Consideration 3, at 40. In addition, on September 15, 2010, the European Commission (EC) proposed the European Market Infrastructure Regulation (EMIR), available at *http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf,* ''to ensure implementation of the G20 commitments to clear standardized derivatives [which can be accessed at *http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf,* and that Central Counterparties (CCPs) comply with high prudential standards * * *,'' among other things, and expressed its intent to be consistent with the Dodd-Frank Act. (EMIR, at 2–3). The EMIR requires that margins ''* * * shall be sufficient to cover losses that result from at least 99 per cent of the exposures movements over an appropriate time horizon * * *.'' (EMIR, Article 39, paragraph 1, at 46).

[110] *See* 2004 CPSS–IOSCO Recommendations at 23.

[111] *See* discussion of § 39.15(b)(2), adopted herein, in section IV.F.3, below.

[112] For purposes of clarification, certain references to customer origin in §§ 39.13 and 39.19 have been replaced with references to ''each customer origin'' to clarify the distinction between customer positions in futures and options segregated pursuant to Section 4d(a) of the CEA, and customer positions in swaps segregated pursuant to Section 4d(f) of the CEA.

suitable or sufficient for swaps. LCH proposed that the key requirement for swaps should be for the DCO to ensure that it has enough margin and guarantee funds to cover its exposures, and for the DCO to prove this on an individual client and clearing member basis. The Commission did not intend to suggest that swaps should be margined pursuant to a product-based margin methodology, nor that they should be subject to defined spread margin rates. The Commission recognizes that swaps are often margined on a portfolio basis and specifically addressed swap portfolios in § 39.13(g)(2)(iii)(D). The Commission would also like to clarify that a 99 percent confidence level, as applied to swap portfolios, means that each portfolio is covered 99 percent of the time, and not that a collection of portfolios is covered 99 percent of the time on an aggregate basis.

The Commission is adopting § 39.13(g)(2)(iii) with the modifications described above.

(4) Appropriate Historic Time Period—§ 39.13(g)(2)(iv)

Proposed § 39.13(g)(2)(iv) would require each DCO to determine the appropriate historic time period of data that it would use for establishing the 99 percent confidence level based on the characteristics, including volatility patterns, as applicable, of each product, spread, account, or portfolio.

LCH recommended that the Commission define the ''historic time period'' as a minimum of one calendar year in order to provide for adequate historical observations. The Commission believes that a DCO should be permitted to exercise its discretion with respect to the appropriate time periods that should be used, based on the characteristics, including volatility patterns, as applicable, of the relevant products, spreads, accounts, or portfolios. The Commission also notes that proposed international standards do not specify a historic time period that would be appropriate in all circumstances, recognizing that either a shorter or a longer historic time period may be appropriate based on the volatility patterns of a particular product.[113] The Commission expects that DCOs would include periods of significant financial stress. Therefore, the Commission is adopting § 39.13(g)(2)(iv) as proposed.

d. Independent Validation—§ 39.13(g)(3)

Proposed § 39.13(g)(3) would require that a DCO's systems for generating initial margin requirements, including the DCO's theoretical models, must be reviewed and validated by a qualified and independent party, on a regular basis. The Commission invited comment regarding whether a qualified and independent party must be a third party or whether there may be circumstances under which an employee of a DCO could be considered to be independent.

In the notice of proposed rulemaking, the Commission explained that a validation should include a comprehensive analysis to ensure that such systems and models achieve their intended goals. The Commission also noted that, although the proposed regulation did not define the meaning of ''regular basis,'' the Commission would expect that, at a minimum, a DCO would obtain such an independent validation prior to implementation of a new margin model and when making any significant change to a model that was in use by the DCO.[114] The Commission further stated that significant changes would be those that could materially affect the nature or level of risks to which a DCO would be exposed, and that the Commission would expect a DCO to obtain an independent validation prior to any significant change that would relax risk management standards. However, the Commission noted that if a DCO needed to adopt a significant change in an expedited manner to enhance risk protections, the Commission would expect the DCO to obtain an independent validation promptly after the change was made.

CME, OCC, MGEX, and KCC all expressed the view that an employee of a DCO could be independent in appropriate circumstances. CME commented that permitting employees of a DCO to conduct the required reviews would be consistent with proposed § 39.18(j)(2), which would allow employees of a DCO to conduct the required testing of a DCO's business continuity and disaster recovery systems, provided that such employees are not the persons responsible for developing or operating the systems being tested.[115] OCC and MGEX took the position that employees of a DCO could be independent as long as they are not, or have not been, involved in designing the models, and OCC further stated that internal personnel must not otherwise be biased due to their involvement in implementation of the models.[116] However, FIA argued that margin models should be required to be validated by an independent third party with expertise in risk and the product being cleared.

The Commission recognizes that a third party could be more critical of a DCO's margin model than an employee of a DCO, even if that employee is ''qualified and independent.'' However, the Commission also believes that a third party could be less critical if, for example, it seeks to provide services to the DCO or the industry in the future.

The Commission agrees with CME, OCC, MGEX, and KCC that an employee of a DCO could be a ''qualified and independent party,'' and thus could review and validate the DCO's systems for generating initial margin requirements, under appropriate circumstances. It would probably be more costly for a DCO to use a third party for this purpose rather than an employee.

On balance, the Commission believes that it may be appropriate for a DCO to have an employee review and validate its margin systems. Therefore, the Commission is adopting § 39.13(g)(3) with the addition of a sentence stating that ''[s]uch qualified and independent parties may be independent contractors or employees of the derivatives clearing organization, but shall not be persons responsible for development or operation of the systems and models being tested.'' This is consistent with the language contained in § 39.18(j)(2), as adopted herein, as well as the

[113] *See* CPSS–IOSCO Consultative Report, Principle 6: Margin, Explanatory Note 3.6.7, at 43.

[114] The Commission also notes that the CPSS–IOSCO Consultative Report recommends that a CCP's initial margin models should be independently validated at least on a yearly basis. CPSS–IOSCO Consultative Report, Principle 6: Margin, Explanatory Note 3.6.8, at 43. The Commission is not requiring an annual validation at this time, although it may revisit this issue in the future.

[115] Section 39.18(j)(2), as proposed, and as adopted herein, states that testing shall be conducted by qualified, independent professionals. Such qualified independent professionals may be independent contractors or employees of the derivatives clearing organization, but shall not be persons responsible for development or operation of the systems or capabilities being tested.

[116] In particular, OCC noted that the Office of the Comptroller of the Currency, the Department of the Treasury, the Federal Reserve System and the Federal Deposit Insurance Corporation recently proposed revisions to their risk-based capital guidelines, which would require that, with respect to the validation of banks' internal risk models, ''[t]he review personnel [would] not necessarily have to be external to the bank in order to achieve the required independence'' but that ''[a] bank should ensure that individuals who perform the review are not biased in their assessment due to their involvement in the development, implementation, or operation of the models.'' *See* 76 FR 1890, at 1897 (Jan. 11, 2011) (Risk-Based Capital Guidelines: Market Risk).

proposed approach of other financial regulators.[117] The Commission also notes that the reference to independent contractors as well as employees in the added language will also prohibit a DCO from using a particular third party to conduct the validation if that third party was or is responsible for development or operation of the relevant systems and models.

KCC requested that the Commission clarify that the CRO or other comparable personnel with responsibility for overall risk management at the DCO would meet the requirements of a ''qualified and independent party.'' The Commission does not believe that a DCO's CRO or personnel responsible for overall risk management would categorically qualify as an ''independent party.'' This determination would need to be made on a case-by-case basis depending on whether the CRO or other similar person was or is responsible for development or operation of the systems and models being tested.

MGEX requested that the Commission clarify whether the requirement for independent validation would apply to the primary risk-based portfolio system such as SPAN,[118] or each DCO's analysis program for determining margins, noting its belief that requiring independent tests on the latter would be excessive. It is not clear what MGEX means by ''each DCO's analysis program for determining margins.'' However, § 39.13(g)(3) requires independent validation with respect to a DCO's underlying model, *e.g.,* SPAN or OCC's STANS model, as well as the methodology used to compute the inputs to any such model. On the other hand, a DCO would not be required to obtain an independent validation of a change in SPAN parameters as described by CME.[119]

OCC commented that, as described in the notice of proposed rulemaking, the ''could materially affect'' standard is deficient in two respects in that: (1) It fails to include any reference to the likelihood that a change would actually materially affect the nature or level of risk, and (2) it omits any reference to the direction of the change in level of risk. OCC contended that a more appropriate standard would be to provide that significant changes are those that ''are reasonably likely to materially change the nature or increase the level of risks to which the DCO would be exposed.''

In response to this comment, the Commission is modifying the standard to provide that significant changes are those for which there is a reasonable possibility that they would materially affect the nature or level of risks to which a DCO would be exposed. While this standard identifies the likelihood that a change would materially affect the nature or level of such risks, the Commission believes that it is more appropriate than identifying significant changes as only those that are ''reasonably likely to materially change'' the nature or level of such risks.

The Commission does not believe that significant changes should be limited to those that are likely to increase the level of risks. As described in the notice of proposed rulemaking, the Commission would expect a DCO to obtain an independent validation prior to any significant change that would relax risk management standards, but the Commission would permit a DCO to obtain an independent validation promptly after a significant change that would enhance risk protections, in appropriate circumstances. A DCO should obtain such a validation even if the change were designed to enhance risk protections, in order to ensure that the change would be effective in achieving its objective.

OCC also requested that the Commission clarify that the addition of a new product or new underlying interest would not inherently be deemed to trigger the independent evaluation requirement. The Commission believes that whether the addition of a new product or a new underlying interest would trigger the independent validation requirement would need to be determined on a case-by-case basis, depending on whether there is a reasonable possibility that such addition will materially change the nature or level of risks to which the DCO would be exposed. One example would be if the addition necessitates a significant change to the margin model as it applies to the new product or new underlying interest. Thus, the addition of a futures contract based on a new broad-based securities index where the DCO already clears futures contracts based on broad-based securities indexes might not require a significant change to the applicable margin model. However, the addition of a new category of swaps, even if the DCO already clears swaps, might require a significantly different margin model. Another example might be if a swap cleared by a DCO became subject to a clearing mandate and the risk profile changed because of changes in volume and open interest.

e. Spread and Portfolio Margins—§ 39.13(g)(4)(i)

Proposed § 39.13(g)(4)(i) would permit a DCO to allow reductions in initial margin requirements for related positions (spread margins), if the price risks with respect to such positions were significantly and reliably correlated. Under the proposed regulation, the price risks of different positions would only be considered to be reliably correlated if there were a theoretical basis for the correlation in addition to an exhibited statistical correlation. Proposed § 39.13(g)(4)(i) would include a non-exclusive list of possible theoretical bases, including the following: (A) The products on which the positions are based are complements of, or substitutes for, each other; (B) one product is a significant input into the other product(s); (C) the products share a significant common input; or (D) the prices of the products are influenced by common external factors. The Commission requested comment regarding the appropriateness of requiring a theoretical basis for the correlation between related positions before reductions in initial margin requirements would be permitted. In addition, proposed § 39.13(g)(4)(ii) would require a DCO to regularly review its spread margins and the correlations on which they are based.[120]

KCC and OCC addressed the proposed requirement that the price risks of related positions would only be considered to be reliably correlated, and thus be eligible for initial margin reductions, if there were a theoretical basis for the correlation in addition to

[117] *Id.*

[118] For a description of SPAN, see CME's Web site, at *http://www.cmegroup.com/clearing/risk-management/span-overview.html#works.*

[119] *See id.* for a description of SPAN parameters. Therefore, § 39.13(g)(1), which requires that a DCO review its margin models and parameters, on a regular basis, requires a broader review than would be met by compliance with § 39.13(g)(3).

[120] In addition to the other comments discussed herein, Alice Corporation noted that it supported the cautious approach taken by the Commission and that offsets across products with different maturities and risk profiles should be avoided where possible, and ISDA stated that spread margins should only permitted when a DCO can demonstrate a strong correlation in stressed market conditions and agrees to periodic public disclosure of its methodology and results. With respect to ISDA's comment, the Commission notes that § 39.13(g)(2)(iii), discussed in section IV.D.6.c.(3), above, requires a DCO to ensure that the actual coverage of its initial margin requirements, along with projected measures of the performance of its margin models, must meet an established confidence level of at least 99 percent, based on data from an appropriate historic time period, for, among other things, spreads within or between products for which there is a defined spread margin rate, for each account held by a clearing member at the DCO, by customer and house origin, and for each swap portfolio, by beneficial owner, and § 39.13(g)(7), discussed in section IV.D.6.g, below, imposes related back testing requirements. In addition, § 39.21(c)(3), discussed in section IV.L, below, requires a DCO to publicly disclose its margin methodology.

an exhibited statistical correlation. KCC contended that the proposed requirement would be difficult for the Commission to implement and unnecessary because DCOs have no incentive to offer margin reductions in the absence of high correlation between positions. KCC further noted that the proposal does not detail what level of observed statistical correlation is required, and the proposed requirement to articulate a theoretical basis is vague.

OCC also questioned the appropriateness of the requirement that there must be a theoretical basis for the correlation, noting that a theoretical basis for correlation is, by definition, theoretical and may not be directly observable or verifiable except through the correlation. OCC stated that it is difficult to imagine a correlation for which no theoretical basis can be constructed, and in many if not most cases, the theoretical basis for any significant correlation is obvious.

The Commission continues to believe that reductions in initial margin requirements should only be allowed if a DCO is able to articulate a reasonable theoretical explanation for an observed statistical correlation to ensure that the positions are reliably correlated. The Commission notes that it is a matter of basic statistics that correlation does not equal causation. The world is replete with examples of events or data that are highly correlated at various points in time but for which there is no theoretical relationship. If there is no theoretical relationship, a DCO has no basis to believe that a statistical relationship—no matter how strong—is stable, and a margin based on such a relationship may be insufficient to capture price variation.

Several commenters addressed the appropriateness of applying proposed § 39.13(g)(4) to portfolio-based margin systems. LCH commented that the spread margin measure which the Commission proposed is unsuited and inappropriate for swaps clearing and that the Portfolio Approach to Interest Rate Scenarios (PAIRS), the historical simulation method that LCH uses, is more suitable to non-standardized swaps. Therefore, LCH urged the Commission to amend proposed § 39.13(g)(4) to afford recognition to this technique. OCC requested that the Commission acknowledge that its STANS methodology meets the requirements of proposed § 39.13(g)(4), noting that STANS currently relies on over 20 million separate correlations. OCC stated that it would be impractical to attempt to document or even articulate the ''theoretical basis'' for all of these correlations even though it believes that they would be supportable on a theoretical level, and further believes that its systems for determining and reviewing the validity of the correlations it uses are sufficient to ensure that OCC does not allow unjustified margin offsets. NYPC requested that the Commission clarify that § 39.13(g)(4) would not be applicable to margin models that calculate initial margin requirements at the account level, including NYPC's historical VaR-based margin model.

The Commission intends § 39.13(g)(4) to apply to portfolio-based margin models as well as product-based margin models. For some products, DCOs establish defined spread margin rates, pursuant to a product-based margin methodology. Typically, this occurs where there is a bilateral correlation, *e.g.,* a March-June calendar spread or a correlation between two related products.[121] For other products, there may be multilateral correlations for which margin is calculated on a portfolio basis, pursuant to a portfolio-based margin methodology. In the latter instance, there is not a defined margin amount or margin reduction for a defined portfolio that remains the same over time. Instead, margin is recalculated each day for each individual portfolio.

Therefore, the Commission is adopting § 39.13(g)(4), with several modifications, in order to clarify that margin reductions calculated on a portfolio basis are also permissible if they meet the standards of the regulation. First, the Commission is changing the heading of the provision from ''[s]pread margins'' to ''[s]pread and portfolio margins.'' The Commission is also removing the parenthetical ''(spread margins)'' after the clause in § 39.13(g)(4)(i) that states ''[a] derivatives clearing organization may allow reductions in initial margin requirements for related positions.'' Finally, the Commission is changing the reference to ''spread margins'' in § 39.13(g)(4)(ii) to ''margin reductions.'' These changes are designed to make it clear that § 39.13(g)(4) applies to reductions in initial margin requirements for related positions, whether a DCO uses a product-based margin model or a portfolio-based margin model.

Better Markets and Mr. Greenberger commented that § 39.13(g)(4) must require that the relationship between positions be calculated using the same standards (with respect to volatility and liquidity requirements) that are applied to the calculation of initial margin for the individual positions. The Commission agrees with Better Markets and Mr. Greenberger and, as discussed above, spread and portfolio margins would also be subject to a 99 percent coverage standard.

f. Price Data—§ 39.13(g)(5)

Proposed § 39.13(g)(5) would require a DCO to have a reliable source of timely price data to measure its credit exposure accurately, and to have written procedures and sound valuation models for addressing circumstances where pricing data is not readily available or reliable.

Interactive Data Corporation expressed its belief that the concept of ''sound valuation models'' should be expanded further with additional prescriptive guidance in four key dimensions, including: (1) Leveraging greater trade transparency; (2) using multiple sources; (3) mitigating conflicts of interest; and (4) sourcing of independent price data.

The Commission does not believe that it is necessary to be more specific or prescriptive with respect to this requirement, and is adopting § 39.13(g)(5) as proposed. As the Commission noted in the notice of proposed rulemaking, the nature of the applicable valuation models would necessarily depend on the particular products and the available sources of any relevant pricing data.

g. Daily Review and Back Tests—§§ 39.13(g)(6) and (g)(7)

Proposed § 39.13(g)(6) would require a DCO to determine the adequacy of its initial margin requirements for each product, on a daily basis, with respect to those products that are margined on a product basis.

Proposed § 39.13(g)(7) would require a DCO to conduct certain back tests. The Commission has defined ''back test'' in § 39.2, adopted herein, as ''a test that compares a derivatives clearing organization's initial margin requirements with historical price changes to determine the extent of actual margin coverage.''

For purposes of proposed § 39.13(g)(7)(i) and (ii), the introductory paragraph of proposed § 39.13(g)(7) would require that, in conducting back tests, a DCO use historical price change data based on a time period that is equivalent in length to the historic time period used by the applicable margin model for establishing the minimum 99 percent confidence level or a longer time period. The applicable time period

[121] A defined spread margin rate may also apply to three related products, *e.g.,* the Chicago Board of Trade's soybean crush spread with respect to soybeans, soybean oil and soybean meal.

was separately specified for the back tests required by proposed § 39.13(g)(7)(iii), as discussed below.

Proposed § 39.13(g)(7)(i) would require a DCO, on a daily basis, to conduct back tests with respect to products that are experiencing significant market volatility. Specifically, a DCO would be required to test the adequacy of its initial margin requirements and its spread margin requirements for such products that are margined on a product basis.

Proposed § 39.13(g)(7)(ii) would require a DCO, on at least a monthly basis, to conduct back tests to test the adequacy of its initial margin requirements and spread margin requirements for each product that is margined on a product basis. The Commission requested comment regarding whether initial margin requirements for all products should be subject to back tests on a monthly basis or whether some other time period, such as quarterly, would be sufficient to meet prudent risk management standards.

Proposed § 39.13(g)(7)(iii) would require a DCO, on at least a monthly basis, to conduct back tests to test the adequacy of its initial margin requirements for each clearing member's accounts, by customer origin and house origin, and each swap portfolio, by beneficial owner, over at least the previous 30 days. In the notice of proposed rulemaking, the Commission noted that, since the composition of such accounts and swap portfolios may change on a daily basis, it was anticipated that back tests with respect to such accounts and portfolios would involve a review of the initial margin requirements for each account and portfolio as it existed on each day during the 30-day period. The Commission also requested comment regarding whether initial margin requirements for all clearing members' accounts, by origin, and swap portfolios, by beneficial owner, should be subject to back tests on a monthly basis or whether some other time period, such as quarterly (based on the previous quarter's historical data), would be sufficient to meet prudent risk management standards.

Several commenters addressed the appropriate frequency of back tests and/or the appropriate historic time period for the analysis of price change data. FIA commented that initial margin requirements should be back tested monthly. MGEX stated that it was not opposed to a monthly back testing requirement with respect to proposed § 39.13(g)(7)(iii) based on its understanding that the Commission intended that the DCO must look at its clearing member's net account and not each underlying customer account with the exception of swaps.[122]

LCH took the position that back tests should be conducted at least on a daily basis for all products cleared by a DCO. However, LCH argued that such back tests should be conducted at the portfolio level because margining techniques appropriate for swaps, such as LCH's PAIRS methodology, do not allow for the disaggregation of initial margin and spread margin requirements at a product level. LCH also commented that, for back tests to be statistically meaningful, the applicable historic time period should be a minimum of one calendar year.

KCC stated that it may be appropriate for the Commission to further define ''significant market volatility,'' for purposes of proposed § 39.13(g)(7)(i),[123] but that, more generally, any back-testing requirements should be based on a discretionary, risk-based determination by the DCO. In addition, KCC expressed its belief that the back testing period should be subject to the discretion of the DCO in light of then-current market conditions, *i.e.,* imposing a specific back-testing period may inappropriately reflect an exaggerated or understated level of market volatility.

NOCC took the position that products, customers or spread credits should reach a specified volume or risk exposure level before being required to be back tested with the proposed frequencies so long as the DCO can demonstrate that it is meeting the core principle objectives underlying proposed § 39.13(f).

NYPC requested that the Commission clarify that proposed §§ 39.13(g)(6) and (g)(7)(i)–(ii) would not be applicable to margin models that calculate initial margin requirements at the account level, including NYPC's historical VaR-based margin model. OCC also stated its belief that it would not be subject to the requirement for daily review in proposed § 39.13(g)(7)(i), as it does not margin on a product basis, but noted that it does conduct daily back testing on all accounts, *i.e.,* on a portfolio basis.

The Commission is adopting § 39.13(g)(6), eliminating the language stating ''for each product (that is margined on a product basis),'' in order to correct a potential inconsistency between the text of the rule and the notice of proposed rulemaking. In the notice of proposed rulemaking, the Commission stated that ''[d]aily review and periodic back testing are essential to enable a DCO to provide adequate coverage of the DCO's risk exposures to its clearing members.'' As proposed, § 39.13(g)(6) would only require a DCO to determine the adequacy of its initial margin requirements, on a daily basis, for products that were margined on a product basis. The adequacy of a DCO's initial margin requirements for futures and options on futures products margined on a portfolio basis, and for swap portfolios, would not have been subject to such daily review. The Commission believes that such a result is untenable, as one of the most rudimentary steps in risk management is to conduct daily review of margin coverage, *i.e.,* to determine whether any margin breaches have occurred. Moreover, the Commission believes that the change will not impose any burden because it believes that all DCOs currently conduct some form of daily review of the adequacy of their initial margin requirements, whether they use a product-based or a portfolio-based margin methodology.

The Commission is adopting § 39.13(g)(7)(i) with modifications that require a DCO to conduct back tests, on a daily basis, to test the adequacy of its initial margin requirements with respect to products or swap portfolios that are experiencing significant market volatility: (a) For that product if the DCO uses a product-based margin methodology; (b) for each spread involving that product if there is a defined spread margin rate; (c) for each account held by a clearing member at the DCO that contains a significant position[124] in that product, by house origin and by each customer origin; and (d) for each such swap portfolio, including any portfolio containing futures and/or options and held in a commingled account pursuant to § 39.15(b)(2),[125] by beneficial owner.

Similarly, the Commission is adopting § 39.13(g)(7)(ii) with modifications that

[122] MGEX correctly understands that the Commission's reference to ''each account held by a clearing member at the DCO, by origin, house and customer'' in proposed § 39.13(g)(7)(iii) was not intended to apply to individual accounts by beneficial owner, although proposed § 39.13(g)(7)(iii) would require monthly back tests with respect to initial margin requirements for each swap portfolio, by beneficial owner.

[123] The Commission believes that each DCO should determine what ''significant volatility'' means based upon the volatility patterns of each individual product or swap portfolio that it clears.

[124] The Commission has not defined a ''significant position,'' leaving that determination to the discretion of each DCO, as the size of a position that would be a ''significant position'' may vary depending on the nature of the particular product or the composition of the particular account.

[125] *See* discussion of the addition of the same language to § 39.13(g)(2)(iii)(D), in section IV.D.6.c.(3), above.

require a DCO to conduct back tests, on at least a monthly basis: (a) For each product for which the DCO uses a product-based margin methodology; (b) for each spread for which there is a defined spread margin rate; (c) for each account held by a clearing member at the DCO, by house origin and by each customer origin; and (d) for each swap portfolio, including any portfolio containing futures and/or options and held in a commingled account pursuant to § 39.15(b)(2),[126] by beneficial owner. As adopted, § 39.13(g)(7) no longer contains a paragraph (iii) as paragraph (ii) now describes all monthly back testing requirements.

As originally proposed, § 39.13(g)(7) would only require daily back testing for products that were experiencing significant market volatility if the DCO used a product-based margin methodology, and for spreads involving that product if there was a defined spread margin rate. It would not require daily back testing for each account, by customer origin and house origin, that contained a significant position in that product, whether the DCO used a product-based or a portfolio-based margin methodology, or for each swap portfolio that was experiencing significant market volatility. As with respect to § 39.13(g)(6), there was a potential inconsistency in the treatment of different positions. There is no reasonable basis to require daily back tests solely with respect to products that are experiencing significant market volatility for which the DCO uses a product-based margin methodology and spreads involving such products if there is a defined spread margin rate, and not to require daily back tests with respect to accounts, by customer origin and house origin, which contain significant positions in those products simply because the DCO uses a portfolio-based margin methodology. Similarly, there is no justification for requiring daily back tests with respect to products that are experiencing significant market volatility and not requiring daily back tests with respect to swap portfolios that are experiencing significant market volatility. A DCO should be required to conduct daily back tests when the instruments that it clears are subject to significant market volatility, whether the DCO bases its initial margin requirements on a product-based or a portfolio-based margin methodology, and whether those instruments are futures, options on futures, or swaps.

Although OCC stated that it currently conducts daily back tests on all accounts on a portfolio basis, and LCH expressed its view that back tests should be conducted on a daily basis for all products and swap portfolios cleared by a DCO, the Commission has determined to permit a DCO to conduct back tests on at least a monthly basis when significant market volatility is not present. FIA and MGEX supported monthly back testing. Apart from KCC's contention that back testing should be subject to the discretion of the DCO, and NOCC's suggestion that DCOs should be able to obtain an exemption from the proposed frequencies for products, customers and spread credits that have not reached a specified volume or risk exposure level,[127] none of the commenters indicated that back tests should be conducted less frequently than monthly. Moreover, a particular DCO would be able to exercise its discretion to conduct back tests on a more frequent basis than that required by the Commission's regulation.

The Commission has not proposed and is not adopting LCH's suggestion that the applicable historic time period for the price change data used for back testing should be a minimum of one calendar year. However, the Commission is removing the proposed language from the introductory paragraph of § 39.13(g)(7) regarding the time periods for historical price changes that must be used in the required back tests and is revising the introductory paragraph to require a DCO to use an appropriate time period but not less than the previous 30 days for all of the back tests required by §§ 39.13(g)(7)(i) and (ii).

h. Customer Margin

(1) Gross Margin for Customer Accounts —§ 39.13(g)(8)(i)

Proposed § 39.13(g)(8)(i) would require a DCO to collect initial margin on a gross basis for each clearing member's customer account equal to the sum of the initial margin amounts that would be required by the DCO for each individual customer within that account if each individual customer were a clearing member and would prohibit a DCO from netting positions of different customers against one another. The proposed regulation would permit a DCO to collect initial margin for its clearing members' house accounts on a net basis.

Better Markets and LCH (with a suggested exception described below) supported proposed § 39.13(g)(8)(i).[128] CME, KCC, OCC, ICE, NYPC, FIA, and the Commodity Markets Council (CMC) argued against the adoption of proposed § 39.13(g)(8)(i).

KCC and ICE pointed out that DCOs that perform net margining have not had any clearing member defaults or customer losses, including during the 2008 financial crisis.

Various commenters opposed the proposal based on the potential extent and costs of operational and technology changes that would need to be made by clearing members and DCOs: (1) To convert net margining systems to gross margining systems, and (2) to permit clearing members to provide individual customer position information to DCOs, and DCOs to receive individual customer position information and calculate the margin required for each individual customer account (CME, KCC, ICE, NYPC, and CMC).

OCC stated that the only means by which it could calculate margin requirements on a customer-by-customer basis within a clearing member's omnibus futures customers' account would be to create subaccounts for each customer. CME, NYPC, KCC, and FIA commented that DCOs do not currently receive position-level information for each individual customer of their clearing members. CME and FIA expressed concern about the costs associated with clearing members having to provide individual customer position information, and CME indicated that DCOs would incur costs in processing the information received from clearing members in order to calculate margin requirements on individual customer accounts on a daily basis. NYPC also stated that the adoption of proposed § 39.13(g)(8)(i) would require it to make significant changes to its systems.[129]

KCC stated that managing gross customer margin at the DCO level

[126] *Id.*

[127] The Commission does not believe that it is appropriate to adopt a regulation establishing an exemption process with respect to back testing requirements based on volume or risk exposure or otherwise.

[128] LCH also expressed its belief that a DCO should also collect margin from all affiliated legal entities within a house account on a gross basis unless there is legal certainty of the DCO's right to offset risks across the affiliates in the event of the default of the group or one or more of its affiliated legal entities. The Commission has not proposed and is not adopting such a requirement. However, although § 39.13(g)(8)(i) permits a DCO to collect initial margin for its clearing members' house accounts on a net basis, it does not require it to do so, and a DCO could determine to collect house margin in the manner suggested by LCH.

[129] *See* further discussion of these costs in section VII, below. NYPC also commented that given the necessary technology builds, it would need more than three years to come into compliance with proposed §§ 39.13(g)(8)(i) and 39.13(h)(2). The Commission believes that the modifications to § 39.13(g)(8)(i), discussed in this section, would minimize any technology changes that would be necessary in order to comply with § 39.13(g)(8)(i).

would require a DCO to assume the role of a back-office account management service, requiring continuous updates from each clearing member regarding customer positions. KCC further noted that DCOs would be required to adjust the timing deadlines for margin payments, DCOs' ability to track margin requirements closely with market movements would be decreased, and DCOs may face difficulty in relaying variation margin payment information to their settlement banks quickly.

ICE noted that converting to a gross margining system would be a major operational change for clearing firms and DCOs that use net margining. However, ICE also stated that most DCOs currently use gross margining, including ICE Trust (now ICE Clear Credit LLC) and ICE Clear U.S., although ICE Clear Europe uses net margining. In particular, ICE stated that gross margining would require reengineering of firms' end-of-day processing. According to ICE, changes would need to be made to such DCOs' margining technology, data submission/input mechanism and margin reporting specifications, and clearing firms or their service providers would need to implement software updates. ICE noted that changes to position reporting, reconciliation and margining methodology are challenging technology changes for clearing members and their third-party software vendors and typically take at least six to nine months to complete. However, ICE indicated that an implementation period of at least 12 months would allow DCOs that currently use net margining, and their clearing members, to adequately test and implement the systems necessary for gross margining.

CME, KCC, and CMC all argued that requiring clearing members to report gross customer positions by beneficial owner to DCOs is not necessary in order to accomplish reasonable and adequate ''modified'' gross margining. Specifically, CME and KCC urged the Commission to permit a version of gross margining of customer accounts that would only require clearing members to report gross customer positions to DCOs (not by beneficial owner) and that would allow clearing firms to submit positions as spreadable for those accounts that have recognized calendar spreads or spreads between correlated products. However, CME further represented that ''[t]his version of gross margining will sometimes lead to less than aggregate gross margins as a result of optimal spreading that occasionally occurs between accounts. Nevertheless, it approximates aggregate gross margins without imposing significant costs on the industry.''

In light of the various concerns raised by CME, KCC, ICE, NYPC, and CMC regarding the operational and technology changes that would be needed and related costs of requiring a DCO to obtain individual customer position information from its clearing members and to use such information to calculate the margin requirements for each individual customer, the Commission is modifying § 39.13(g)(8)(i). In particular, the Commission is adding a provision, which states that ''[f]or purposes of calculating the gross initial margin requirement for each clearing member's customer account(s), to the extent not inconsistent with other Commission regulations, a derivatives clearing organization may require its clearing members to report the gross positions of each individual customer to the derivatives clearing organization, or it may permit each clearing member to report the sum of the gross positions of its customers to the derivatives clearing organization.'' [130]

Thus, the Commission is providing a DCO with the discretion to either calculate customer gross margin requirements based on individual customer position information that it obtains from its clearing members or based on the sum of the gross positions of all of a clearing member's customers that the clearing member provides to the DCO, without forwarding individual customer position information to the DCO. In either case, the customer gross margin requirement determined by a DCO must equal ''the sum of the initial margin amounts that would be required by the derivatives clearing organization for each individual customer within that account if each individual customer were a clearing member.'' The customer gross margin collected by a DCO may not be subject to ''spreading that occasionally occurs between accounts'' that may lead to ''less than aggregate gross margins,'' as described by CME.

CME commented that proposed § 39.13(g)(8)(i) was unclear regarding how DCOs would be expected to treat customer omnibus accounts of non-clearing FCMs and foreign brokers for which the clearing firm carrying the account generally does not know the identities of individual customers within the omnibus accounts. Under current industry practice, omnibus accounts report gross positions to their clearing members and clearing members collect margins on a gross basis for positions held in omnibus accounts.[131] The Commission does not intend to alter this current practice by adopting § 39.13(g)(8)(i). Therefore, the Commission is adding a provision, which states that ''[f]or purposes of this paragraph, a derivatives clearing organization may rely, and may permit its clearing members to rely, upon the sum of the gross positions reported to the clearing members by each domestic or foreign omnibus account that they carry, without obtaining information identifying the positions of each individual customer underlying such omnibus accounts.''

The Commission believes that giving a DCO the option of permitting its clearing members to provide the sum of their customers' gross positions to a DCO, without the need to provide individual customer position information to the DCO, allows DCOs to provide their clearing members with a much less costly alternative to requiring clearing members to provide individual customer position information to the DCO, and requiring the DCO to calculate the gross margin requirement for each customer of each clearing member.

The Commission recognizes that § 39.13(g)(8)(i), even as modified, will require DCOs and their clearing members to incur certain costs. However, the Commission continues to believe, as stated in the notice of proposed rulemaking, that gross margining of customer accounts will: (a) More appropriately address the risks posed to a DCO by its clearing members' customers than net margining; (b) will increase the financial resources available to a DCO in the event of a

[130] The Commission is including the phrase ''to the extent not inconsistent with other Commission regulations'' because, in a separate rulemaking, the Commission has proposed regulations that would require FCM clearing members to provide daily information identifying the positions of individual cleared swaps customers to the relevant DCO and that would require such DCOs to calculate the amount of collateral required for each cleared swaps customer of such clearing members on a daily basis. If these regulations are adopted, they will supersede the provisions of § 39.13(g)(8)(i) to the extent that they are inconsistent with such provisions, with respect to cleared swaps. *See* 76 FR 33818 (June 9, 2011) (Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions).

The Commission is also making a conforming amendment by inserting ''and may not permit its clearing members to'' in the sentence that now reads as follows (added text in italics): ''A derivatives clearing organization may not, *and may not permit its clearing members to,* net positions of different customers against one another.''.

[131] *See, e.g.,* Margins Handbook, *http://www.nfa.futures.org/NFA-compliance/publication-library/margins-handbook.pdf,* at 34; CME Rule 930.J.; ICE Futures U.S. Inc. Rule 5.04; and CBOE Futures Exchange, LLC Rule 516.

customer default; [132] and (c) with respect to cleared swaps, will support the requirement in § 39.13(g)(2)(iii) that a DCO must margin each swap portfolio at a minimum 99 percent confidence level.

The Commission believes that the clearing of swaps will increase the risk that DCOs face. Gross margining will maximize the amount of money DCOs hold. Because a DCO may not have access to customer initial margin collected by and held at an FCM if the DCO collects initial margin on a net basis, if the FCM defaults, the Commission believes that holding gross initial margin at a DCO is the safest mechanism by which DCOs can protect themselves from increased risk. If a DCO is unable to obtain customer margin in the event of default, there is significant risk of contagion. Consequently, if more margin is held at the DCO, the potential risk that the failure of one clearing member will propagate throughout the financial system to other clearing members and other entities is decreased.[133]

CME and KCC commented that proposed § 39.13(g)(8)(i) would require clearing members to ''pass-through'' the margin deposits that they receive from their customers to the DCO, thus requiring clearing members to apply to their customers the DCO's standards for acceptable collateral as well as the DCO's concentration limits with respect to collateral types. CME indicated that this would add pressure with respect to the available collateral pool, and argued that the Commission should not impose such additional and costly constraints on market participants in the absence of significant and demonstrable benefits. The Commission notes that, although as a business matter clearing members may determine to ''pass-through'' the margin deposits that they receive from their customers to the relevant DCO, proposed § 39.13(g)(8)(i) does not require that a clearing member only accept from its customers those types of margin assets that are acceptable for the clearing member to deposit with the DCO.

KCC requested that the Commission clarify whether the requirement to collect gross customer margin imposes an obligation on the DCO to determine the defaulting customer accounts in a customer default situation (which would be costly and burdensome) and stated that having the total customer gross margin available to the DCO in the event of a customer default is a prudent risk management technique. The Commission notes that Commission rules currently permit a DCO to commingle the initial margin with respect to all of a clearing member's customers in a single customer origin account at the DCO and to apply the entire customer origin account to cover losses with respect to a customer default, whether the DCO collects initial margin on a net basis or on a gross basis. The Commission does not intend § 39.13(g)(8)(i), by its terms, to alter this approach.

In a separate rulemaking, however, the Commission has proposed to require DCOs to legally segregate customer funds and assets margining swap positions that are held by a clearing member at the DCO in a commingled cleared swaps customer account.[134] In addition, European Union legislation, although not yet finalized, would require central counterparties to provide individual customer segregation in certain circumstances.[135] As previously noted, gross margining will be instrumental if individual customer segregation is adopted. OCC requested that the Commission restrict the applicability of proposed § 39.13(g)(8)(i) to futures customer accounts at both the clearing level and the FCM level, to make it clear that it does not intend to impose these margin requirements on accounts that are restricted to securities products (with respect to an entity that is both a DCO and an SEC-regulated clearing agency). OCC is correct that § 39.13(g)(8)(i) applies only to customer and house accounts, cleared by a DCO, which contain futures, options on futures, and/or swap positions that are subject to the jurisdiction of the Commission. It does not apply to accounts that only contain securities products that are subject to the jurisdiction of the SEC.

LCH requested that the Commission allow DCOs operating from non-U.S. jurisdictions to offer ''net omnibus'' account structures for associated entities operating under the same group or umbrella structure to customers outside the U.S. The treatment of customers is outside the scope of this rulemaking. However, to the extent a DCO is clearing products subject to the Commission's jurisdiction, this rule would apply at the clearing level regardless of the location of the DCO or the customer.

The Commission is adopting § 39.13(g)(8)(i) with the modifications described above. The Commission recognizes that DCOs that currently use net margining, or that use a ''modified'' version of gross margining, as well as their clearing members and their service providers, will need time to make the necessary operational and technology enhancements that will facilitate gross margining, as described herein. Therefore, the Commission is adopting an effective date that is 12 months after the publication of final § 39.13(g)(8)(i) in the **Federal Register**.

(2) End-of-Day Position Reporting—§ 39.19(c)(1)(iv)

Proposed § 39.19(c)(1)(iv) would require each DCO to report to the Commission, on a daily basis, the end-of-day positions for each clearing member, by customer origin and house origin; and for customer origin, separately, the gross positions of each beneficial owner.[136]

As noted by KCC and CMC, the Commission currently receives certain information about the ownership and control of reportable positions through its large trader reporting program, under Parts 15 through 21 of the Commission's

[132] ICE commented that the Commission's rationale for gross margining, *i.e.,* that it would increase the financial resources available to a DCO in the event of a customer default, is based upon the mutualization of customer risk to protect the DCO. ICE stated its belief that this rationale conflicts with the reasoning behind the proposal that DCOs individually segregate cleared swaps customer funds to protect such customers from fellow customer risk. The Commission notes, however, that gross margining is not only consistent with, but will be instrumental in achieving, complete legal segregation for cleared swaps accounts. *See* 76 FR 33818 (June 9, 2011) (Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions).

[133] As pointed out in the CPSS–IOSCO Consultative Report, under certain circumstances gross margining may also increase the portability of customer positions in an FCM insolvency. That is, a gross margining requirement would increase the likelihood that there will be sufficient collateral on deposit in support of a customer position to enable the DCO to transfer it to a solvent FCM. *See* CPSS–IOSCO Consultative Report, Principle 14: Segregation and Portability, Explanatory Notes 3.14.6 and 3.14.8, at 67–68.

[134] *See* 76 FR 33818 (June 9, 2011) (Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions).

[135] *See Financial markets: OTC derivatives, central counterparties and trade repositories (amend. Directive 98/26/EC),* COD/2010/0250 (June 7, 2011), available at *http://www.europarl.europa.eu/oeil/FindByProcnum.do?lang=en&procnum=COD/2010/0250.*

[136] As originally proposed, § 39.19(c)(1)(iv) would require each DCO to report to the Commission, on a daily basis, the end-of-day positions for each clearing member, by customer origin and house origin. *See* 75 FR 78185 (Dec. 15, 2010) (Information Management). The preamble in the notice of proposed rulemaking (76 FR 3698 (Jan. 20, 2011) (Risk Management)), described a proposed amendment to proposed § 39.19(c)(1)(iv) to add ''and for customer origin, separately, the gross positions of each beneficial owner.'' However, this clause was inadvertently omitted from the language of the regulation in the notice of proposed rulemaking. Therefore, the Commission subsequently issued a correction at 76 FR 16588 (Mar. 24, 2011) (Risk Management Requirements for Derivatives Clearing Organizations; Correction).

regulations. Commission staff reviews the effectiveness of this program on a regular basis, and will continue to adopt enhancements where appropriate.[137] The large trader reporting system, however, does not currently apply to many swaps that are, or may be, cleared. The Commission may need information about large swap positions to assess the risk profile of a DCO or a clearing FCM.

CME, KCC, MGEX, FIA, and CMC commented that clearing members do not generally have information identifying the underlying customers in customer omnibus accounts carried on behalf of non-clearing member FCMs, foreign brokers, hedge funds or commodity pools, and therefore clearing members cannot reasonably be expected to report such information to DCOs, and DCOs cannot reasonably be expected to report such information to the Commission. The Commission notes that a DCO may be able to obtain such information under its own rules. For example, CME Rule 960 requires a clearing member to immediately disclose the identities and positions of the beneficial owners of any omnibus account to CME upon its request.

MGEX expressed its concern that the significant costs resulting from compliance with a requirement for the routine daily reporting of all gross customer positions by beneficial owner could lead to further consolidation in the industry at the FCM, clearing member, and DCO levels.

The Commission is not adopting the proposed requirement in § 39.19(c)(1)(iv) that a DCO provide daily reports to the Commission of the gross positions of each beneficial owner within each clearing member's customer origin account. However, the Commission is adopting § 39.19(c)(5)(iii),[138] which requires a DCO to provide this information to the Commission upon the Commission's request, in the format and manner, and within the time, specified by the Commission.

For example, the Commission could request that a DCO provide information about customer positions by beneficial owner, on a case-by-case basis, with respect to a particular clearing member, customer, or product. Moreover, the Commission could request that such information be provided for a particular day, month, or until further notice by the Commission. In recent years, the Commission has worked cooperatively with several DCOs to obtain information about cleared swap positions. The Commission notes that any potential costs should be substantially reduced by the modified requirement that a DCO provide information to the Commission identifying the positions of beneficial owners of customer accounts only upon Commission request and not on a daily basis.

(3) Customer Initial Margin Requirements—§ 39.13(g)(8)(ii)

Proposed § 39.13(g)(8)(ii) would require a DCO to require its clearing members to collect customer initial margin [139] from their customers for non-hedge positions at a level that is greater than 100 percent of the DCO's initial margin requirements [140] with respect to each product and swap portfolio. Proposed § 39.13(g)(8)(ii) would permit a DCO to have reasonable discretion in determining the percentage by which customer initial margins would have to exceed the DCO's initial margin requirements with respect to particular products or swap portfolios. However, under the proposed regulation, the Commission could review such percentage levels and require different percentage levels if the Commission deemed the levels insufficient to protect the financial integrity of the clearing members or the DCO in accordance with Core Principle D.[141]

OCC stated its view that exchanges, which have historically set customer level margin requirements, should continue to do so, rather than DCOs, noting that clearing organizations would ordinarily have no means to enforce customer level margin requirements.

KCC stated that it generally supports the concept that clearing members should collect customer initial margin at a level above that of DCO initial margin, but requested that the Commission clarify the circumstances in which it may deem the ratio of customer initial margin to DCO initial margin insufficient to protect the DCO. Although the FHLBanks opposed the proposal, they recommended that if the Commission were to adopt it, the Commission should provide additional guidance and/or establish criteria for DCOs with respect to setting the required amount of excess margin. MGEX noted that although it currently maintains a 130 percent requirement, this is a decision that should be left to each DCO and its clearing members to determine. Because the circumstances for each DCO or the nature of its clearing members vary, it would be difficult to provide the general clarification or criteria that KCC and the FHLBanks are seeking, because such a determination would need to be made on a case-by-case basis.

MFA argued that a requirement that a DCO must require its clearing members to collect customer initial margin at a level that is greater than the DCO's initial margin requirements would be inappropriate because DCOs do not have information about individual customers' creditworthiness and such a requirement would impair market liquidity by limiting the trading activity of certain market participants, resulting in greater market concentration. Citadel and the FHLBanks made similar comments.

ICE stated that FCMs are best able to determine how much to charge above the initial margin requirement because they have complete visibility into their customers' positions, and the Commission should not place this requirement on a DCO, but should address this with FCMs through another set of rules. FIA opposed the proposed rule stating that the amount of excess margin, if any, that an FCM may require from its customers is a credit decision that should be made by each FCM based on its analysis of the creditworthiness of the particular customer, including the nature of the customer's trading activity and its record of meeting margin calls.

Currently DCMs require their FCM members to impose customer initial margin requirements that are a specified percentage higher than the DCO's initial margin requirements, generally in the neighborhood of 125 percent to 140 percent, as determined by the DCM. DCMs generally permit FCM members to impose customer initial margin requirements for hedge positions that are equal to the applicable maintenance margin requirements (which are generally the same as the applicable clearing initial margin requirements). This rule simply shifts the responsibility for establishing customer initial margin requirements from DCMs to DCOs.

DCOs have greater expertise in risk management and a direct financial stake in whether their clearing members' customers, and consequently their clearing members, are able to meet their margin obligations. Moreover, it is anticipated that some DCOs will clear fungible swaps that may be listed on multiple SEFs. SEFs may or may not

[137] For example, the Commission recently adopted final rules on Large Trader Reporting for Physical Commodity Swaps at 76 FR 43851 (July 22, 2011).

[138] *See* further discussion of § 39.19, adopted herein, in section IV.J, below.

[139] The term ''customer initial margin'' is now defined in § 1.3(kkk), adopted herein.

[140] A DCO's initial margin requirements are also referred to herein as ''clearing initial margin'' requirements. ''Clearing initial margin'' is defined as ''initial margin posted by a clearing member with a [DCO]'' in § 1.3(jjj), adopted herein.

[141] Section 5b(c)(2)(D)(iii) of the CEA, 7 U.S.C. 7a–1(c)(2)(D)(iii).

impose customer initial margin requirements on their members for cleared swaps. Requirements set by DCOs may be less susceptible to pressure to being lowered for competitive reasons. Finally, DCOs will be the only self-regulatory organizations that will be in a position to set customer initial margin requirements for swaps that are executed bilaterally, and voluntarily cleared. Moreover, DCOs will have the opportunity to review whether their clearing members are collecting customer initial margin, as required by the DCO, during their reviews of the risk management policies, procedures, and practices of their clearing members, pursuant to § 39.13(h)(5).[142]

Section 39.13(g)(8)(ii) permits a DCO to exercise its discretion in determining the appropriate percentage by which the customer initial margin for a particular product or swap portfolio should exceed the clearing initial margin,[143] as DCMs do today with respect to futures and options. This percentage should be based on the nature and volatility patterns of the particular product or swap portfolio, and the DCO's related evaluation of the potential risks posed by customers in general to their clearing members and, in turn, the potential risks posed by such clearing members in general to the DCO, rather than the creditworthiness of particular customers. Consequently, a DCO will retain the flexibility to establish an appropriate percentage for customer initial margin that applies to each product that it clears, which will apply to all of its clearing FCMs and all of their customers. However, as is also the case today, such clearing FCMs would remain free to exercise their discretion to determine whether they will collect additional margin over and above that amount either from all of their customers, or from particular customers based on such customers' risk profiles.[144]

The Commission continues to believe that requiring a DCO to require its clearing members to collect customer initial margin in a percentage higher than 100 percent of the clearing initial margin, for non-hedge positions, provides a valuable cushion of readily available customer margin. Citadel stated that the market's extensive experience in a range of cleared markets demonstrates preparedness for the regular exchange of margin between clearing members and their customers for cleared OTC derivatives, even where margin calls occur more frequently than once daily, and that frequent exchange of margin is also current market practice for uncleared trades. However, the maintenance of such a cushion would enable clearing members to deposit additional margin with a DCO on behalf of their customers, as necessitated by adverse market movements, without the need for the clearing members to make such frequent margin calls to their customers. In addition, many clearing members choose to deposit excess margin with their DCOs to provide their own cushion, which may in some instances obviate the need to transfer funds to the DCO on a daily basis in order to meet variation margin requirements.

ISDA, FIA, and the FHLBanks commented that if the Commission were to adopt proposed § 39.13(g)(8)(ii), it should clarify the meaning of ''non-hedge positions.'' The FHLBanks also stated that the Commission should provide guidance regarding how the determination as to whether a position is a hedge or a non-hedge position would be made, whether by the DCO, the clearing member, or the customer, and expressed the belief that a clearing member's customers should be responsible for determining and certifying, to their clearing members or DCOs, whether their swap positions are ''hedge'' or ''non-hedge'' positions.

Several commenters have argued that there is no basis for distinguishing between hedge positions and non-hedge positions in determining whether such positions should be subject to customer initial margin requirements in excess of clearing initial margin requirements.[145] LCH stated that it does not believe that a DCO or a clearing member should distinguish in any way between a customer's hedge and non-hedge positions because: (1) if the two parts of the hedge are carried by the same clearing member within the same DCO, such hedges would in any event implicitly be recognized by the DCO's risk calculations and the provision would be unnecessary; and (2) if one or the other leg of the hedge is uncleared, or is carried by a different clearing member, or by the same or another clearing member at another DCO, no recognition of the offsetting hedge should be allowed either by the DCO(s) or by the clearing member(s), as neither party would have the economic benefit of the hedged transaction. The Commission notes that the categorization of a position as a hedge for purposes of this regulation does not affect the margin collected by the DCO; it only affects the additional increment that the clearing member collects from its customer.

Freddie Mac indicated that the Commission should consider eliminating the proposed requirement for increased customer initial margin for ''non-hedge positions,'' noting that customers with non-hedge positions are not inherently riskier or more likely to miss margin calls than customers with ''hedge positions.''

As previously noted, DCMs have historically drawn a distinction between hedge positions and non-hedge positions in setting customer initial margin requirements, and the Commission believes that it is reasonable to assume that hedgers may present less risk than speculators, in that losses on their derivatives positions should be offset by gains on the positions whose risks they are hedging. The relevant consideration is the relative risks posed by hedgers versus non-hedgers, rather than the

[142] *See* discussion of § 39.13(h)(5), adopted herein, in section IV.D.7.e, below.

[143] OCC commented that its STANS margin system calculates margin based on all positions in an account and not on a position-by-position basis; therefore it would not be able to furnish clearing members with a number representing the initial margin on a particular position without conducting subaccounting for each customer. OCC also noted that since STANS requirements are data-driven on a month-to-month, and even a day-to-day, basis they can vary in ways that cannot be readily predicted. The Commission is adopting § 39.13(g)(8)(i) herein, which requires a DCO to collect initial margin on a gross basis for its clearing members' customer accounts. Therefore, a clearing member (or the DCO) will be required to determine the initial margin that must be posted with the DCO with respect to each customer's positions. Even if that amount changes from day to day as a result of the application of a portfolio-based margin system, a DCO could require that its clearing members collect customer initial margin in an amount that is a given percentage in excess of 100 percent of the daily clearing initial margin requirement with respect to each customer.

[144] *See, e.g.,* CME Rule 8G930.E (''IRS Clearing members may call for additional performance bond at their discretion.'') (available at *http://www.cmegroup.com/rulebook/CME/I/8G/*) and International Derivatives Clearinghouse, LLC Rule 614(g) (''A Clearing Member may call, at any time, for [margin] above and beyond the minimums required by the Clearinghouse.'') (available at *http://www.idch.com/pdfs/idch/20100901rulebook.pdf*).

[145] MFA stated that it would be highly burdensome to distinguish between hedge and non-hedge positions for purposes of the application of differentiated margining, especially in a portfolio margining context. As noted in n. 143, above, a DCO that uses a portfolio-based margin model could require that its clearing members collect customer initial margin in an amount that is a given percentage in excess of 100 percent of the daily clearing initial margin requirement with respect to each customer. If all of a particular customer's positions were hedge positions, the DCO could permit the clearing member to collect customer initial margin in an amount that equals the amount of clearing initial margin with respect to that customer's positions. It is only in those circumstances where a hedger may also engage in speculative trading that it may be difficult to distinguish between positions for purposes of the application of differentiated margining in a portfolio margining context.

creditworthiness of particular customers.

Freddie Mac recommended that, if the Commission does not eliminate the distinction between hedge and non-hedge positions, the Commission should clarify that, for purposes of § 39.13(g)(8)(ii): (1) ''hedge positions'' would include all swaps that hedge or mitigate any form of a customer's business risks; (2) such swaps may qualify as ''hedge positions'' regardless of whether they qualify as ''bona fide hedging transactions'' under the CEA and § 1.3(z) or qualify as hedges under applicable accounting standards; and (3) such swaps may qualify as ''hedge positions'' regardless of the nature of the entity that holds such positions (*e.g.,* whether it is a financial entity or a non-financial entity). Freddie Mac indicated that such treatment would be consistent with Commission proposals for defining hedging for purposes of other Dodd-Frank Act rules, including the definition of a ''major-swap participant'' [146] and rules relating to the availability of the end-user exception to mandatory clearing.[147]

The Commission intends to interpret ''hedge positions,'' for purposes of § 39.13(g)(8)(ii), as referring to those that meet either the definition set forth in § 1.3(z), or the definition set forth in § 1.3(ttt), when, and in the form in which, it is ultimately adopted.[148] The Commission also believes that, as is currently the practice, it would be the customer's responsibility to identify its positions as hedge positions to its clearing FCM.

The Commission is adopting § 39.13(g)(8)(ii) as proposed.

(4) Withdrawal of Customer Initial Margin—§ 39.13(g)(8)(iii)

Proposed § 39.13(g)(8)(iii) would require a DCO to require its clearing members to prohibit their customers from withdrawing funds from their accounts with such clearing members unless the net liquidating value plus the margin deposits remaining in the customer's account after the withdrawal would be sufficient to meet the customer initial margin requirements with respect to the products or swap portfolios in the customer's account, which were cleared by the DCO.

LCH agreed with the underlying requirement, but stated that it should be imposed in rules that directly apply to clearing members rather than in rules applicable to DCOs. KCC also supported the concept but noted that DCM rules already require customers to maintain minimum margin levels and that these restrictions are generally tested by a clearing member's risk department and the clearing member's self-regulatory organization during examinations. KCC further noted that DCOs do not have full access to information regarding each customer's financial condition. MGEX took the position that the Commission [149] or a clearing member's designated self-regulatory organization (DSRO) should monitor compliance with such a requirement rather than the DCO, indicating that it would not be economically feasible for the DCO to do so.

As noted in the notice of proposed rulemaking, the requirement stated in § 39.13(g)(8)(iii) is consistent with the definition of ''Margin Funds Available for Disbursement'' in the Margins Handbook prepared by the JAC.[150] Therefore, DSROs currently review FCMs to determine whether they are appropriately prohibiting their customers from withdrawing funds from their futures accounts unless the net liquidating value plus the margin deposits remaining in such customers' accounts after the withdrawal would be sufficient to meet the customer initial margin requirements with respect to such accounts. However, it is unclear to what extent this requirement would apply to cleared swaps accounts when such swaps are executed on a DCM which participates in the JAC. Moreover, clearing members which only clear swaps that are executed on a SEF will not be subject to the requirements set forth in the Margins Handbook or subject to review by a DSRO.

The Commission anticipates that, at a minimum, DCOs will be able to review whether their clearing members are ensuring that customers do not make withdrawals from their accounts unless the specified conditions are met, when they conduct reviews of their clearing members' risk management policies, procedures, and practices pursuant to § 39.13(h)(5).[151]

The Commission is adopting § 39.13(g)(8)(iii) as proposed.

i. Time Deadlines—§ 39.13(g)(9)

Proposed § 39.13(g)(9) would require a DCO to establish and enforce time deadlines for initial and variation margin payments.

LCH submitted a comment letter indicating that it agrees with the proposal, but stated that it should apply only to a DCO's clearing members since a DCO has no direct relationship with clients of its clearing members. Consistent with its original intent, the Commission is adopting § 39.13(g)(9) with a modification to make it clear that it only applies to time deadlines for initial and variation margin payments to a DCO by its clearing members.

7. Other Risk Control Mechanisms

a. Risk Limits—§ 39.13(h)(1)(i)

Proposed § 39.13(h)(1)(i) would require a DCO to impose risk limits on each clearing member, by customer origin and house origin, in order to prevent a clearing member from carrying positions where the risk exposure of those positions exceeds a threshold set by the DCO relative to the clearing member's financial resources, the DCO's financial resources, or both. The Commission believes that an FCM engages in excess risk-taking if it, or its customers, take on positions that require financial resources that exceed this threshold. The DCO would have reasonable discretion in determining: (1) the method of computing risk exposure; (2) the applicable threshold(s); and (3) the applicable financial resources, provided however, that the ratio of exposure to capital would have to remain the same across all capital levels. For example, if a DCO set limits under which margin could not exceed 200 percent of capital, the limit for a $100 million clearing member would be $200 million and the limit for a $200 million clearing member would be $400 million. The Commission could review any of these determinations and require different methods, thresholds, or financial resources, as appropriate.

Proposed § 39.13(h)(1)(ii) would allow a DCO to permit a clearing member to exceed the threshold(s) applied pursuant to paragraph (h)(1)(i) provided that the DCO required the clearing member to post additional initial margin that the DCO deemed sufficient to appropriately eliminate excessive risk

[146] *See* 75 FR 80174 (Dec. 21, 2010) (Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant'').

[147] *See* 75 FR 80747 (Dec. 23, 2010) (End-User Exception to Mandatory Clearing).

[148] The Commission has proposed a definition of ''hedging or mitigating commercial risk,'' to be codified at § 1.3(ttt), for the purposes of the definition of ''Major Swap Participant,'' 75 FR at 80214–80215 (Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant'').

[149] The Commission does not believe that it would be practical for the Commission to review each clearing member of each DCO to determine whether the clearing member is prohibiting its customers from making impermissible withdrawals from their accounts.

[150] *See http://www.nfa.futures.org/NFA-compliance/publication-library/margins-handbook.pdf,* at 45.

[151] *See* discussion of § 39.13(h)(5), adopted herein, in section IV.D.7.e, below.

exposure at the clearing member. The Commission could review the amount of additional initial margin and require a different amount, as appropriate.

J.P. Morgan and Alice Corporation supported the proposal to require DCOs to establish risk-based position limits for their clearing members. J.P. Morgan indicated that in setting such position limits applicable to any one clearing member, a DCO should consider its overall exposure to clearing members in the aggregate. The Commission agrees that this would be prudent and expects that DCOs would take into consideration the aggregate exposure in establishing individual levels. J.P. Morgan further took the position that DCOs should monitor exposures against these limits on a real time basis. As discussed in section IV.D.4, above, § 39.13(e)(2) requires a DCO to monitor its credit exposure to each clearing member periodically during each business day.

FIA stated that it generally agrees with the proposed requirement that ''the ratio of exposure to capital must remain the same across all capital levels'' but indicated that the rule should make clear that, in computing the ratio of exposure to capital, a clearing member's capital should be calculated net of all risk exposures and potential assessment obligations at other clearing organizations of which it is a clearing member. The Commission agrees that it would be appropriate for a DCO to consider a clearing member's exposures to other clearing organizations, to the extent that it is able to obtain such information, in determining a clearing member's applicable financial resources for the purpose of setting appropriate risk limits.

CME argued that a requirement that DCOs impose risk limits for every clearing member would be overly prescriptive and unnecessary, provided that a DCO collects adequate margin, its stress-test results regarding the clearing member's exposures are acceptable, and it employs concentration margining (whereby the DCO would set a level of risk at which it would begin to charge higher margins based on indicative stress-test levels). In other words, CME suggested that risk limits may be unnecessary if a DCO sets a level of risk at which it would begin to charge higher margins based on stress test results with respect to a clearing member. However, § 39.13(h)(1)(ii) would allow a DCO to permit a clearing member to exceed an established risk limit provided that the DCO required the clearing member to post additional margin. Although CME's proposed approach is worded slightly differently, the effect would be the same as that of § 39.13(h)(1)(ii), *i.e.,* a clearing member could only exceed a defined risk level if it posted additional margin.

MGEX indicated that the proposed rule requiring DCOs to impose risk limits on each clearing member might not be practical, adding additional cost with little benefit, noting that DCOs currently address credit and default risk via margins and security deposits on a daily basis and conduct risk reviews. Rather, according to MGEX, a DCO should be looking for risk signs and focusing on those that are most relevant. The Commission believes that the establishment of risk limits for clearing members would impose little additional cost on DCOs since DCOs are already required to monitor their clearing members' capital levels and their own financial resources, as well as the trading activity of their clearing members. On the other hand, the Commission believes that the establishment of such risk limits would add significant risk management benefits to the benefits already conferred by margins, security deposits, and reviews of clearing members' risk management policies and procedures.

The Commission is adopting § 39.13(h)(i) as proposed, except for a technical revision that replaces the phrase ''by customer orgin and house origin'' with ''by house origin and by each customer origin,'' which conforms the language with other provisions of part 39. OCC requested that the Commission clarify that proposed § 39.13(h)(i) would not apply to securities accounts of broker-dealers that are not FCMs and do no futures business. The Commission does not intend for § 39.13(h)(i) to apply to such accounts. The Commission is also adopting § 39.13(h)(ii) as proposed.

b. Large Trader Reports—§ 39.13(h)(2)

Proposed § 39.13(h)(2) would require a DCO to obtain from its clearing members, copies of all reports that such clearing members are required to file with the Commission pursuant to part 17 of the Commission's regulations, *i.e.,* large trader reports. Large trader reports are necessary for stress testing to ensure that FCMs and their customers have not taken on too much risk. A DCO would be required to obtain such reports directly from the relevant reporting market if the reporting market exclusively listed self-cleared contracts, and would therefore be required to file such reports on behalf of clearing members pursuant to § 17.00(i).

Proposed § 39.13(h)(2) would further require a DCO to review the large trader reports that it receives from its clearing members, or reporting markets, as applicable, on a daily basis to ascertain the risk of the overall portfolio of each large trader. A DCO would be required to review positions for each large trader, across all clearing members carrying an account for the large trader. A DCO would also be required to take additional actions with respect to such clearing members in order to address any risks posed by a large trader, when appropriate. Such actions would include those actions specified in proposed § 39.13(h)(6).[152]

FIA supported the proposal to require DCOs to obtain copies of all large trader reports that are filed with the Commission. MGEX commented that the Commission should provide large trader reports to each DCO rather than imposing a requirement that would require clearing members to make redundant filings. KCC argued that the proposed requirement that DCOs obtain large trader reports from clearing members is duplicative because a DCO receives large trader information from the exchange.[153]

MGEX recommended that the Commission perform the review of large trader reports itself or permit a clearing member's DSRO to perform such review instead of DCOs.

NYPC recommended that the Commission not adopt proposed § 39.13(h)(2) because the Commission has expended considerable resources to modify its own internal programs and processes in order to glean potentially relevant financial and risk management information from the large trader data that it receives from clearing members and DCMs, and even if DCOs had comparable financial and human resources that they could deploy for such a purpose, the information that they would obtain would frequently be fragmented and inconclusive, given that—unlike the Commission—no single DCO will ever have access to information relating to the futures, option and swap positions that are cleared by other DCOs or to uncleared swaps. NYPC further argued that given the necessary technology builds, it would need more than three years to come into compliance with proposed §§ 39.13(g)(8)(i) and 39.13(h)(2).

OCC indicated that it should be the role of a clearing member's DSRO to require that an FCM submit sufficient information to permit the DSRO to identify customer accounts that could potentially cause a clearing member to

[152] See discussion of § 39.13(h)(6), adopted herein, in section IV.D.7.f, below.

[153] KCC further noted that, in its case, the exchange in turn receives the relevant large trader reports from the Commission.

default, and that if DCOs were required to perform all tasks required by the proposed rules alone, they would be required to build new surveillance systems and significantly increase their surveillance staff.

In response to suggestions that the Commission should conduct the required review of large trader reports, the Commission notes that it does review large trader reports for financial, market, and risk surveillance purposes. However, the Commission believes that DCOs should also have an obligation to review large trader reports for those large traders whose trades they clear, for their own risk surveillance purposes, even though as noted by NYPC, they may not have access to information relating to positions cleared by other DCOs or to uncleared swaps. Moreover, § 39.13(h)(2) requires a DCO to review such large trader reports with a view toward taking any necessary additional actions with respect to such large traders' clearing members in order to address risks posed by such large traders to the DCO.

In addition, it would not be feasible for a clearing member's DSRO to review large trader reports. DSRO designations apply to FCMs that are members of multiple DCMs. Therefore, clearing members that only trade for their own accounts do not have a DSRO. Clearing members that solely clear SEF-executed trades also will not have DSROs. Moreover, risk management ultimately is the responsibility of each DCO. A DSRO would not be in a position to analyze the daily risk of the overall portfolio of each large trader at a particular DCO, nor to take any additional actions to address such risks at a particular DCO.

KCC stated that it is the clearing member's obligation to determine the financial fitness of large trader customers, in that clearing members have better, more direct information regarding the credit quality of the customer and the exposures of the customer under positions the customer may hold outside the DCO. KCC stated its belief that imposing a duplicative requirement on DCOs would achieve little risk management benefit at a high cost. The Commission agrees that clearing members must determine the financial capacity of their customers and they may have information which a particular DCO may not have regarding positions that they may clear for their customers on other DCOs.[154] However, this does not obviate the need for each relevant DCO to ascertain the risks that the large trader poses to that DCO based on the information which the DCO is able to obtain through large trader reports.

ISDA noted that while the expansion of oversight required by proposed §§ 39.13(h)(2) and § 39.13(h)(3) [155] may provide benefits, many DCOs do not currently have the systems or infrastructure to monitor or assess non-clearing member risk.[156]

In response to ISDA's comment, as well as other comments that in order to comply with § 39.13(h)(2), DCOs would need technology builds (NYPC), new surveillance systems and additional surveillance staff (OCC), and that there would be a high cost (KCC), the Commission notes that some DCOs already receive and review large trader reports for risk surveillance purposes on a daily basis. In fact, KCC stated in its comment letter that ''KCC would also remind the Commission that DCO compliance staff review the reportable position files that they receive on a daily basis to ascertain large trader risks that [clearing members] face.'' In addition, at least five years ago, Commission staff began recommending that DCOs do so, if they had not already been doing so, in DCO reviews that Commission staff has conducted to determine whether such DCOs were in compliance with relevant core principles under the CEA.

The Commission is modifying § 39.13(h)(2) to require a DCO to obtain large trader reports either from its clearing members or from a DCM or a SEF for which it clears, which are required to be filed with the Commission by, or on behalf of, such clearing members. However, the Commission does not believe that it is practical or appropriate for a DCO to rely on the Commission to provide large trader reports to the DCO.

The Commission is adopting § 39.13(h)(2) with the modifications described above.

c. Stress Tests—§ 39.13(h)(3)

Proposed § 39.13(h)(3) would require a DCO to conduct certain daily and weekly stress tests. The Commission has defined a ''stress test'' in § 39.2, adopted herein, as ''a test that compares the impact of potential extreme price moves, changes in option volatility, and/or changes in other inputs that affect the value of a position, to the financial resources of a derivatives clearing organization, clearing member, or large trader, to determine the adequacy of such financial resources.'' [157]

Proposed § 39.13(h)(3)(i) would require a DCO to conduct daily stress tests with respect to each large trader who poses significant risk to a clearing member or the DCO in the event of default, including positions at all clearing members carrying accounts for the large trader. The DCO would have reasonable discretion in determining which traders to test and the methodology used to conduct the stress tests. However, the Commission could review the selection of accounts and the methodology and require changes, as appropriate.

Proposed § 39.13(h)(3)(ii) would require a DCO to conduct stress tests at least once a week with respect to each account held by a clearing member at the DCO, by customer origin and house origin, and each swap portfolio, by beneficial owner, under extreme but plausible market conditions. The DCO would have reasonable discretion in determining the methodology used to conduct the stress tests. However, the Commission could review the methodology and require any appropriate changes. The Commission requested comment regarding whether all clearing member accounts, by origin, and all swap portfolios should be subject to such stress tests on a weekly basis or whether some other time period, such as monthly, would be sufficient to meet prudent risk management standards.

Several commenters addressed daily stress testing. FIA recommended that all of the proposed stress tests should be conducted on a daily basis. LCH stated its belief that stress testing requirements should not be extended to cover large traders that are clients of clearing

[154] The Commission is modifying the language in proposed § 39.13(h)(2), which would have referred to ''positions at all clearing members carrying accounts for each such large trader'' by revising it to read as follows: ''futures, options, and swaps cleared by the [DCO] which are held by all clearing members carrying accounts for each such large trader.'' This will make it clear that the Commission is not attempting to require a DCO to review a large trader's positions that were cleared by another DCO, as it would not typically have access to information about such positions. The technical change from ''positions'' to ''futures, options, and swaps'' conforms the language with other provisions of part 39.

[155] See discussion of § 39.13(h)(3), adopted herein, in section IV.D.7.c, below.

[156] ISDA also stated that further clarity regarding how the Commission intends to apply the large trader definition to swaps is needed. The Commission notes that it has begun this process by adopting final rules for Large Trader Reporting for Physical Commodity Swaps, in a new part 20, at 76 FR 43851 (July 22, 2011). Since these large trader reporting rules were adopted subsequent to the Commission's proposal of § 39.13(h)(2), the Commission is modifying § 39.13(h)(2) to refer to reports required to be filed with the Commission by, or on behalf of, clearing members pursuant to parts 17 and 20 of this chapter.

[157] *See* further discussion of § 39.2 in section III.B, above.

members but that the proposed weekly stress tests should be conducted daily. OCC stated that it did not see a sufficient benefit to justify the increased DCO resources that would be required to undertake daily stress tests on each large trader,[158] noting that the costs would be passed on to clearing members and their customers. MGEX indicated that a requirement for daily stress testing of large traders seems excessive since the data may be dated even after one day and may not be more relevant than doing an average stress test over a weekly or monthly period. MGEX also expressed the view that the value of stress testing large traders is diminished if they have accounts with different clearing members.

As stated above, proposed § 39.13(h)(3)(i) would require a DCO to include positions at all clearing members carrying accounts for the large trader in the required stress tests. The Commission is making the same change to § 39.13(h)(3)(i) that it is making to § 39.13(h)(2) by replacing the reference to ''positions at all clearing members carrying accounts for each such large trader'' with ''futures, options, and swaps cleared by the derivatives clearing organization, which are held by all clearing members carrying accounts for each such large trader.''

KCC stated its belief that the frequency of stress testing should be left to the discretion of the DCO and should be risk-based in light of prevailing market conditions. NOCC indicated that products, customers or spread credits should reach a specified volume or risk exposure level before being required to be stress tested with the proposed frequencies so long as the DCO can demonstrate that it is meeting the core principle objectives underlying proposed § 39.13(f).[159]

The Commission believes that it is appropriate to specify the minimum frequency of stress tests as set forth in § 39.13(h)(3). As noted above, several commenters supported certain daily stress testing requirements. With the exception of KCC's and NOCC's comments, no commenters suggested that stress tests should be conducted less frequently than weekly.

LCH recommended that the Commission prescribe that the stress scenarios used by the DCO in its testing should be adapted for current market conditions such that price or market shifts should not be translated literally, but rather proportionally. The Commission believes that § 39.13(h)(3) should explicitly permit DCOs to exercise reasonable discretion in determining the methodology to be used in conducting the required stress tests. The Commission would recognize the approach suggested by LCH to be an appropriate element of a DCO's stress testing methodology, but does not believe that it is necessary to adopt such a prescriptive requirement.

OCC indicated that for regulatory reasons associated with OCC's status as a dual SEC/Commission registrant, OCC's system does not consolidate all positions into a single ''customer origin'' and ''house origin'' for each clearing member, but rather permits multiple account types, including a firm (proprietary) account that incorporates both securities and futures positions, a securities customers' account, a regular futures customer segregated funds account subject to Section 4d of the CEA, separate segregated funds accounts for cross-margining arrangements as provided in various Commission orders approving such arrangements, and others. OCC further stated that because of the mathematical properties of the risk measures that it uses, its unconsolidated account level stress testing is more rigorous than if such stress testing were conducted at the level of each origin as a whole and argued that it makes sense to aggregate positions for stress testing in the same manner as they would be aggregated or netted for liquidation purposes. Therefore, OCC requested that the Commission clarify that this method of stress testing at the unconsolidated account level based on appropriate historical data would meet the requirements of proposed § 39.13(h)(3)(ii). The Commission agrees with OCC that it would be appropriate for a DCO to conduct the stress tests required by § 39.13(h)(3)(ii) with respect to separate house origin and customer origin accounts such as the house account that incorporates both securities and futures positions identified by OCC,[160] separate customer accounts subject to Sections 4d(a) and 4d(f) of the CEA, respectively, or cross-margining accounts.

OCC also argued that while the requirement of conducting stress tests under ''extreme but plausible'' market conditions may be appropriate for determining the adequacy of a clearing organization's resources for withstanding the default of its largest participant, it would be inappropriate for measuring the adequacy of an individual clearing member's margin deposits. In particular, OCC expressed its belief that stress testing the positions, including margin assets, in clearing member accounts on a daily basis to ensure a positive liquidating value at more than a 99 percent confidence level is adequate and appropriate and that DCOs should have the ability to cover for more extreme market conditions through the use of additional financial resources, including clearing fund deposits.

A stress test, as defined by the Commission, is not designed to measure the adequacy of a clearing member's margin deposits or to ensure that margin assets in clearing members' accounts meet a 99 percent confidence level. Rather, these are the functions of the daily review and back testing required by §§ 39.13(g)(6) and (g)(7), adopted herein.[161] Stress tests address the adequacy of the applicable financial resources to cover losses resulting from potential extreme price moves, changes in option volatility, and/or changes in other inputs that affect the value of a position. In other words, if margin deposits would be sufficient to cover losses 99 percent of the time, stress tests would determine whether other financial resources would be available and sufficient to cover losses the remaining 1 percent of the time. Such other financial resources could include the capital of the clearing member or the DCO, or a DCO's guaranty fund.

The Commission is adopting § 39.13(h)(3) with the modifications described above.

d. Portfolio Compression—§ 39.13(h)(4)

Proposed § 39.13(h)(4)(i) would require a DCO to offer multilateral portfolio compression exercises, on a regular basis, for its clearing members that clear swaps, to the extent that such

[158] As noted above, proposed § 39.13(h)(3)(i) would not require daily stress tests on each large trader, but only with respect to those large traders who pose significant risk to a clearing member or the DCO in the event of default.

[159] NOCC made a similar comment with respect to the frequency of back testing, which is discussed in section IV.D.6.g,, above. The Commission does not believe that it is appropriate to adopt a regulation establishing an exemption process with respect to stress testing requirements based on volume or risk exposure or otherwise.

[160] A DCO that is dually-registered as a securities clearing agency would not be subject to the stress testing requirements of § 39.13(h)(3)(ii) with respect to an account that only contains securities positions. However, such a DCO would be subject to the requirements of § 39.13(h)(3)(ii) with respect to any relevant account that contains positions in instruments regulated by the Commission, even if that account also contains securities positions. In this regard, the Commission is revising § 39.13(h)(3)(ii) to refer to ''each clearing member account, by house origin and by each customer origin, and each swap portfolio, including any portfolio containing futures and/or options and held in a commingled account pursuant to § 39.15(b)(2) of this part, * * *''

[161] See discussion of §§ 39.13(g)(6) and (g)(7) in section IV.D.6.g, above.

exercises are appropriate for those swaps that it clears. The Commission requested comment regarding whether such exercises should be offered monthly, quarterly, or on another frequency. In addition, the Commission requested comment regarding whether the frequency of such exercises should vary for different categories of swaps.

Proposed § 39.13(h)(4)(ii) would mandate that a DCO require its clearing members to participate in all multilateral portfolio compression exercises offered by the DCO, to the extent that any swap in the applicable portfolio was eligible for inclusion in the exercise, unless including the swap would be reasonably likely to significantly increase the risk exposure of the clearing member.

Proposed § 39.13(h)(4)(iii) would permit a DCO to allow clearing members participating in such exercises to set risk tolerance limits for their portfolios, provided that the clearing members could not set such risk tolerances at an unreasonable level or use such risk tolerances to evade the requirements of proposed § 39.13(h)(4).

CME commended the Commission for recognizing the importance of portfolio compression exercises as an important risk management tool. CME further suggested that the Commission refrain from prescribing the frequency of such exercises, stating its belief that each DCO is best positioned to determine the optimal frequency of portfolio compression exercises for the swaps that it clears, based on the unique characteristics of the particular products and markets. On the other hand, the FHLBanks stated that the Commission should specify how often portfolio compression exercises are to take place. The Commission agrees with CME and is retaining the language that simply refers to ''a regular basis.''

ISDA requested that the Commission clarify the meaning of ''multilateral portfolio compression'' in these proposals. ISDA stated that if the Commission is referring to position netting, then it agrees that a DCO must offer such exercises. However, ISDA indicated that if it refers to the provision of multilateral portfolio compression services such as those currently provided by entities such as TriOptima, DCOs should not be required to build such duplicative services, which would be likely to delay their roll-out of comprehensive clearing services. The Commission agrees that a DCO should not be required to incur the expense of building its own multilateral compression services. Therefore, the Commission is modifying the requirement to make it clear that although a DCO may develop its own portfolio compression services if it chooses, it is only required to make such exercises available to its clearing members if applicable portfolio compression services have been developed by a third party for those swaps that it clears.[162]

The FHLBanks urged the Commission to further define ''reasonably likely to increase risk exposure to a clearing member'' to include the risk exposures of a clearing member's customers, and also stated their view that a clearing member's customers must have the ability to ''opt-out'' of portfolio compression requirements to the extent that those customers' swap positions need to be retained for hedge accounting and other business purposes. In particular, the FHLBanks expressed their concern that the proposal's ambiguities would cause the internal risk management strategies of entities that are not swap dealers or major swap participants to be adversely affected, noting that portfolio compression could potentially jeopardize hedge accounting treatment for customers' swap transactions and disrupt anticipated cash flows.

LCH stated that it strongly supports the use of compression services and believes that they should be encouraged by the Commission to the greatest extent possible, but it would not necessarily always be appropriate for a DCO to require its clearing members to participate in all such exercises. First, LCH noted that a DCO's clearing members may not always be subject to the Commission's supervision and may not be required to engage in such compression activities; therefore imposing such a requirement on the DCO may discourage such firms from becoming clearing members of that DCO and thereby have the perverse effect of discouraging such firms from clearing. Second, LCH stated that a clearing member may have legitimate reasons for not participating in such compression exercises at all times, or for not submitting all eligible swaps to such exercises. Therefore, LCH took the position that the use of compression services should be encouraged but should not be compulsory, and suggested that the Commission eliminate § 39.13 (h)(4)(ii) in its entirety. For the reasons stated by LCH and the FHLBanks, the Commission is modifying § 39.13(h)(4) to provide that participation in compression exercises by clearing members and their customers would be voluntary.

[162] This also addresses the FHLBanks' comment that the Commission should specify what types of swaps are to be included in portfolio compression exercises.

e. Clearing Members' Risk Management Policies and Procedures—§ 39.13(h)(5)

Proposed § 39.13(h)(5) would impose several requirements upon DCOs relating to their clearing members' risk management policies and procedures. Specifically, a DCO would be required to adopt rules that: (a) require its clearing members to maintain current written risk management policies and procedures (proposed § 39.13(h)(5)(i)(A)); (b) ensure that the DCO has the authority to request and obtain information and documents from its clearing members regarding their risk management policies, procedures, and practices, including, but not limited to, information and documents relating to the liquidity of their financial resources and their settlement procedures (proposed § 39.13(h)(5)(i)(B)); and (c) require its clearing members to make information and documents regarding their risk management policies, procedures, and practices available to the Commission upon the Commission's request (proposed § 39.13(h)(5)(i)(C)).

In addition, proposed § 39.13(h)(5)(ii) would require a DCO to review the risk management policies, procedures, and practices of each of its clearing members on a periodic basis and document such reviews. The Commission invited comment regarding whether it should require that a DCO must conduct risk reviews of its clearing members on an annual basis or within some other time frame. The Commission also requested comment regarding whether it should require that such reviews be conducted in a particular manner, *e.g.,* whether there must be an on-site visit or whether any particular testing should be required. In addition, the Commission invited comment regarding whether, and to what extent, a DCO should be permitted to vary the method and depth of such reviews based upon the nature, risk profiles, or other regulatory supervision of particular clearing members.

ISDA and FIA supported the proposed requirement in § 39.13(h)(5)(i)(A) that clearing members must have written risk management policies and procedures. FIA also recommended that clearing members should be required to have adequate staff and systems to monitor customer risk on a real-time or near-real time basis and to routinely test their risk management procedures under theoretical stress scenarios.

NGX stated that the requirement that clearing members have and follow risk management policies is a sensible requirement in the context of the

typical, intermediated clearinghouse.However, NGX argued that such requirements should not apply to a non-intermediated DCO such as NGX, where clearing participants are commercial end users, trading and clearing for their own accounts, and none of the clearing participants are exposed to the default risk of any other clearing participant or to that of fellow customers of a clearing participant.

The Commission believes that it is appropriate for a DCO to require all of its clearing members to maintain written risk management policies and procedures, regardless of whether such clearing members have customer business or are exclusively self-clearing. As noted above, the Commission believes that written policies are a crucial component of any risk management framework. Moreover, § 39.13(h)(5)(i)(A) does not specify the nature or extent of the required written risk management policies and procedures, which could vary as appropriate to a particular type of clearing member, subject to the requirements of any other applicable Commission regulations.[163]

The Commission has not proposed and is not adopting the additional requirements suggested by FIA, described above, as part of this rulemaking. However, the Commission has proposed additional requirements with respect to clearing members' risk management policies and procedures in a separate rulemaking applicable directly to clearing members.[164]

With respect to the proposed requirement in § 39.13(h)(5)(i)(C) that a DCO must have rules requiring its clearing members to make information regarding their risk management policies, procedures, and practices available to the Commission, MGEX stated that the Commission should seek access to a clearing member's risk management policies and processes directly and a DCO should not act as an unnecessary conduit between the Commission and clearing members. The Commission notes that even if it were to propose a regulation to impose such a requirement directly on clearing members in the future, it does not preclude the Commission from requiring DCOs to impose this requirement on their clearing members at this time.[165]

LCH stated that it concurs with the provisions of proposed § 39.13(h)(5) but suggested that the Commission limit the requirements under proposed paragraph (h)(5)(C) so that they would be applicable only to those clearing members that are subject to the Commission's oversight and not to all clearing members of a DCO regardless of the jurisdiction in which they operate. The Commission notes that risk management practices of clearing members of registered DCOs, to the extent that such clearing members are clearing products subject to the Commission's oversight, are of importance to the Commission in its capacity as the regulator of the DCO. For purposes of risk management oversight, there is no basis for differentiating among clearing members because of their registration status or domicile. Although the Commission does not directly supervise non-registrants, the Commission has previously adopted rules that apply to clearing members, whether or not they are Commission registrants, *e.g.,* §§ 1.35(b) and (c) (recordkeeping requirements), and Part 17 of the Commission's regulations (reporting requirements). Section 39.13(h)(5)(C) is consistent with the Commission's approach with respect to such other rules, and is an appropriate component of the regulatory framework for DCO risk management.

With regard to the proposed requirement in § 39.13(h)(5)(ii) that a DCO must review the risk management policies, procedures, and practices of each of its clearing members on a periodic basis, FIA stated that all clearing members should be subject to on-site audits at least annually. NGX suggested that if the Commission requires non-intermediated DCOs to require their members to have written risk management policies, the Commission should provide guidance that a non-intermediated DCO would not be required to conduct on-site audits of clearing participants and that the DCO would meet its obligations to review the policies of such clearing participants if it does so only on a for-cause basis.

The Commission is adopting § 39.13(h)(5)(ii) as proposed, without prescribing the specific frequency, depth, or methodology of such reviews, and without specifying when an on-site audit may or may not be appropriate. The Commission believes that such a review is important to ensure that each clearing member's risk management framework is sufficient and properly implemented. The Commission also believes that a DCO should be permitted to exercise reasonable discretion with respect to each of these matters, based upon the nature, risk profiles, or other regulatory supervision of particular clearing members. The requirement that such reviews must be conducted on a ''periodic basis'' means that reviews must be conducted routinely and, therefore, the requirement would not permit a DCO to only conduct such reviews on a for-cause basis.

A number of commenters noted that many clearing members are clearing members of multiple DCOs and thus could be subject to multiple duplicative risk reviews. CME, OCC, MGEX, ICE, and NYPC indicated that this would be burdensome for such clearing members. For example, MGEX noted ''the burden a clearing member may be faced with due to duplication of efforts and associated costs.'' KCC indicated that such duplicative reviews would achieve little with great expenditure of resources.

OCC and NYPC also expressed their concerns about the costs to DCOs. In particular, OCC noted that requiring DCOs to conduct such reviews would impose a very high cost on a DCO that is not integrated with a DCM. NYPC noted its concern that the Commission may be underestimating the immensity of conducting such reviews in that a clearing member's risk management plan will not address solely the risks associated with clearing membership, but will be integrated and cover the broad spectrum of risks, including market, credit, liquidity, capital, and operational risk, that are associated with the entirety of the clearing member's securities, banking and futures business, much of which may have nothing to do with business through the DCO.

In order to address NYPC's specific concern, the Commission is modifying § 39.13(h)(5)(i)(A) to add the qualifier ''which address the risks that such clearing members may pose to the derivatives clearing organization'' after ''risk management policies and procedures'' and is adding the same qualifier in § 39.13(h)(5)(ii) after ''risk

[163] For example, in a separate rulemaking, proposed § 23.600 would set forth detailed requirements for the risk management programs of swap dealers and major swap participants, and would require such entities to maintain written procedures and policies describing their Risk Management Programs. *See* 75 FR 71397 (Nov. 23, 2010) (Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants). Such swap dealers and major swap participants may or may not be clearing members.

[164] *See* 76 FR 45724 (Aug. 1, 2011) (Clearing Member Risk Management). In that rulemaking, the Commission has proposed to require FCMs, swap dealers, and major swap participants, each of which are clearing members, to adopt certain specified risk management procedures, including written procedures to comply with the proposed requirements.

[165] In another context, *e.g.,* a DCM has adopted a rule that requires the operator of a DCM-approved delivery facility to '' * * * make such reports, keep such records and permit such facility visitation as the Exchange, the Commodity Futures Trading Commission or any other applicable government agency may require * * * .'' *See* CBOT Rule 703.A.

management policies, procedures, and practices of each of its clearing members.''

To reduce the potential burden of duplicative risk reviews of clearing members that are clearing members of multiple DCOs, CME and NYPC urged the Commission to give each DCO reasonable discretion regarding the frequency, scope, or manner in which it conducts risk reviews of its clearing members, taking into account various factors including other regulatory supervision, or review by a governmental entity or self-regulatory organization, of particular firms. Other commenters variously suggested that risk reviews should be conducted by the Commission (OCC and MGEX), by the clearing member's DSRO or a similar DCO industry group (KCC, OCC, ICE, and MGEX), or by NFA (OCC).

The Commission notes that the current DSRO system is not a viable option for reviewing clearing members' risk management policies, procedures and practices. Because DSROs are only responsible for conducting examinations of DCM-member FCMs' compliance with financial requirements, clearing members that only engage in house trading do not have a DSRO, nor will clearing members that solely clear SEF-executed trades. Moreover, such examinations do not address all of the risk issues which would concern a particular DCO. Furthermore, even if the current DSRO system were expanded to include DCOs, or a similar industry group composed of DCOs were formed, it would be impractical to allocate the responsibility to one DCO to analyze the risk management policies, procedures and practices of a common clearing member, on behalf of all relevant DCOs, when each DCO may impose different risk management requirements on its clearing members and each DCO may have differing margin methodologies that call for different risk management responses from clearing members.

The Commission does not believe that it should assume the sole oversight of the risk management policies, procedures, and practices of clearing members of DCOs. The Commission conducts risk surveillance with respect to both DCOs and clearing members; however, this cannot replace a DCO's obligation to ensure that its clearing members are appropriately managing the risks that such clearing members pose to that particular DCO. Similarly, it does not appear that NFA would be an efficient alternative. The Commission recognizes that certain DCMs have entered into regulatory services agreements with NFA, and that NFA has thereby assumed certain audit responsibilities with respect to FCMs that are members of those DCMs. However, a DCO remains in the best position to review the risk management policies, procedures, and practices of its clearing members in the context of their obligations to that particular DCO.

The Commission is adopting § 39.13(h)(5) with the modifications described above.

f. Additional Authority—§ 39.13(h)(6)

Proposed § 39.13(h)(6) would require a DCO to take additional actions with respect to particular clearing members, when appropriate, based on the application of objective and prudent risk management standards. Such actions could include, but would not be limited to: (i) Imposing enhanced capital requirements; (ii) imposing enhanced margin requirements; (iii) imposing position limits; (iv) prohibiting an increase in positions; (v) requiring a reduction of positions; (vi) liquidating or transferring positions; and (vii) suspending or revoking clearing membership.

KCC stated that it generally supports the concept that DCOs should impose heightened risk management requirements on clearing members as their risk profiles change and requested that the Commission clarify whether each of the potential heightened risk management requirements enumerated in proposed § 39.13(h)(6)(i)–(vii) must be explicitly delineated in DCO rules or in the DCO's clearing membership agreement. The Commission believes that a DCO must have the authority and ability to take appropriate additional actions with respect to particular clearing members, as described in § 39.13(h)(6), but how the DCO asserts such authority, whether by rule or contractual agreement, should be left to the discretion of the DCO.

J.P. Morgan expressed the view that higher margin multipliers should be adopted for members who present a higher risk profile as a result of excessive concentration of risk cleared, reduced creditworthiness, or other factors affecting a particular member, and that such margin multipliers should be documented in risk management policies applicable to all members.

J.P. Morgan's concern that margin multipliers should be applied to clearing members with a higher risk profile, is addressed in § 39.13(h)(1), adopted herein and discussed in section IV.D.7.a, above, which requires a DCO to impose risk limits on each clearing member.

The Commission is adopting § 39.13(h)(6) as proposed.

E. Core Principle E—Settlement Procedures—§ 39.14

Core Principle E,[166] as amended by the Dodd-Frank Act, requires a DCO to: (1) Complete money settlements on a timely basis, but not less frequently than once each business day; (2) employ money settlement arrangements to eliminate or strictly limit its exposure to settlement bank risks (including credit and liquidity risks from the use of banks to effect money settlements); (3) ensure that money settlements are final when effected; (4) maintain an accurate record of the flow of funds associated with money settlements; (5) possess the ability to comply with the terms and conditions of any permitted netting or offset arrangement with another clearing organization; (6) establish rules that clearly state each obligation of the DCO with respect to physical deliveries; and (7) ensure that it identifies and manages each risk arising from any of its obligations with respect to physical deliveries. The Commission proposed § 39.14 to establish requirements that a DCO would have to meet in order to comply with Core Principle E.[167]

1. Definitions—§ 39.14(a)

''Settlement'' was defined in proposed § 39.14(a)(1) to include: (i) Payment and receipt of variation margin for futures, options, and swap positions; (ii) payment and receipt of option premiums; (iii) deposit and withdrawal of initial margin for futures, options, and swap positions; (iv) all payments due in final settlement of futures, options, and swap positions on the final settlement date with respect to such positions; and (v) all other cash flows collected from or paid to each clearing member, including but not limited to, payments related to swaps such as coupon amounts. ''Settlement bank'' was defined in proposed § 39.14(a)(2) as ''a bank that maintains an account either for the [DCO] or for any of its clearing members, which is used for the purpose of transferring funds and receiving transfers of funds in connection with settlements with the [DCO].''

ISDA and FIA commented that posting of variation margin on swaps should not be viewed as ''settling'' the present value of the trade and noted that price alignment interest would still be paid on variation margin. ISDA stated that, similarly, initial margin is not ''paid'' by a clearing member to a DCO

[166] Section 5b(c)(2)(E) of the CEA, 7 U.S.C. 7a–1(c)(2)(E) (Core Principle E).

[167] Without addressing any specific aspect of proposed § 39.14, LCH commented that it agrees with the Commission's proposals for settlement procedures.

but is often posted with a security interest granted by the clearing member. FIA also commented that the deposit and withdrawal of initial margin is not properly defined as a settlement.

NGX stated that, with the exception of a relatively small power contract, its clearing model does not require daily variation margin payments and collections from its clearing participants; rather, it holds collateral (initial margin) in an account at a depository bank rather than in a settlement account, and additional collateral may be called for as required. Therefore, NGX stated that it would be clearer when applied to the NGX model, to use the term ''payment and receipt'' rather than the term ''deposit'' when referring to initial margin.

The Commission proposed a broad definition of ''settlement'' in § 39.14(a)(1) to encompass all cash flows between clearing members and a DCO. The Commission recognizes that accounts that are used for the payment and receipt of variation margin are frequently called settlement accounts, while accounts that are used for the deposit and withdrawal of initial margin may be called deposit accounts, or custody accounts, if the initial margin deposited therein is in the form of securities. The definition of ''settlement bank'' in § 39.14(a)(2) was intended to encompass any bank that a DCO uses for settlements, as defined in § 39.14(a)(1), whether the relevant accounts are called settlement accounts, deposit accounts, or custody accounts. In order to avoid confusion, the Commission is modifying § 39.14(a)(2) to define a settlement bank simply as ''a bank that maintains an account either for the [DCO] or for any of its clearing members, which is used for the purpose of any settlement described in paragraph (a)(1) above.'' The Commission is adopting § 39.14(a)(1) as proposed, except for a non-substantive change, which replaces each reference to ''futures, options, and swap positions'' with ''futures, options, and swaps.''

2. Daily Settlements—§ 39.14(b)

Proposed § 39.14(b) would require a DCO to effect a settlement with each clearing member at least once each business day, and to have the authority and operational capacity to effect a settlement with each clearing member, on an intraday basis, either routinely, when thresholds specified by the DCO were breached, or in times of extreme market volatility.

CME expressed its support for intra-day settlements. LCH suggested that a DCO must measure its credit exposures ''several times each business day,'' and should be obliged to recalculate initial and variation margin requirements more than once each business day. J.P. Morgan stated that intraday margin calls should be made with greater frequency for clearing members who have a higher risk profile.

The Commission does not believe that it is necessary to adopt a requirement that all DCOs recalculate initial and variation margin requirements more than once each business day or an explicit requirement for intraday margin calls for clearing members with a higher risk profile. The Commission believes that it has struck the appropriate balance in § 39.14(b), by requiring a DCO to conduct daily settlements, while permitting a DCO to exercise its discretion regarding whether it will conduct routine intraday settlements, or whether it will settle positions on an intraday basis only when certain thresholds are breached [168] or in times of extreme market volatility. This approach is also generally consistent with proposed international standards.[169] A particular DCO could determine to conduct routine intraday settlements, as some have done, or to conduct intraday settlements for particular clearing members based on their risk profiles.

NEM, NGX, and NOCC all requested that the Commission afford recognition to a clearing model that does not require daily variation margin payments and collections but permits accrual accounting with respect to certain energy products.

NEM noted that most Retail Energy Marketers (REMs) [170] use an accrual accounting practice that recognizes revenues and costs after energy delivery to their retail customers and that clearing solutions that require daily cash settlements would either complicate their accounting practices or significantly impact REM cash flows.

NGX stated that its clearing model generally does not require daily variation margin payments and collections, and that settlement on its energy contracts [171] occurs only on a monthly basis, after clearing participant obligations have been netted, consistent with practices in the cash market and with the end-user nature of the vast majority of NGX clearing participants. NGX noted that, therefore, the type of daily settlement risk that proposed § 39.14 addresses is not present in the NGX model and the degree of risk in the monthly settlement process is reduced.

Although NOCC supported adoption of proposed § 39.14(b) for traditional futures and cleared swaps, it indicated that it intends to develop a clearinghouse that will seek registration as a DCO to clear energy products, including commercial forward contracts that it believes will be outside the scope of regulation as futures contracts or as swaps under the CEA, as well as financial forwards that it believes will fall within the definition of swaps under the CEA. NOCC stated that while gains and losses on the commercial forward contracts and financial forwards that it intends to clear are calculated daily, they are accrued throughout the delivery period and following the delivery period, and are not cash settled until final payment occurs approximately three weeks after the month in which the commodity is delivered. NOCC proposed that the Commission adopt a rule that would permit exemptions for alternative risk management frameworks, which would provide NOCC with the ability to demonstrate to the Commission that daily accrual settlement of variation margin is a sound practice appropriately tailored to the unique characteristics of the cash energy markets and market participants for which NOCC is seeking to provide the benefits of clearing.

The Commission has not proposed and is not adopting a rule permitting exemptions for alternative risk management frameworks. However, a particular DCO may petition the Commission for an exemption if it believes that it can demonstrate that the daily accrual of gains and losses provides the same protection to the DCO as would daily variation margin payments and collections. Therefore, the Commission is adding a clause to § 39.14(b) that states ''[e]xcept as otherwise provided by Commission order'' prior to the requirement that a DCO ''shall effect a settlement with each clearing member at least once each business day.''

[168] *E.g.*, a DCO could establish thresholds that relate to the extent of market volatility, or with respect to a particular clearing member, the extent of losses that it has suffered on a particular day or whether it has reached a risk limit established by the DCO pursuant to § 39.13(h)(1)(i), which is discussed in section IV.D.7.a, above.

[169] *See* CPSS–IOSCO Consultative Report, Principle 6: Margin, Key Consideration 4, at 40; EMIR, Article 39, paragraph 3, at 46.

[170] NEM stated that REMs ''sell electricity and natural gas to consumers as a competitive alternative to the local utility'' and ''often purchase wholesale physical natural gas and electricity on a spot (delivery) month (day) basis and also purchase swaps to lock in prices for any consumers who want a long-term fixed price contract.''

[171] NGX stated that it ''operates a trading and clearing system for energy products that provides electronic trading, central counterparty clearing and data services to the North American natural gas, electricity and oil markets.''

3. Settlement Banks—§ 39.14(c)

The introductory paragraph of proposed § 39.14(c) would require a DCO to employ settlement arrangements that eliminate or strictly limit its exposure to settlement bank risks, including the credit and liquidity risks arising from the use of such banks to effect settlements with its clearing members.

OCC commented that it would not be possible for a DCO to ''eliminate'' all exposure to settlement bank risks and that the Commission had not provided any guidance as to what it means to ''strictly limit'' such exposure. The Commission notes that the language in the introductory paragraph of proposed § 39.14(c), which would require a DCO to ''employ settlement arrangements that eliminate or strictly limit its exposure to settlement bank risks, including the credit and liquidity risks arising from the use of such banks to effect settlements * * *,'' is virtually identical to the statutory language in Core Principle E.[172] The Commission is adopting the introductory paragraph of § 39.14(c) with two modifications. First, in response to OCC's comment, the Commission is adding the words ''as follows:'' at the end of the sentence, in order to clarify that a DCO that complies with § 39.14(c)(1), (2), and (3), discussed below, will be deemed to have ''employ[ed] settlement arrangements that eliminate or strictly limit its exposure to settlement bank risks'' within the meaning of § 39.14(c). The Commission is also inserting parentheses around the letter ''s'' in the word ''banks'' in order to clarify that the Commission is not intending to require that a DCO must have more than one settlement bank in all circumstances. However, a DCO will need to have more than one settlement bank to the extent that it is reasonably necessary in order to eliminate or strictly limit the DCO's exposures to settlement bank risks, pursuant to § 39.14(c)(3), as further discussed below.

4. Criteria for Acceptable Settlement Banks—§§ 39.14(c)(1) and (c)(2)

Proposed § 39.14(c)(1) would require a DCO to have documented criteria with respect to those banks that are acceptable settlement banks for the DCO and its clearing members, including criteria addressing the capitalization, creditworthiness, access to liquidity, operational reliability, and regulation or supervision of such banks. Proposed § 39.14(c)(2) would require a DCO to monitor each approved settlement bank on an ongoing basis to ensure that such bank continues to meet the criteria established pursuant to § 39.14(c)(1). Proposed §§ 39.14(c)(1) and (c)(2) are consistent with international recommendations.[173]

NYPC agreed with the proposed requirement that DCOs must articulate the standards that they apply to the selection of settlement banks.

OCC indicated that a DCO may have to deviate from its written policies on the selection of clearing banks during a major market disruption, as those settlement banks that are the best options available at the time may not meet the technical criteria set forth in a DCO's written policies. The Commission agrees with OCC that a DCO may have to deviate from its written policies during a major market disruption. However, whether the Commission would permit a DCO to do so would need to be addressed in the context of the particular major market disruption, *e.g.,* based on an analysis of whether all available settlement banks no longer meet such written criteria.

MGEX commented that the Federal Reserve and other banking authorities are in the best position to review a bank's financial condition. NYPC recommended that the Commission modify the proposed rule to reflect the fact that the only criteria that are likely to be susceptible to observation by a DCO are a bank's operational reliability, regulatory capital, and the rating of its parent bank holding company. The Commission agrees that the Federal Reserve and other banking authorities may be in the best position to review a bank's financial condition and that there is certain information about settlement banks to which a DCO will not have regular access. Nonetheless, a DCO has a responsibility to undertake reasonable efforts to ensure that its settlement bank(s) continue to meet the criteria established by the DCO. A DCO may be able to obtain pertinent information from public sources, and it should be able to request and obtain information from an approved settlement bank, which demonstrates whether the bank continues to meet the criteria established by the DCO.

The Commission is adopting § 39.14(c)(1) with a modification that replaces the language that states: ''with respect to those banks that are acceptable settlement banks for the derivatives clearing organization and its clearing members'' with ''that must be met by any settlement bank used by the derivatives clearing organization or its clearing members.'' In addition, the Commission is inserting parentheses around the letter ''s'' in the word ''banks.'' Consistent with the modification to the introductory paragraph of § 39.14(c) described above, these modifications also clarify that there may be circumstances in which it may be appropriate for a DCO to use a single settlement bank. The Commission is adopting § 39.14(c)(2) as proposed.

5. Monitoring and Addressing Exposure to Settlement Banks—§ 39.14(c)(3)

Proposed § 39.14(c)(3) would require a DCO to monitor the full range and concentration of its exposures to its own and its clearing members' settlement banks and assess its own and its clearing members' potential losses and liquidity pressures in the event that the settlement bank with the largest share of settlement activity were to fail.[174] A DCO would be required to: (i) maintain settlement accounts at additional settlement banks; (ii) approve additional settlement banks for use by its clearing members; (iii) impose concentration limits with respect to its own or its clearing members' settlement banks; and/or (iv) take any other appropriate actions if any such actions are reasonably necessary in order to eliminate or strictly limit such exposures.

OCC commented that the requirement that a DCO monitor its clearing members' exposure to the settlement banks used by such clearing members could result in a massive duplication of effort and would be very burdensome for the DCO. Therefore, OCC suggested that clearing members or their primary regulators should be responsible for monitoring clearing members' exposure to their settlement banks.

The Commission does not agree with OCC that proposed § 39.14(c)(3) could result in a massive duplication of effort. The focus of the monitoring required by § 39.14(c)(3) is on a DCO's exposures and its clearing members' potential losses insofar as they may create exposures for the DCO. Therefore, each

[172] *See* Section 5b(c)(2)(E)(ii) of the CEA, 7 U.S.C. 7a–1(c)(2)(E)(ii).

[173] *See* CPSS–IOSCO Consultative Report, Principle 9: Money Settlements, Key Consideration 3, at 54.

[174] Some DCOs have their own settlement accounts at each settlement bank used by their clearing members, in which case a clearing member's settlement bank is also the DCO's settlement bank, and transfers between a clearing member's settlement account and a DCO's settlement account are made internally. Other DCOs permit their clearing members to use settlement banks at which such DCOs do not have their own settlement accounts, and settlement transfers are made between a clearing member's settlement bank and the DCO's settlement bank. In either event, the settlement bank with the largest share of settlement activity will always be a bank at which the DCO maintains a settlement account, as all settlement activity will involve the DCO.

DCO must conduct the required monitoring as each DCO's exposures are unique to that DCO. In addition, this provision of § 39.14(c)(3) is consistent with proposed international standards.[175]

NYPC commented that since initial and variation margin requirements fluctuate daily, proposed § 39.14(c)(3) would require DCOs to monitor their exposures to all settlement banks and not merely the largest. The Commission agrees with NYPC. Proposed § 39.14(c)(3) would require a DCO to ''monitor the full range and concentration of its exposures to its own and its clearing members' settlement banks,'' which means that a DCO must conduct such monitoring with respect to all such settlement banks. The reference to ''the settlement bank with the largest share of settlement activity'' was made in the context of requiring a DCO to assess the potential impact of the failure of such bank.

CME and OCC requested that the Commission clarify that a DCO would only be required to take any of the actions specified in proposed § 39.14(c)(3)(i)–(iv), if the specific action were reasonably necessary in order to eliminate or strictly limit exposures to settlement banks, and that a DCO would not be required to take all of the specified actions in all cases. CME supported this interpretation and OCC stated its belief that these requirements would be reasonable if the final rule were expressly limited in this manner. The Commission is modifying § 39.14(c)(3)(i)–(iv) to clarify the Commission's intent to obligate a DCO to employ any one or more of the actions specified in (i) through (iv), only if any one or more of such actions is reasonably necessary in order to eliminate or strictly limit such exposures.

CME, ICE, MGEX, and KCC variously commented that prescribing concentration limits and requiring that a DCO and its clearing members maintain multiple settlement banks would impose significant expenses on the DCO, its clearing members, and their customers. CME, MGEX, and NYPC stated their belief that it would be difficult to comply with this regulation given the limited number of banks that are qualified and willing to serve as settlement banks.[176] CME also commented that the meaning of ''concentration limits'' is unclear, and stated its belief that it would be unwise to impose artificial limits on the number of clearing members or the size of clearing member accounts at a particular settlement bank.

ICE took the position that hard concentration limits could increase systemic risk because a DCO would need to distribute funds across multiple banks. ICE indicated that as settlement funds increased, highly rated banks would eventually be consumed by the concentration limits and DCOs may have to open accounts with lower rated banks. ICE further commented that concentration limits could act as a constraint on customer choice, in that if one bank had a large number of settlement customers, there would be natural concentration of settlement flows, and the DCO could have to direct customers not to use their chosen bank.

NYPC also questioned whether current settlement banks would be willing to continue to act in that role if the Commission required a DCO and some of its clearing members to transfer their business to other banks. NYPC stated that this would leave the existing settlement banks with an expensive infrastructure supported by fewer client accounts.

MGEX stated its belief that requiring a DCO to oversee clearing members' banks and establishing credit or concentration limits would be intrusive and suggested that the final rule should provide DCOs with flexibility.

The Commission notes that proposed § 39.14(c)(3)(iii) would require a DCO to impose concentration limits with respect to its own or its clearing members' settlement banks if such action were reasonably necessary in order to eliminate or strictly limit its exposures to such settlement banks. Section 39.14(c)(3) would provide a DCO with other possible options for addressing such exposures. For example, a DCO could open an account at an additional settlement bank pursuant to § 39.14(c)(3)(i), or approve an additional settlement bank for use by its clearing members pursuant to § 39.14(c)(3)(ii), without imposing concentration limits, if doing so would mean that such limits would not be reasonably necessary. In addition, proposed § 39.14(c)(3)(iv) would allow a DCO to take other appropriate actions, which could obviate the potential need for concentration limits.

KCC commented that identifying multiple settlement banks for use by clearing members could increase a DCO's operational risk by fragmenting the DCO's margin pool. KCC suggested that there is no need for multiple settlement banks because there would be little effect on the operations of a DCO if a non-systemically significant settlement bank failed. KCC noted that the Federal Deposit Insurance Corporation generally facilitates the transfer of the accounts and operations of a failed bank to a successor institution or a bridge bank with little or no disruption to depositors at the failed bank. KCC further stated that a DCO's settlement account is essentially a pass-through account and DCOs generally do not maintain large, long-term balances in the account. According to KCC, even if a DCO held significant guaranty funds or security deposits at a settlement bank, such assets would likely be held in a trust or custody account, which would be unavailable to creditors of the failed institution and would generally be available to the DCO within a short period of time following the insolvency of the settlement bank. KCC also noted that a requirement that DCOs identify additional settlement banks for use by clearing members would cause a significant rise in bank service fees for DCOs and clearing members.

NGX noted that proposed § 39.14(c) generally refers to settlement banks, in the plural, assuming that all DCOs will maintain accounts with at least two settlement banks. NGX questioned the benefit of requiring all DCOs, regardless of size, to use multiple settlement banks. According to NGX, settlement risk varies across DCOs, and the type of daily settlement risk the proposed rule addresses is not present at a DCO like NGX, which does not engage in daily variation margin payments and collections from its clearing participants. NGX stated that the rule should take account of the level of settlement activity because requiring a DCO with a relatively small need for settlement services to divide the flow of funds may cause the DCO to be less attractive, bear higher costs, and be less competitive with larger DCOs, while having a negligible impact on systemic risk.[177] NGX also commented that the rule could result in increased operational risk at a DCO like NGX with complex contract settlement and delivery that requires a settlement bank to have specialized expertise and to maintain specialized processes and operational capabilities. NGX requested that the Commission provide the flexibility to permit a DCO to

[175] *See* CPSS–IOSCO Consultative Report, Principle 9: Money Settlements, Explanatory Note, 3.9.5, at 56.

[176] CME also expressed concern that, as drafted, the proposed regulation appears to require a DCO to approve at least two more settlement banks, because of the reference to ''settlement banks'' in the plural.

[177] However, NGX stated that where a DCO has daily settlements or monthly settlements in a greater amount, requiring more than one settlement bank may materially reduce systemic risk without adverse effects.

demonstrate that the use of a single settlement bank is appropriate from both a policy and a financial perspective.

As noted above, the Commission does not intend to require a DCO to use more than one settlement bank if the particular DCO otherwise employs settlement arrangements that eliminate or strictly limit its exposure to settlement bank risks. The Commission understands that the number of banks that are willing to serve settlement functions might be limited, particularly for smaller DCOs. The Commission further understands that it might be costly for some DCOs that currently only have one settlement bank to use an additional settlement bank. However, pursuant to § 39.14(c)(3), a DCO would be required to have a second settlement bank, if it were reasonably necessary in order to eliminate or strictly limit the DCO's exposures to settlement bank risks.

The Commission is modifying §§ 39.14(c)(3)(i) and (ii) to refer to ''one or more'' additional settlement banks, so that it will be clear that a DCO would not necessarily be required to maintain settlement accounts with more than one additional settlement bank or to approve more than one additional settlement bank that its clearing members could choose to use, under the specified circumstances. In addition, the Commission is modifying § 39.14(c)(3)(iii) to similarly clarify that a DCO may only be required to impose concentration limits with respect to ''one or more'' of its own or its clearing members' settlement banks, under the specified circumstances. The Commission is also modifying § 39.14(c)(3)(ii) by replacing ''for use by its clearing members'' with ''that its clearing members could choose to use'' to make it clear that the Commission is not suggesting that a single clearing member might be required to use more than one settlement bank.[178]

The Commission is adopting § 39.14(c)(3) with the modifications described above.

6. Settlement Finality—§ 39.14(d)

Proposed § 39.14(d) would require a DCO to ensure that settlement fund transfers are irrevocable and unconditional when the DCO's accounts are debited or credited. In addition, the proposed regulation would require that a DCO's legal agreements with its settlement banks must state clearly when settlement fund transfers would occur and a DCO was required to routinely confirm that its settlement banks were effecting fund transfers as and when required by those legal agreements.

ISDA and FIA requested that the rule allow for the correction of errors.[179] The Commission agrees with ISDA and FIA that settlement finality should not preclude the correction of errors, and is adding a clause to § 39.14(d) that explicitly provides that a DCO's legal agreements with its settlement banks may provide for the correction of errors.

In addition, the Commission is adding the modifier ''no later than'' before ''when the derivatives clearing organization's accounts are debited or credited'' in recognition of the fact that a DCO's legal agreements with its settlement banks may provide for settlement finality prior to the time when the DCO's accounts are debited or credited, *e.g.,* upon the bank's acceptance of a settlement instruction.

KCC commented that a DCO can never effectively ensure that settlement payments are irrevocable, given the existence of a legal risk that a settlement payment may be deemed to be an inappropriate transfer pursuant to applicable bankruptcy law. Therefore, KCC urged the Commission to eliminate the requirement or to restate the rule as a requirement to monitor operational risks related to settlement finality. The Commission does not believe that it is appropriate to do so. Core Principle E requires a DCO to ''ensure that money settlements are final when effected.''[180] In addition, Section 546(e) of the U.S. Bankruptcy Code[181] provides that a bankruptcy trustee may not avoid a transfer that is a margin payment or a settlement payment made to a DCO by a clearing member, or made to a clearing member by a DCO (with the exception of fraudulent transfers). However, the Commission is modifying § 39.14(d) to state that ''[a DCO] shall ensure that settlements are final when effected by ensuring that *it has entered into legal agreements that state that* settlement fund transfers are irrevocable and unconditional * * *'' (added text in italics).

The Commission is adopting § 39.14(d) with the modifications described above.

7. Recordkeeping—§ 39.14(e)

Proposed § 39.14(e) would require a DCO to maintain an accurate record of the flow of funds associated with each settlement.

KCC expressed its general support of the concept of maintaining accurate records of settlement fund flows, but stated that it may be prudent for the Commission to further clarify the extent to which the additional recordkeeping applies to cross-margining and netting arrangements that a DCO may have in place with certain clearing members and their customers. The language in § 39.14(e) is virtually identical to the Core Principle E language, which the Dodd-Frank Act added to the CEA.[182] Moreover, this language is similar to the language that had been contained in Core Principle E prior to its amendment by the Dodd-Frank Act.[183]

Therefore, proposed § 39.14(e) would not impose any additional recordkeeping requirements. The Commission believes that the requirement that a DCO must maintain an accurate record of the flow of funds associated with each settlement would necessarily require the maintenance of an accurate record with respect to any cross-margining or netting arrangements, without the need to separately address such arrangements. The Commission is adopting § 39.14(e) as proposed.

8. Netting Arrangements—§ 39.14(f)

Proposed § 39.14(f) would incorporate Core Principle E's requirement that a DCO must possess the ability to comply with each term and condition of any permitted netting or offset arrangement with any other clearing organization.[184]

[178] For example, it appears that CME may have interpreted proposed § 39.14(c)(3)(ii) in this unintended manner, since it stated that ''we do not believe the CFTC should *require* clearing members to have accounts at multiple settlement banks, which may prove to be an impossible (and/or extremely costly) requirement to satisfy.'' It appears that KCC may also have interpreted proposed § 39.14(c)(3)(ii) in this manner, in light of its comment that a requirement that DCOs identify additional settlement banks for use by clearing members would cause a significant rise in bank service fees for DCOs and clearing members. There is no reason that providing greater choice to clearing members regarding which single settlement bank they could elect to use would cause a rise in bank service fees for clearing members.

[179] ISDA also requested that the Commission clarify how the proposed requirement would be compatible with the fact that title transfer of initial margin may not occur when it is posted to a DCO. Title transfer is not a necessary element of settlement finality. Although in some jurisdictions a clearing member may need to transfer title to margin collateral to a DCO in order for the DCO to effectively exert control over such collateral, in other jurisdictions a clearing member may transfer margin collateral to a DCO and grant a security interest to the DCO without transfer of title.

[180] *See* Section 5b(c)(2)(E)(iii) of the CEA, 7 U.S.C. 7a–1(c)(2)(E)(iii).

[181] 11 U.S.C. 546(e).

[182] *See* Section 5b(c)(2)(E)(iv) of the CEA, 7 U.S.C. 7a–1(c)(2)(E)(iv).

[183] Prior to amendment by the Dodd Frank Act, Core Principle E provided, in part, that a [DCO] applicant shall have the ability to ''* * * [m]aintain an adequate record of the flow of funds associated with each transaction that the applicant clears. * * *''

[184] *See* Section 5b(c)(2)(E)(v) of the CEA, 7 U.S.C. 7a–1(c)(2)(E)(v).

The Commission did not receive any comment letters discussing § 39.14(f) and is adopting § 39.14(f) as proposed.

9. Physical Delivery—§ 39.14(g)

Proposed § 39.14(g) would require a DCO to establish rules clearly stating each obligation that the DCO has assumed with respect to physical deliveries, including whether it has an obligation to make or receive delivery of a physical instrument or commodity, or whether it indemnifies clearing members for losses incurred in the delivery process, and to ensure that the risks of each such obligation are identified and managed.

KCC commented that it generally supports the concept of proposed § 39.14(g), but requested that the Commission clarify that a DCO may be deemed to have satisfied its obligation to establish rules relating to physical deliveries if the rules of the exchange that lists the cleared contracts clearly delineates such physical delivery obligations. The Commission notes that the rules referenced in § 39.14(g) must be enforceable by and against the DCO. If a DCO were integrated with a DCM and the DCM's rules were enforceable by and against the DCO, then it may be that the DCM's rules would satisfy the requirements of § 39.14(g). However, such compliance would need to be determined on a case-by-case basis. The Commission is adopting § 39.14(g) as proposed, except for a technical revision that replaces ''contracts, agreements and transactions'' with ''products'' to ensure consistency with other provisions in part 39.

F. Core Principle F—Treatment of Funds—§ 39.15

Core Principle F, [185] as amended by the Dodd-Frank Act, requires a DCO to: (i) Establish standards and procedures that are designed to protect and ensure the safety of its clearing members' funds and assets; (ii) hold such funds and assets in a manner by which to minimize the risk of loss or of delay in the DCO's access to the assets and funds; and (iii) only invest such funds and assets in instruments with minimal credit, market, and liquidity risks. The Commission proposed § 39.15 to establish requirements that a DCO would have to meet in order to comply with Core Principle F.

1. Required Standards and Procedures—§ 39.15(a)

Proposed § 39.15(a) would require a DCO to establish standards and procedures that are designed to protect and ensure the safety of funds and assets belonging to clearing members and their customers.[186] The Commission did not receive any comments on proposed § 39.15(a) and is adopting the provision as proposed.

2. Segregation—§ 39.15(b)(1)

Proposed § 39.15(b)(1) would require a DCO to comply with the segregation requirements of Section 4d of the CEA and Commission regulations thereunder, or any other applicable Commission regulation or order requiring that customer funds and assets be segregated, set aside, or held in a separate account.

LCH suggested that the Commission clarify the meaning of ''segregated'' and limit the segregation requirement to the funds of clearing members' clients. LCH also urged the Commission to limit these requirements to client business cleared by the DCO under the FCM clearing structure, noting that a DCO based outside the United States may offer client clearing services through alternative structures and that it did not believe it would be appropriate for clients clearing under these non-U.S. structures to be subject to the segregation requirements of Section 4d of the CEA, but rather to the requirements set out by the DCO's home or other regulators.

FIA recommended that the proposed rule be revised to make clear that a DCO should keep margin posted by clearing members to support proprietary positions separate from the DCO's own assets, noting that although proprietary funds held at a DCO are not subject to the segregation provisions of the CEA, it is essential that these funds are protected in the event of the default of the DCO. The Commission has not proposed and is not adopting FIA's suggestion that the Commission expand the applicability of § 39.15(b)(1) in this manner.

BlackRock and FHLBanks expressed their views on specific segregation models. The Commission has proposed rules in a separate rulemaking regarding the segregation of cleared swaps customer contracts and collateral, and the Commission will address BlackRock's and FHLBanks' comments in connection with the final rulemaking for that proposal.[187]

The comments submitted by LCH, FIA, BlackRock, and FHLBanks all address the substance or applicability of segregation requirements. Proposed § 39.15(b)(1) would not have imposed any additional substantive segregation requirements upon a DCO. It would simply require a DCO to comply with the substantive segregation requirements of the CEA and other Commission regulations or orders, which are currently applicable or which may become applicable in the future. In particular, § 39.15(b)(1) is not intended to extend the extraterritorial reach of existing segregation requirements beyond that which may already exist in such requirements. However, in order to clarify the Commission's intent in this regard, the Commission has added ''applicable'' before ''segregation requirements'' in § 39.15(b)(1). In addition, the Commission wishes to clarify that its current segregation requirements apply to a non-U.S. based DCO with respect to clearing members that are registered as FCMs, whether they are clearing business for U.S. based customers or non-U.S. based customers. Such requirements do not apply with respect to clearing members that are non-U.S. based and that are not registered as FCMs, nor required to be registered as FCMs.

The Commission is adopting § 39.15(b)(1) with the modification described above.

3. Commingling of Futures, Options on Futures, and Swap Positions—§ 39.15(b)(2)

Proposed § 39.15(b)(2)(i) would permit a DCO to commingle, and a DCO to permit clearing member FCMs to commingle, customer positions in futures, options on futures, and swaps, and any money, securities, or property received to margin, guarantee, or secure such positions, in an account subject to the requirements of Section 4d(f) of the CEA (cleared swaps account), pursuant to DCO rules that have been approved by the Commission under § 40.5 of the Commission's regulations. The DCO's rule filing [188] would have to include, at a minimum, the following: (A) an identification of the futures, options on futures, and swaps that would be commingled, including contract specifications or the criteria that would

[185] Section 5b(c)(2)(F) of the CEA, 7 U.S.C. 7a–1(c)(2)(F) (Core Principle F).

[186] Such ''assets'' would include any securities or property that clearing members deposit with a DCO in order to satisfy initial margin obligations, which are also sometimes referred to as ''collateral.'' Proposed § 39.15 uses the term ''assets'' rather than ''securities or property'' or ''collateral'' in order to be consistent with the statutory language.

[187] *See* 76 FR 33818 (June 9, 2011) (Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions).

[188] The DCO's rule filing would also need to comply with the procedural requirements of § 40.5(a).

be used to define eligible futures, options on futures, and swaps; (B) an analysis of the risk characteristics of the eligible products; (C) a description of whether the swaps would be executed bilaterally and/or executed on a DCM and/or a SEF; (D) an analysis of the liquidity of the respective markets for the futures, options on futures, and swaps that would be commingled, the ability of clearing members and the DCO to offset or mitigate the risks of such products in a timely manner, without compromising the financial integrity of the account, and, as appropriate, proposed means for addressing insufficient liquidity; (E) an analysis of the availability of reliable prices for each of the eligible products; (F) a description of the financial, operational, and managerial standards or requirements for clearing members that would be permitted to commingle the eligible products; (G) a description of the systems and procedures that would be used by the DCO to oversee such clearing members' risk management of the commingled positions; (H) a description of the financial resources of the DCO, including the composition and availability of a guaranty fund with respect to the commingled products; (I) a description and analysis of the margin methodology that would be applied to the commingled products, including any margin reduction applied to correlated positions, and any applicable margin rules with respect to both clearing members and customers; (J) an analysis of the ability of the DCO to manage a potential default with respect to any of the commingled products; (K) a discussion of the procedures that the DCO would follow if a clearing member defaulted, and the procedures that a clearing member would follow if a customer defaulted, with respect to any of the commingled products; and (L) a description of the arrangements for obtaining daily position data from each beneficial owner of the commingled products.[189]

Proposed § 39.15(b)(2)(ii) would address situations where customer positions in futures, options on futures, and cleared swaps could be carried in a futures account subject to Section 4d(a) of the CEA. Proposed § 39.15(b)(2)(ii) would incorporate the informational requirements of proposed § 39.15(b)(2)(i), but would require a DCO to file a petition with the Commission for an order pursuant to Section 4d(a) of the CEA, permitting the DCO and its clearing members to commingle customer positions in futures, options on futures, and swaps in a futures account (4d order).

Proposed § 39.15(b)(2)(iii)(A) would provide that the Commission may request additional information in support of a rule submission and that it may approve the rules in accordance with § 40.5.[190] Proposed § 39.15(b)(2)(iii)(B) would provide that the Commission could request additional information in support of a petition and that it could issue a 4d order in its discretion.

As noted in the notice of proposed rulemaking, in the case of a rule approval under § 39.15(b)(2)(i), as well as the issuance of an order under § 39.15(b)(2)(ii), the Commission would take action pursuant to Section 4d of the CEA (permitting commingling) and Section 4(c) of the CEA (exempting the DCO and clearing members from the requirement to hold customer positions in a 4d(a) or 4d(f) account, as applicable).

The Commission requested comment on whether it should take the same approach (rule submission or petition for an order) with respect to the futures account and the cleared swap account and, if so, what that approach should be. In addition, the Commission requested comment on whether the enumerated informational requirements fully capture the relevant considerations for making a determination on either rule approval or the granting of an order, and whether the Commission's analysis should take into consideration the type of account in which the positions would be carried, the particular type of products that would be involved, or the financial resources of the clearing members that would hold such accounts. The Commission further requested comment on what, if any, additional or heightened requirements should be imposed to manage the increased risks introduced to a futures account that also holds cleared swaps.

In some instances, commenters addressed topics that are more properly considered by the Commission in connection with a separate rulemaking,[191] that relate to substantive requirements that the Commission might impose as a condition of approving a rule or granting an order under § 39.15(b)(2),[192] or that relate to other provisions adopted herein.[193] The Commission is not addressing those comments in its discussion of § 39.15(b)(2) because they are not within the scope of the proposal.

CME, FIA, and MFA expressed their general support for the adoption of rules that would allow commingling of customer positions in futures, options on futures, and cleared swaps. In particular, CME indicated that such commingling could achieve important benefits with respect to greater capital efficiency which would result from margin reductions for correlated positions, and that adoption of a regulation permitting such commingling would be consistent with the public interest, in accordance with Section 4(c) of the CEA. CME further stated that ''[h]aving positions in a single account can also enhance risk management practices and systemic risk containment by allowing the customer's portfolio to

[189] As noted in the Commission's notice of proposed rulemaking regarding the protection of cleared swaps customer contracts and collateral, 76 FR at 33818 (June 9, 2011) (Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions), if the complete legal segregation model is adopted for cleared swaps, a DCO could more easily justify the approval of rules or the issuance of a 4d order allowing the commingling of futures, options, and swaps, since the impact of any different risk from the product being brought into the portfolio would be limited to the customer who chooses to trade that product. In such case, the Commission may still wish to obtain and review all of the information specified in proposed § 39.15(b)(2)(i), although its specific concerns may be minimized. However, if the complete legal segregation model is adopted for cleared swaps, and after the Commission obtains experience with respect to considering requests to commingle futures, options, and swaps under § 39.15(b)(2) in an environment where that margin model applies, the Commission may revisit its ongoing need for all of the information listed in § 39.15(b)(2)(i).

[190] A rule submitted for prior approval would be approved unless the rule is inconsistent with the CEA or the Commission's regulations. *See* Section 5c(c)(5) of the CEA, 7 U.S.C. 7a–2(c)(5); and 75 FR at 44793–44794 (Provisions Common to Registered Entities; final rule).

[191] *E.g.,* CME and FIA raised operational concerns in the event the Commission adopts a different segregation regime for each type of customer account. Those comments will be considered in connection with the Commission's proposal regarding the appropriate segregation regime for cleared swaps accounts. *See* 76 FR 33818 (June 9, 2011) (Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions).

[192] *E.g.,* LCH suggested additional factors that the Commission should consider before a DCO or its clearing members should be able to commingle, and offer offsets between, futures, options on futures, and swaps, including: (a) clients must hold their futures, options, and swaps under the same account structure and within the same legal entity, and (b) the DCO must margin the futures, options, and swaps using the same margin model; and ELX expressed the view that in order for a customer to gain the portfolio margining benefits of commingling futures, options, and swaps executed on a SEF, it would be necessary for a customer to clear its futures, options, and swaps through the same DCO.

[193] LCH stated that all offset assumptions in the DCO's margin calculations must, at a minimum, be replicated in the DCO's stress testing and must be recalibrated frequently. The Commission notes that permitted spread and portfolio margins are addressed in § 39.13(g)(4), discussed in section IV.D.6.e, above, and back testing of such spread and portfolio margins is addressed in § 39.13(g)(7), discussed in section IV.D.6.g, above.

be handled in a coordinated fashion in a transfer or liquidation scenario.''

CME stated its belief that it would be logical to apply the same methodology (rule submission or petition for an order) with respect to the futures account and the cleared swaps account, and that a rule submission would be the most efficient and optimal approach. The Commission is retaining the proposed distinction whereby the Commission may permit futures to be commingled in a Section 4d(f) cleared swaps account subject to a rule approval process, and may permit cleared swaps to be commingled in a Section 4d(a) futures account subject to a 4d order. In the latter instance, the 4d petition process would provide additional procedural protections in that: (1) Review of a 4d petition by the Commission is not subject to the time limits that apply to a request for rule approval under § 40.5; and (2) the Commission may impose conditions in a 4d order, as appropriate. The Commission has determined that, at this time, it is appropriate to provide these additional procedural protections before exposing futures customers to the risks of swaps that may be commingled in a futures account. As also noted in other contexts in this notice of final rulemaking, DCOs have greater experience in clearing futures. Swaps will expose DCOs to risks that can differ in their nature and magnitude. However, as the Commission and the industry gain more experience with cleared swaps, the Commission may revisit this issue in the future.

The Commission is adopting CME's suggestion that it revise § 39.15(b)(2)(i)(L) to remove the reference to obtaining daily position data ''from each beneficial owner.'' Therefore, § 39.15(b)(2)(i)(L), as modified, requires a DCO to submit ''[a] description of the arrangements for obtaining daily position data with respect to futures, options on futures, and swaps in the account,'' without specifying the level of detail or the source of the daily position data that the DCO must obtain. As noted by CME, the Commission could request additional information from the DCO, in support of its request for rule approval or petition for a 4d order, pursuant to § 39.15(b)(2)(iii).

The Commission is also making conforming changes to § 39.15(b)(2), to replace a reference to ''cleared swap account'' with ''cleared swaps account'' to achieve consistency with the terminology in another Commission rulemaking;[194] is revising the references to ''futures, options on futures, and swap positions'' and ''futures, options on futures, and swaps'' to read ''futures, options, and swaps;''[195] is replacing a reference to ''contract'' with ''product;'' and is correcting the references to § 39.15(b)(2)(i) and (ii) in § 39.15(b)(iii)(A) and (B), respectively.

The Commission is adopting § 39.15(b)(2) with the modifications described above.

4. Holding of Funds and Assets—§ 39.15(c)

The introductory paragraph of proposed § 39.15(c) would require that a DCO hold funds and assets belonging to clearing members and their customers in a manner that minimizes the risk of loss or of delay in the DCO's access to those funds and assets. The Commission did not receive any comment letters discussing the introductory paragraph of proposed § 39.15(c) and is adopting the provision as proposed.

5. Types of Assets—§ 39.15(c)(1)

Proposed § 39.15(c)(1) would require a DCO to limit the assets it accepts as initial margin to those that have minimal credit, market, and liquidity risks, and prohibit a DCO from accepting letters of credit as initial margin.

LCH agreed with the provisions of proposed § 39.15(c), but added that the rules might more properly require that a DCO must be able to convert any funds and assets held promptly into cash, and should prove that it is able to do so on an ongoing basis. J.P. Morgan stated that it is necessary for DCOs to maintain sufficient liquidity, and that this could be achieved by requiring that clearing members post a minimum amount of liquid (cash and qualifying government securities) margin, among other things.[196]

The Commission believes that the standard of ''minimal credit, market, and liquidity risks'' is sufficient and that it is not necessary to modify the language of the regulation to include an explicit requirement that a DCO must be able to convert funds and assets promptly into cash or to require that clearing members must post a minimum amount of cash and qualifying government securities. Moreover, the requirement that a DCO shall limit the assets that it accepts as initial margin to those that have ''minimal credit, market, and liquidity risks'' is consistent with international recommendations.[197]

OCC expressed its belief that the proposal places an excessive focus on the types of assets that may be used as margin and that the Commission's central focus should be on whether a DCO's procedures and risk management systems are sufficient to provide a high degree of assurance that a portfolio, including margin assets, can be liquidated with a positive liquidation value. OCC further noted its concern that some of the collateral that it currently accepts as initial margin, including less-liquid stocks and long-dated Treasury securities, would no longer be permitted under the proposed rule. OCC explained that its ''collateral in margins'' or ''CIM'' program looks at each type of collateral as an asset with specific risk characteristics rather than as a fixed value, and it recognizes both positive and negative correlations with other assets and liabilities in a particular account.

As an example, OCC stated that even though XYZ stock may be less liquid than other stocks, it may have a greater value than a more liquid stock when it is used as margin for a short position in XYZ call options. Therefore, OCC urged the Commission not to impose a standard of ''minimal credit, market, and liquidity risk,'' or not to adopt an interpretation of such a standard in a manner that would reduce the opportunities for diversification of collateral and use of assets that may have specific risk-reducing properties in a particular portfolio. In particular, OCC stated that ''[w]here a DCO is capable of reflecting the risk of certain assets in its margin model, we see no reason why less liquid instruments or instruments with higher than average credit or market risks should not be acceptable for initial margin.''

The Commission agrees that a DCO should be permitted to accept assets as initial margin if such assets have specific risk-reducing properties in a particular portfolio and the DCO's margin model is capable of appropriately reflecting the risk of those

[194] *See* 76 FR 33818 (June 9, 2011) (Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions).

[195] This conforming terminology, which appears elsewhere in part 39, streamlines the rule text without changing the meaning of the provision. The scope of part 39 covers only those products subject to the Commission's oversight and would not include, for example, options on securities. Refinements in the definitions of products subject to Commission oversight will be addressed in the future.

[196] J.P. Morgan also suggested that DCOs could maintain liquidity by requiring clearing members to make guarantee fund contributions or by requiring clearing members to participate in a liquidity facility. The Commission has not proposed and is not adopting such requirements.

[197] *See* CPSS–IOSCO Consultative Report, Principle 5: Collateral, at 37.

assets. Accordingly, although the Commission is retaining the standard of minimal credit, market, and liquidity risk, it is revising the provision to add the following: ''A [DCO] may take into account the specific risk-reducing properties that particular assets have in a particular portfolio.'' As illustrated by OCC, an asset that would not generally be acceptable could be acceptable for use in connection with a particular portfolio.

Freddie Mac requested that the Commission clarify that DCOs may accept collateral types beyond those specified as permitted investments under § 1.25. Section 39.15(c) does not prohibit a DCO from accepting collateral types that are not specified as permitted investments under § 1.25. The Commission believes that it is appropriate to permit DCOs to retain the flexibility to accept a broader range of assets that meet the general requirement of ''minimal credit, market, and liquidity risks'' than those which are appropriate investments for funds received from clearing members.

Several comment letters specifically discussed the proposal to prohibit the use of letters of credit as initial margin. The commenters disagreed with the Commission's proposed requirement that a DCO may not accept letters of credit for this purpose. CME stated that letters of credit provide an absolute assurance of payment and, therefore, the issuing bank must honor the demand even in circumstances where the DCO (the beneficiary) breached its duty to the clearing member and even if the clearing member is unable to reimburse the bank for its payment. CME also stated that it was not aware of any instances in the cleared derivatives industry in which a beneficiary of a letter of credit posted as collateral had sought to draw upon the letter of credit and had not been promptly paid by the issuer. CME noted that letters of credit have been especially useful for clearing members to post as collateral for late-day margin calls. ICE and NOCC similarly commented that letters of credit should be permitted to serve as non-cash collateral. NGX indicated that letters of credit are consistent with Section 4s(e)(3)(D) of the CEA, which provides that the financial regulators shall establish comparable capital requirements and minimum initial and variation margin requirements, including the use of non-cash collateral, for swap dealers.[198]

Many commenters suggested that letters of credit should be acceptable if they are subject to appropriate conditions. OCC recommended that the Commission should allow letters of credit as long as a DCO sets criteria with respect to issuers, diversifies concentration of risk among issuers, and limits the proportion of a clearing member's margin requirement that can be represented by letters of credit. In addition, OCC stated that it would be appropriate for the Commission to prohibit a DCO from accepting a letter of credit from a clearing member if the letter of credit is issued by an institution affiliated with the clearing member.

Similarly, FIA suggested that a DCO should be permitted to accept letters of credit on a case-by-case basis subject to the credit quality of the bank and appropriate limits on the percentage of a clearing member's margin requirements that can be met by letters of credit. FIA also indicated that DCOs should limit the aggregate value of letters of credit that may be issued by any one bank.

FHLBanks wrote that ''a hard and fast prohibition against letters of credit is inappropriate because it fails to take into account that a letter of credit issued by a highly creditworthy entity could contain terms that would make the letter of credit just as liquid as a funded asset.'' [199]

CME stated that it only accepts letters of credit that comply with its specified terms and conditions, including payment within one hour of notification of a draw, from issuers that it has reviewed and approved and that meet its criteria for issuing banks. CME further noted that it conducts periodic reviews of approved banks and uses caps and concentration limits in connection with letters of credit.

NGX stated that it has accepted letters of credit that comply with its requirements regarding timing and acceptable institutions, for many years, and has successfully drawn on such letters of credit.

Several commenters warned of the potential risks associated with prohibiting letters of credit, including higher costs for clearing members and their customers (OCC), the placement of U.S. DCOs at a disadvantage to foreign clearing houses (ICE),[200] and increased systemic risk as a result of decreased voluntary clearing (NOCC).

The Commission acknowledges that DCOs have historically been permitted to exercise their discretion regarding whether and to what extent they would accept letters of credit for initial margin for futures and options. Certain DCOs have accepted such letters of credit without incident and continue to do so. On the other hand, as stated in the notice of proposed rulemaking, letters of credit are unfunded financial resources with respect to which funds might be not be available when they are most needed by the DCO. Moreover, the initial margin of a defaulting clearing member would typically be the first asset tapped to cure the clearing member's default. Taking into account both the strong track record of letters of credit in connection with cleared futures and options on futures and the potentially greater risks of cleared swaps, the Commission is modifying the provision to permit DCOs to accept letters of credit as initial margin for futures and options on futures. However, the Commission has determined to maintain an additional safeguard for swaps at this time by prohibiting a DCO from accepting letters of credit as initial margin for swaps. In cases where futures and swaps are margined together, the Commission has determined that letters of credit may not be accepted. The Commission will monitor developments in this area and may revisit this issue in the future.

The Commission is adopting § 39.15(c)(1), redesignated as § 39.13(g)(10),[201] with the modification described above.

6. Valuation and Haircuts—§§ 39.15(c)(2) and 39.15(c)(3)

Proposed § 39.15(c)(2) would require a DCO to use prudent valuation practices to value assets posted as initial margin on a daily basis. Proposed § 39.15(c)(3) would require a DCO to apply appropriate reductions in value to reflect the market and credit risk of the assets that it accepts in satisfaction of

[198] The Commission notes that the minimum initial and variation margin requirements referenced in Section 4s(e)(3)(D) of the CEA, 7 U.S.C. 6s(e)(3)(D), apply to uncleared swaps.

NGX also stated its view that in a non-intermediated model, such as that operated by NGX, the DCO is familiar with its clearing participants, and can exercise a degree of discretion in accepting letters of credit without the same risk management challenges that may be faced by an intermediated DCO.

[199] The FHLBanks further noted that the prohibition on letters of credit may unnecessarily constrain certain end-users from clearing swaps because they may be precluded from pledging other assets, *e.g.,* by loan covenants.

[200] ICE noted that the CPSS–IOSCO Consultative Report did not prohibit any type of collateral.

[201] Redesignation of this provision and several other provisions proposed as part of § 39.15 is a non-substantive change that moves the provisions to the risk management rules for margin requirements. As a risk management rule, the provision implements Core Principle D, Section 5b(c)(2)(D)(iii) of the CEA, which provides that ''Each [DCO], through margin requirements and other risk control mechanisms, shall limit the exposure of the [DCO] to potential losses from defaults by members and participants of the [DCO].''

initial margin obligations and to evaluate the appropriateness of its haircuts on at least a quarterly basis.

OCC commented that if a DCO can only accept instruments with minimal risk, then haircuts should either not be required at all or should be very small. The Commission notes that, as defined in § 39.15(c)(3), haircuts are ''appropriate reductions in value to reflect market and credit risk.'' This is a flexible standard that would allow a DCO to determine the extent of the haircut based on the extent of the risk posed by the instrument deposited as initial margin.

OCC further stated that proposed § 39.15(c)(3) is ambiguous regarding what OCC would be required to test on a quarterly basis. OCC explained that its STANS margin methodology does not apply fixed haircuts to securities deposited as collateral, but rather treats collateral as part of a clearing member's overall portfolio, revisiting each ''haircut'' or valuation on a security-by-security, account-by-account, and day-by-day basis. Thus, OCC stated that it checks the adequacy of its haircuts through back testing and not through a periodic review.

The general language of § 39.15(c)(3), requiring a DCO to ''apply appropriate reductions in value to reflect market and credit risk * * * to the assets that it accepts in satisfaction of initial margin obligations'' and to ''evaluate the appropriateness of such haircuts on at least a quarterly basis,'' is broad enough to encompass the method of daily valuation and back testing described by OCC.

The Commission is adopting § 39.15(c)(2), redesignated as § 39.13(g)(11), as proposed. The Commission is adopting a technical revision to § 39.15(c)(3), redesignated as § 39.13(g)(12), by adding a reference to ''liquidity'' risk to conform the terminology used to describe haircuts (proposed as ''appropriate reductions in value to reflect market and credit risk'') with the terminology used in § 39.13(g)(10), which refers to assets that have ''minimal credit, market, and liquidity risks.'' [202] The Commission is also making a non-substantive revision to replace the phrase ''including in stressed market conditions'' with ''taking into consideration stressed market conditions.''

7. Concentration Limits—§ 39.15(c)(4)

Proposed § 39.15(c)(4) would require a DCO to apply appropriate limitations on the concentration of assets posted as initial margin, as necessary, in order to ensure the DCO's ability to liquidate those assets quickly with minimal adverse price effects. The proposed regulation also would require a DCO to evaluate the appropriateness of its concentration limits, on at least a monthly basis.

OCC indicated that the proposed rule was not clear regarding whether it would be sufficient to impose concentration charges rather than imposing concentration limits, but argued that if the margin system adequately penalizes concentration of risk, it does not believe that fixed concentration limits are required. The Commission agrees that concentration charges, rather than concentration limits, may be appropriate in certain circumstances, and is modifying the provision to permit a DCO to apply ''appropriate limitations or charges on the concentration of assets posted as initial margin'' and to ''evaluate the appropriateness of any such concentration limits or charges, on at least a monthly basis.'' The inclusion of concentration charges as an acceptable alternative to concentration limits is consistent with international recommendations.[203]

CME stated its view that the Commission should not prescribe the frequency of a DCO's reviews of its concentration limits and it urged the Commission to revise § 39.15(c)(4) to replace ''on at least a monthly basis'' with ''on a regular basis.'' The Commission believes that it is appropriate to require a DCO to evaluate the appropriateness of its concentration limits (or charges) on at least a monthly basis and notes that § 39.15(c)(4) provides a DCO with the discretion to determine the nature of such evaluation.

The Commission is adopting § 39.15(c)(4), redesignated as § 39.13(g)(13), with the modifications described above.

8. Pledged Assets—§ 39.15(c)(5)

Under proposed § 39.15(c)(5), if a DCO were to permit its clearing members to pledge assets for initial margin while retaining such assets in accounts in the names of such clearing members, the DCO would have to ensure that the assets are unencumbered and that the pledge has been validly created and validly perfected in the relevant jurisdiction. The Commission did not receive any comments discussing proposed § 39.15(c)(5) and is adopting the provision, redesignated as § 39.13(g)(14), as proposed.

9. Permitted Investments—§ 39.15(d)

Proposed § 39.15(d) would require that clearing members' funds and assets that are invested by a DCO must be held in instruments with minimal credit, market, and liquidity risks and that any investment of customer funds or assets by a DCO must comply with § 1.25 of the Commission's regulations. Moreover, the proposed regulation would apply the limitations contained in § 1.25 to all customer funds and assets, whether they are the funds and assets of futures and options customers subject to the segregation requirements of Section 4d(a) of the CEA, or the funds and assets of cleared swaps customers subject to the segregation requirements of Section 4d(f) of the CEA.

The Commission did not receive any comment letters discussing proposed § 39.15(d). The Commission is adopting the provision, redesignated as § 39.15(e), as proposed.

10. Transfer of Customer Positions—§ 39.15(d)

The Commission proposed regulations addressing the processing, clearing, and transfer of customer positions by swap dealers (SDs), major swap participants (MSPs), FCMs, SEFs, DCMs, and DCOs.[204] Proposed § 39.15(d) would require a DCO to have rules providing that, upon the request of a customer and subject to the consent of the receiving clearing member, the DCO would promptly transfer all or a portion of such customer's portfolio of positions and related funds from the carrying clearing member of the DCO to another clearing member of the DCO, without requiring the close-out and rebooking of the positions prior to the requested transfer.

MFA, Citadel, and FHLBanks supported the proposal. MFA and Citadel suggested that the Commission clarify that associated margin should transfer simultaneously with the transferred positions.

LCH also suggested that the section should be revised to require that the transfer of positions and related funds be effected simultaneously. LCH believes that absent such a provision, a

[202] Credit, market, and liquidity risks are concepts that are not mutually exclusive, and this articulation of the types of risks to be evaluated by a DCO appears in the CEA (Core Principle F, Treatment of Funds (requiring that ''[f]unds and assets invested by a [DCO] shall be held in instruments with minimal credit, market, and liquidity risks''), and ''minimal credit, market, and liquidity risks'' is set forth as the standard for assets acceptable for a guaranty fund (§ 39.11(e)(3)(i)), and as the standard for assets acceptable as initial margin (§ 39.13(g)(10)).

[203] *See* CPSS–IOSCO Consultative Report, Principle 5: Collateral, Explanatory Note 3.5.4, at 38.

[204] 76 FR 13101 (March 10, 2011) (Straight-Through Processing).

DCO could be understood to be required to transfer either the positions or the funds, but not both, and such an obligation would expose the DCO to risk during the customer transfer.

FIA agreed with the Commission that a customer should not be required to close-out and re-book positions as a condition of transferring such positions, and that a clearing member should not unnecessarily interfere with a customer's request to transfer positions. However, FIA noted that a DCO will not have the immediate ability to determine which positions carried in a clearing member's omnibus account belong to a particular customer. FIA suggested that a DCO's rules provide that the customer submit its request to transfer its positions to the clearing member carrying the positions, not to the DCO. FIA also suggested that the Commission revise the proposed rule to confirm that a clearing member is required to transfer a customer's positions only after that customer has met all contractual obligations, including outstanding margin calls and any additional margin required to support any remaining positions.

OCC also noted that a customer will not ask a DCO directly to transfer a customer position. Like FIA, OCC believes that any such transfer must be subject to all legitimate conditions or restrictions established by the DCO in connection with its clearing of swaps.

CME stated that it fully supports the concept of applying the same standards to transfer of customer cleared swaps as have historically been applied to transfer of customer futures. It noted that a customer request to transfer its account is made not to a DCO but to the FCM that carries the customer's account.

ISDA commented that any transfer rule must provide that a party seeking transfer not be in default to its existing clearing member. ISDA believes that the transfer rule must take into account any cross-cleared or cross-margined transactions and in the case where only a portion of a customer's portfolio is transferred, clearing members must have the ability to condition the transfer on the posting of additional margin by the customer.

KCC commented that this rule is not necessary because KCC has never required a futures position to be closed out and re-booked prior to transfer from the carrying clearing member to another clearing member, nor would KCC require a wheat calendar swap to be closed out and re-booked prior to transfer. The Commission notes that such a requirement has been imposed by other clearinghouses in connection with swaps.

In response to concerns raised by commenters, the Commission is revising § 39.15(d) to read as set forth in the regulatory text of this final rule.

The language making it explicit that positions and margin be transferred at the same time is responsive to the comments of MFA, Citadel, and LCH and consistent with prudent risk management procedures. The language clarifying that a customer transfer instruction would go to a clearing member and not directly to the DCO is responsive to the comments of FIA, OCC, and CME. The requirement that a customer may not be in default is responsive to the comments of FIA and ISDA and consistent with the statement in the notice of proposed rulemaking that transfers should be subject to contractual requirements. The requirement that positions at both clearing members will have appropriate margin is responsive to the comments of MFA, Citadel, and ISDA and consistent with the statement in the notice of proposed rulemaking that transfers should be subject to contractual requirements.

G. Core Principle G—Default Rules and Procedures—§ 39.16

Core Principle G,[205] as amended by the Dodd-Frank Act, requires each DCO to have rules and procedures designed to allow for the efficient, fair, and safe management of events during which clearing members become insolvent or otherwise default on their obligations to the DCO. In addition, Core Principle G requires each DCO to clearly state its default procedures, make its default rules publicly available, and ensure that it may take timely action to contain losses and liquidity pressures and to continue meeting its obligations. The Commission proposed § 39.16 to establish requirements that a DCO would have to meet in order to comply with Core Principle G.

1. General—§ 39.16(a)

Proposed § 39.16(a) would require a DCO to adopt rules and procedures designed to allow for the efficient, fair, and safe management of events during which clearing members become insolvent or default on the obligations of such clearing members to the DCO.

The Commission did not receive any comment letters discussing proposed § 39.16(a), although LCH stated that it concurs with all the provisions set out under proposed § 39.16. The Commission is adopting § 39.16(a) as proposed.

2. Default Management Plan—§ 39.16(b)

Proposed § 39.16(b) would require a DCO to maintain a current written default management plan that delineates the roles and responsibilities of its board of directors, its Risk Management Committee, any other committee that has responsibilities for default management, and the DCO's management, in addressing a default, including any necessary coordination with, or notification of, other entities and regulators. The proposed regulation also would require the default management plan to address any differences in procedures with respect to highly liquid contracts (such as certain futures) and less liquid contracts (such as certain swaps). In addition, proposed § 39.16(b) would require a DCO to conduct and document a test of its default management plan on at least an annual basis.

OCC agreed with the proposal for annual testing of a DCO's default management plan, while ISDA stated that such tests should be conducted at least on a semi-annual basis. FIA indicated that the default management plan should be subject to frequent, periodic testing. The Commission believes that it is appropriate and sufficient to require at least annual testing of a DCO's default management plan. A particular DCO could determine to test its plan on a semi-annual or other periodic basis, in its discretion.

ISDA expressed its view that regulators should review and sign off on the default management plans of DCOs. KCC requested that the Commission clarify that the default management plan concepts in proposed § 39.16(b) may be satisfied by annual testing of the DCO's existing set of default rules and procedures. The Commission does not believe that it is necessary to adopt an explicit requirement that the Commission review and approve a DCO's default management plan. However, Commission staff will review a DCO's default management plan in the context of the Commission's ongoing DCO review program, including a determination of whether a DCO's ''existing set of default rules and procedures'' meet the requirements of § 39.16(b).

The Commission is making a technical revision to § 39.16(b), removing the parentheticals and substituting the word ''products'' for the word ''contracts.'' The sentence now reads: ''Such plan shall address any differences in procedures with respect

[205] Section 5b(c)(2)(G) of the CEA, 7 U.S.C. 7a–1(c)(2)(G) (Core Principle G).

to highly liquid products and less liquid products.''

3. Default Procedures—§ 39.16(c)(1)

Proposed § 39.16(c)(1) would require a DCO to adopt procedures that would permit the DCO to take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a default on the obligations of a clearing member to the DCO.

The Commission did not receive any comment letters discussing proposed § 39.16(c)(1) and is adopting § 39.16(c)(1) as proposed.

4. Default Rules—§ 39.16(c)(2)

Proposed § 39.16(c)(2) would require a DCO to include certain identified procedures in its default rules. In particular, proposed § 39.16(c)(2)(i) would require a DCO to set forth its definition of a default. Proposed § 39.16(c)(2)(ii) would require a DCO to set forth the actions that it is able to take upon a default, which must include the prompt transfer, liquidation, or hedging of the customer or proprietary positions of the defaulting clearing member, as applicable. Proposed § 39.16(c)(2)(ii) would further state that such procedures could also include, in the DCO's discretion, the auctioning or allocation of such positions to other clearing members. Proposed § 39.16(c)(2)(iii) would require a DCO to include in its default rules any obligations that the DCO imposed on its clearing members to participate in auctions, or to accept allocations, of a defaulting clearing member's positions, and would specifically provide that any allocation would have to be proportional to the size of the participating or accepting clearing member's positions at the DCO.

Proposed § 39.16(c)(2)(iv) would require that a DCO's default rules address the sequence in which the funds and assets of the defaulting clearing member and the financial resources maintained by the DCO would be applied in the event of a default. Proposed § 39.16(c)(2)(v) would require that a DCO's default rules contain a provision that customer margin posted by a defaulting clearing member could not be applied in the event of a proprietary default.[206] Proposed § 39.16(c)(2)(vi) would require that a DCO's default rules contain a provision that proprietary margins posted by a defaulting clearing member would have to be applied in the event of a customer default, if the relevant customer margin were insufficient to cover the shortfall.

The Commission did not receive any comment letters discussing proposed § 39.16(c)(2)(i), (ii) or (iii). The Commission is adopting § 39.16(c)(2)(i) as proposed. The Commission is making technical revisions to §§ 39.16(c)(2)(ii), (iii), (v) and (vi), as well as § 39.16(d)(3), by replacing each use of the word ''proprietary'' with ''house.''

As discussed above in connection with participant eligibility requirements under § 39.12,[207] the Commission is revising § 39.16(c)(2)(iii) to require a DCO that imposes obligations on its clearing members to participate in auctions or to accept allocations of a defaulting clearing member's positions, to permit its clearing members to outsource these obligations to qualified third parties, subject to appropriate safeguards imposed by the DCO. The Commission believes that it is important to permit outsourcing, while recognizing that it is essential to limit participation only to qualified third parties. Accordingly, a DCO's rules may impose appropriate terms and conditions on outsourcing arrangements, addressing, for example, the necessary qualifications to be eligible to act in the clearing member's place and conflicts of interest issues. Thus, for example, a clearing member could hire a qualified third party to act as its agent in an auction. The Commission cautions, however, that any DCO imposing terms and conditions that could indirectly deny fair and open access and therefore are not ''appropriate,'' *i.e.,* not supported by sound risk management policies, may run afoul of Core Principle C and § 39.12.

The Commission is also making two additional technical revisions to § 39.16(c)(2)(iii). First, the Commission is replacing ''a defaulting clearing member's positions'' with ''the customer or house positions of the defaulting clearing member,'' to correct an oversight in the proposed language. Second, the Commission is revising § 39.16(c)(2)(iii)(A) to provide that any allocation shall be ''[p]roportional to the size of the participating or accepting clearing member's positions *in the same product class* at the derivatives clearing organization'' (added text in italics) to clarify the Commission's intent.

With respect to proposed § 39.16(c)(2)(iv), OCC agreed that it would be appropriate to require DCOs to adopt rules that would define the sequence in which the funds and assets of a defaulting clearing member and the financial resources maintained by the DCO would be applied in the event of a default.

Freddie Mac expressed concern with the broad discretion that would be given to DCOs to determine the sequence in which financial resources would be applied in the event of a clearing member default, and recommended that DCOs should be required to place non-customer resources (*e.g.,* clearing member guaranty funds and their own capital) ahead of non-defaulting customer collateral in the risk waterfall. In particular, Freddie Mac indicated that if the Commission does not require individual segregation of customer collateral, it should require DCOs to place non-defaulting customers at the bottom of the risk waterfall. Freddie Mac stated that the Commission should defer adoption of proposed § 39.16(c) until after adoption of rules relating to customer segregation.

The Commission is adopting § 39.16(c)(2)(iv) to require that a DCO adopt rules that identify the sequence of its default waterfall, as proposed, without imposing any substantive requirements with respect to such sequence, as suggested by Freddie Mac. The Commission is addressing the issue of the application of the collateral of non-defaulting swaps customers in a separate pending rulemaking,[208] but does not believe that it is appropriate to defer the adoption of proposed § 39.16(c) until that rulemaking is complete.

The Commission is making a technical revision to § 39.16(c)(2)(iv) by inserting ''and its customers'' after ''the funds and assets of the defaulting clearing member'' to correct an oversight in the proposed language.

ISDA commented that proposed § 39.16(c)(2)(v), which would require a DCO to adopt ''[a] provision that customer margin posted by a defaulting clearing member shall not be applied in the event of a proprietary default'' should be revised to replace the words ''in the event of'' with ''to cover losses in respect of''; otherwise, ISDA believed that customer margin would not be able to be applied even to cover customer losses. The Commission agrees with ISDA and is modifying § 39.16(c)(2)(v) by replacing ''in the event of'' with ''to cover losses with respect to'' and has made a similar modification to § 39.16(c)(2)(vi).

CME recommended that the Commission replace ''proprietary

[206] This is consistent with the segregation requirements of Section 4d of the CEA and § 1.20 of the Commission's regulations.

[207] *See* discussion in section IV.C.1.i, above.

[208] *See* 76 FR 33818 (June 9, 2011) (Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions).

margins posted by a defaulting clearing member'' in § 39.16(c)(2)(vi) with ''proprietary margins, positions and any other assets in the account of the defaulting clearing member.'' CME argued that the Commission's proposed reference to ''proprietary margins posted by a defaulting clearing member'' is too narrow in scope, since in the event of a clearing member default (whether originating in the customer origin or the house origin), a DCO would likely liquidate positions in the defaulting clearing member's house account and then apply excess funds and not just proprietary margins to cure the default. The Commission agrees that ''proprietary margins posted by a defaulting clearing member'' is too narrow and is replacing the phrase in § 39.16(c)(2)(vi) with ''house funds and assets of a defaulting clearing member.'' The Commission believes that ''house funds and assets'' is broad enough to include ''proprietary margins, positions and any other assets,'' as suggested by CME, and is consistent with the language in § 39.16(c)(2)(iv) and § 39.15. The Commission is similarly replacing ''customer margin posted by a defaulting clearing member'' in § 39.16(c)(2)(v) with ''the funds and assets of a defaulting clearing member's customers'' and is replacing ''customer margin'' in § 39.16(c)(2)(vi) with ''customer funds and assets.''

ISDA commented that proposed § 39.16(c)(2)(vi) should be revised to insert the word ''excess'' immediately before the words ''proprietary margins'' to make it clear that proprietary margin is to be applied first to cover proprietary losses, noting that the use of proprietary margin to cover customer losses ahead of proprietary losses would hasten the mutualization of losses among clearing members, which would likely result in higher margin levels being imposed with respect to customer positions in order to avoid that outcome. The Commission agrees with ISDA and is modifying § 39.16(c)(2)(vi) by inserting ''excess'' before ''house funds and assets of a defaulting clearing member,'' as suggested by ISDA.

The Commission is adopting § 39.16(c)(2) with the modifications described above.

5. Publication of Default Rules—§ 39.16(c)(3)

Proposed § 39.16(c)(3) would require that a DCO must make its default rules publicly available, and would cross-reference § 39.21, adopted herein, which also addresses this requirement.[209]

The Commission did not receive any comment letters discussing proposed § 39.16(c)(3) and is adopting § 39.16(c)(3) as proposed.

6. Insolvency of a Clearing Member—§ 39.16(d)

Proposed § 39.16(d)(1) would require a DCO to adopt rules that require a clearing member to provide prompt notice to the DCO if the clearing member becomes the subject of a bankruptcy petition, a receivership proceeding, or an equivalent proceeding, *e.g.,* a foreign liquidation proceeding. Proposed § 39.13(d)(2) would require a DCO to review the clearing member's continuing eligibility for clearing membership, upon receipt of such notice. Proposed § 39.16(d)(3) would require a DCO to take any appropriate action, in its discretion, with respect to the clearing member or its positions, including but not limited to liquidation or transfer of positions, and suspension or revocation of clearing membership, upon receipt of such notice.

CME recommended that, in order to preserve a DCO's right to take appropriate steps before a clearing member files for, or is placed into, bankruptcy, the Commission should amend proposed §§ 39.16(d)(2) and (3) to require DCOs to take appropriate actions ''no later than upon receipt'' of notice that the clearing member is the subject of a bankruptcy petition or similar proceeding. The Commission is adopting § 39.16(d) with the modifications to §§ 39.16(d)(2) and (3) suggested by CME. In addition, the Commission is making a technical revision to § 39.16(d)(3) by replacing the phrase ''with respect to such clearing member or its positions'' with the phrase ''with respect to such clearing member or its house or customer positions.'' This revision eliminates possible ambiguity in the reference to ''its positions,'' which was intended to reflect current industry practice and include both house and customer positions, not just house positions.

H. Core Principle H—Rule Enforcement—§ 39.17

Core Principle H,[210] as amended by the Dodd-Frank Act, requires a DCO to maintain adequate arrangements and resources for the effective monitoring and enforcement of compliance with its rules and resolution of disputes. It also requires a DCO to have the authority and ability to discipline, limit, suspend, or terminate the activities of a member or participant due to a violation by the member or participant of any rule of the DCO. It further requires that a DCO report to the Commission regarding rule enforcement activities and sanctions imposed against clearing members.

Proposed § 39.17 would codify these requirements, adding a provision that would require a DCO to report to the Commission in accordance with proposed § 39.19(c)(4)(xiii). As proposed, § 39.19(c)(4)(xiii) would require a DCO to report the initiation of a rule enforcement action against a clearing member or the imposition of sanctions against a clearing member, no later than two business days after the DCO takes such action. As discussed in connection with rules implementing Core Principle J (Reporting), the Commission is adopting that reporting requirement with a modification that only requires a DCO to report sanctions imposed against a clearing member.[211]

The Commission received no comments on proposed § 39.17. The Commission is adopting § 39.17 as proposed, but with a change to the cross-reference to § 39.19(c)(4)(xiii) in § 39.17(a)(3) to reflect the redesignation of that provision as § 39.19(c)(4)(xi).[212]

I. Core Principle I—System Safeguards—§ 39.18

Core Principle I,[213] as amended by the Dodd-Frank Act, requires a DCO to establish and maintain a program of risk analysis and oversight that identifies and minimizes sources of operational risk through the development of appropriate controls and procedures, and automated systems that are reliable, secure and have adequate scalable capacity. Core Principle I also requires that the emergency procedures, back-up facilities, and disaster recovery plans that a DCO is obligated to establish and maintain specifically allow for the timely recovery and resumption of the DCO's operations and the fulfillment of each obligation and responsibility of the DCO. Finally, Core Principle I requires that a DCO periodically conduct tests to verify that the DCO's back-up resources are sufficient to ensure daily processing, clearing, and settlement.

Proposed § 39.18 would codify the obligations contained in Core Principle I and delineate the minimum requirements that a DCO would be required to satisfy in order to comply with Core Principle I. Proposed § 39.18 also would define the terms ''relevant

[209] *See* discussion of § 39.21 in section IV.L, below.

[210] Section 5b(c)(2)(H) of the CEA, 7 U.S.C. 7a–1(c)(2)(H).

[211] *See* discussion of rule enforcement reporting in section IV.J.5.j, below.

[212] *See id.* (The Commission is adopting § 39.19(c)(4)(xiii) as a renumbered § 39.19(c)(4)(xi)).

[213] Section 5b(c)(2)(I) of the CEA, 7 U.S.C. 7a–1(c)(2)(I).

area,'' ''recovery time objective,'' and ''wide-scale disruption'' for purposes of that section.

The Commission received one general comment from LCH. LCH generally ''concurred with all the provisions set out under proposed rule 39.18,'' but urged the Commission to align these provisions with the CPSS–IOSCO standards, and to phase in such standards.

As discussed below, the Commission received comments on proposed §§ 39.18 (h), (j), and (k), and proposed § 39.30(a).

The Commission did not receive any comments specifically related to the definitions contained in proposed § 39.18(a); proposed §§ 39.18(b),(c) and (d), which would address the required program of risk analysis and oversight; proposed § 39.18(e), which would require a DCO to have a business continuity and disaster recovery (BC–DR) plan and resources sufficient to enable the DCO to resume daily processing, clearing and settlement no later than the next business day following a disruption; proposed § 39.18(f), which would address outsourcing by a DCO of resources required to meet its responsibilities with respect to business continuity and disaster recovery plans; proposed § 39.18(g), which would delineate certain exceptional events upon the occurrence of which a DCO would be obligated to notify promptly the Commission's Division of Clearing and Risk; proposed § 39.18(h)(1), which would require a DCO to provide timely advance notice to the Division of Clearing and Risk of certain planned changes to automated systems; or proposed § 39.18(i), which would set forth certain records that a DCO would be required to maintain. The Commission is adopting each of these provisions as proposed, except that the Commission is replacing ''contracts'' with ''products'' in § 39.18(a) and is adding ''of the derivatives clearing organization's'' before ''own and outsourced resources'' in § 39.18(f)(2)(ii) for clarification.

1. Notice of Changes to Program of Risk Analysis and Oversight—§ 39.18(h)(2)

Proposed § 39.18(h)(2) would require a DCO to give Division of Clearing and Risk staff ''timely advance notice'' of ''planned changes to the DCO's program of risk analysis and oversight.'' CME commented that this is an ''extraordinarily broad requirement'' and urged the Commission to ''appropriately consider[] context and relative risks.''

The Commission is adopting § 39.18(h)(2) as proposed. The provision merely requires that DCOs submit such notice as part of their planning process. The Commission expects that staff will evaluate compliance with this provision, as with all other provisions, giving appropriate consideration to context and relative risks.

2. Testing—§ 39.18(j)

Proposed § 39.18(j) would set forth the requirements for the testing that a DCO must conduct of its automated systems and BC–DR plans. Proposed § 39.18(j)(1) would require that DCOs conduct regular, periodic, and objective testing and review of (i) their automated systems, to ensure that such systems are reliable, secure, and have adequate scalable capacity, and (ii) their BC–DR capabilities, to ensure that the DCO's backup resources meet the standards set forth in proposed § 39.18(e). Proposed § 39.18(j)(2) would require that these tests ''be conducted by qualified, independent professionals * * * [who] may be independent contractors or employees [of the DCO] but shall not be persons responsible for development or operation of the capabilities being tested.'' Proposed § 39.18(j)(3) would require that reports setting forth the protocols for, and the results of, such tests ''be communicated to, and reviewed by, senior management of the [DCO]'' and that ''[p]rotocols of tests which result in few or no exceptions shall be subject to more searching review.''

ICE, OCC, and MGEX objected to the obligation that the testing required by § 39.18(j) be performed by ''qualified, independent professionals.'' ICE contended that the proper standard should be to have qualified, independent professionals review, rather than conduct testing of, systems or capabilities. Similarly, OCC suggested that the testing could be overseen, rather than conducted, by an independent professional. MGEX objected more generally to the requirement that tests of its BC–DR capabilities be performed by ''independent professionals'' and expressly objected to the proposal's prohibition on the use of any employees who participated in the development or the operation of the systems or capabilities being tested to fulfill this role. MGEX argued that such persons are the most qualified persons to run the tests. KCC requested that a DCO's CRO or other similar official qualify as an 'independent professional' for purposes of the testing rule.

The Commission is adopting § 39.18(j) as proposed. The Commission notes that the obligation that the required testing of automated systems and BC–DR capabilities be performed by qualified, independent professionals is consistent with the Commission's historical practice of requiring independent testing of systems where appropriate.[214]

The Commission recognizes that persons charged with developing or operating a system are frequently called upon to test that system. The Commission believes, however, that the active involvement and direction of qualified, independent professionals in the testing process is needed to ensure objective and accurate results.

MGEX's requested approach would result in tests being conducted only by persons with an inherent conflict of interest (because negative results of the tests might call into question the work of those who developed or operate the systems) and, separately, would deny the DCO the benefit of an independent analysis of the workings of the system. Accordingly, while some testing of a DCO's automated systems and BC–DR capabilities may be conducted by persons who design or operate such system or capabilities, the Commission has decided to retain the requirement that the objective testing performed to satisfy § 39.18(j) must be conducted by qualified, independent persons, as defined therein. While a DCO's CRO may appropriately serve this function if he or she has the appropriate training and experience to be ''qualified'' in this context, and the appropriate role in the organization to be ''independent,'' the Commission does not believe it would be advisable to determine that the person serving in such a role is *necessarily* qualified and independent.

3. Coordination of BC–DR Plans With Members and Providers of Essential Services—§ 39.18(k)

Proposed § 39.18(k) would require that a DCO to the extent practicable: (1) Coordinate its BC–DR plan with those of its clearing members, in a manner adequate to enable effective resumption of daily processing, clearing, and settlement following a disruption; (2) initiate and coordinate periodic, synchronized testing of its BC–DR plans and the plans of its clearing members; and (3) ensure that its BC–DR plan takes into account the plans of its providers

[214] For example, paragraph (a)(2) of the application guidance to Core Principle 9 (prior to amendment by the Dodd-Frank Act) for contract markets noted that ''Any program of independent testing and review of [an automated] system should be performed by a qualified, independent professional.'' 17 CFR part 38, appendix B at Core Principle 9, paragraph (a)(2).

of essential services, including telecommunications, power, and water.

MGEX proposed that industry-sponsored events should suffice to satisfy the requirement that a DCO must coordinate its BC–DR plan with those of its members. Similarly, KCC requested that the Commission clarify that coordination would be deemed to be satisfied if the DCO reviews the BC–DR plans of its clearing members and essential service providers and subsequently provides to such parties the DCO's own BC–DR plan. KCC stated that it does not believe that coordination should involve extensive efforts at achieving specific consistency between the procedures of each party, as each has a distinct business model that faces varying operational risks.

NYPC objected to the requirement contained in proposed § 39.18(k)(3). NYPC noted that its business continuity plan (BCP) would be invoked any time a service provider ceases to provide an essential service, regardless of whether that service provider has invoked its own BCP, and thus such information would not necessarily give DCOs any additional insight into their own BCP. Similarly, CME noted that, while it obtains representations that its major vendors have disaster recovery plans, CME does not control, or generally have access to, the details of the proprietary plans of those service providers.

The Commission is adopting § 39.18(k) as proposed. With respect to the requirements of §§ 39.18(k)(1) and (2), the Commission recognizes that participation in industry-sponsored events, such as the annual testing conducted by FIA, serves as an important assessment of the connectivity between the systems of DCOs and their members (including backup sites), but such participation would not, in and of itself, satisfy the requirements of these regulations. The level of participation of a particular DCO in a particular industry test is left to the discretion of the DCO, and different DCOs may participate in such tests to different extents. Moreover, while such industry-sponsored events may be helpful, it is the responsibility of each DCO—not that of an industry organization—to ensure that the functionality of clearing will be maintained between the DCO and its members. The Commission believes that a DCO will best be able to meet its responsibilities reliably in a wide-area disaster that affects a DCO and its clearing members if the DCO has actively worked together with those clearing members to coordinate their plans and has obtained some evidence that such plans will appropriately mesh when implemented.

While it is true that a DCO should have backup arrangements that promptly can be engaged to address a failure of essential services, it is likely that most DCOs will prepare for a temporary, rather than an indefinite, loss of such services. Among the benefits provided by coordination of a DCO's BCP with that of providers of essential services is an insight into the period of time for which the DCO should be prepared to provide such services itself.

The Commission recognizes that a service provider may reasonably be reluctant to provide sensitive details of its own BCP, such as the precise location of backup facilities, and notes that the proposed requirement is prefaced with the limitation that a DCO is required to obtain this information only ''to the extent practicable.'' Nonetheless, merely obtaining a representation that states that a service provider has a backup plan—with no detail as to the Recovery Time Objective (RTO) of that service provider, and no insight into how that service provider's BCP might affect the BCP of the DCO—would likely be insufficient.

4. Recovery Time Objective—§ 39.18(a)

Proposed § 39.18(a) would define an RTO as the period within which an entity should be able to achieve recovery and resumption of clearing and settlement of existing and new contracts after those capabilities become temporarily inoperable for any reason up to a wide-scale disruption, and defines a wide-scale disruption as an event that causes a severe disruption or destruction of transportation, telecommunications, power, water or other critical infrastructure components in a relevant area, or an event that results in an evacuation or unavailability of the population in a relevant area. Proposed § 39.18(e)(3) would require that a DCO have an RTO of the next business day, while proposed § 39.30(a) would require that a SIDCO have an RTO of two hours.

ICE noted that proposed § 39.18(a) does not specify a minimum time that a wide-scale disruption must be accommodated, and that costs would be higher if the unavailability of staff in the relevant area that must be accommodated is the total loss of personnel. ICE suggested that one week would allow relocation of personnel outside the affected area.

The Commission is adopting §§ 39.18(a) and 39.18(e)(3) as proposed. However, as discussed above in connection with the financial resources requirements, the Commission believes that it would be premature to take action regarding § 39.30 at this time. The Commission will consider the proposals relating to SIDCOs together in the future.

J. Core Principle J—Reporting Requirements—§ 39.19

Core Principle J,[215] as amended by the Dodd-Frank Act, requires a DCO to provide the Commission with all information that the Commission determines to be necessary to conduct oversight of the DCO. The Commission proposed § 39.19 to establish requirements that a DCO would have to meet in order to comply with Core Principle J. Under proposed § 39.19, certain reports would have to be made by a DCO to the Commission: (1) On a periodic basis (daily, quarterly, or annually), (2) where the reporting requirement is triggered by the occurrence of a significant event; and (3) upon request by the Commission. Section 39.19(a) states the general requirement of Core Principle J. The Commission did not receive any comment letters discussing § 39.19(a) and is adopting the provision as proposed.

1. Submission of Reports—§ 39.19(b)

The Commission proposed § 39.19(b) to establish procedural requirements for electronic submission of reports and determination of time zones applicable to filing deadlines. The Commission received no comments and is adopting §§ 39.19(b)(1) and (2) as proposed. For purposes of clarification, the Commission is also adopting § 39.19(b)(3) to provide a definition of ''business day'' as ''the intraday period of time starting at the business hour of 8:15 a.m. and ending at the business hour of 4:45 p.m., on all days except Saturdays, Sundays, and Federal holidays.'' This is consistent with the definition of ''business day'' set forth in § 40.1(a).[216]

2. Daily Reporting—§ 39.19(c)(1)

Proposed § 39.19(c)(1) would require a DCO to submit daily reports with certain initial margin and variation margin data as well as other cash flows for each clearing member. More specifically, § 39.19(c)(1)(i) would require a DCO to report both the initial margin requirement for each clearing member, by customer origin and house origin, and the initial margin on deposit for each clearing member, by origin.

[215] Section 5b(c)(2)(J) of the CEA, 7 U.S.C. 7a–1(c)(2)(J).

[216] *See* 76 FR at 44790 (July 27, 2011) (Provisions Common to Registered Entities; final rule).

Proposed § 39.19(c)(1)(ii) would require a DCO to report the daily variation margin collected and paid by the DCO, listing the mark-to-market amount collected from or paid to each clearing member, by origin.[217]

Proposed § 39.19(c)(1)(iii) would require a DCO to report all other cash flows relating to clearing and settlement including, but not limited to, option premiums and payments related to swaps such as coupon amounts, collected from or paid to each clearing member, by origin. Proposed § 39.19(c)(1)(iv) would require a DCO to report the end-of-day positions for each clearing member, by customer origin and house origin.

In addition, as discussed in section IV.D.6.h.(2), above, in connection with the Commission's proposal to require DCOs to collect initial margin for customer accounts on a gross basis under proposed § 39.13(g)(8)(i), the Commission further proposed an addition to proposed § 39.19(c)(1)(iv) that would also require DCOs to report, for each clearing member's customer account, the end-of-day positions of each beneficial owner. The Commission is adopting § 39.19(c)(1) with two modifications. First, the Commission is not requiring reporting of customer positions by beneficial owner, except upon Commission request.[218] Second, as discussed below, the Commission is renumbering the paragraphs in § 39.19(c)(1) and adding a new paragraph (ii) to clarify the applicability of the daily reporting requirements to FCM/BDs. In addition, the Commission is replacing ''by customer origin and house origin'' with ''by house origin and by each customer origin''; and is replacing ''options on futures positions'' with ''options positions.''

MGEX and KCC commented that while such information is available to them,[219] they are concerned that if the Commission mandates a specific form of delivery, the cost to DCOs will be significantly higher than expected. MGEX referred to its recent experience with the Trade Capture Reporting initiative conversion to the Commission's new FIXML standards, which was more costly and time consuming than expected. KCC commented that all of the data proposed to be reported to the Commission is already made readily available to the Commission in varying degrees, and there is little need for the Commission to require the increasing level of detailed information in specified formats. In addition, MGEX expressed concern with the Commission's potential data storage capacity limitations. MGEX concluded that the combination of these two factors suggest that the burden of the daily reporting requirements on DCOs and the Commission outweigh the value of these reports.

MGEX suggested that requiring such data on an as-needed, rather than a daily, basis would limit the burden on DCOs and the Commission while ensuring relevancy as to the data being requested. KCC asked that the Commission reconsider the amount and detail of information necessary for its oversight role. While CME supported the proposed reporting requirement, it suggested that the Commission work with DCOs to determine the form and manner of delivery.

As mentioned in the notice of proposed rulemaking, many DCOs already provide the Commission with much of the data required under this provision. The Commission recognizes that the daily reporting requirements may place an additional burden on a DCO, particularly if the DCO must employ a specific form of delivery that it does not already have in place. However, establishment of an automated reporting system is a one-time cost, and a uniform reporting format for all DCOs is necessary to facilitate the Commission's ability to receive data promptly and quickly disseminate it within the agency.[220]

The overall purpose of receiving the daily data is to enable Commission staff to analyze the data on a regular basis so that it can detect certain trends or unusual activity on a timely basis. Receiving such data less frequently would significantly reduce its usefulness. While there may be initial costs for DCOs to set up the reporting systems, there should be little cost to DCOs on a continuing basis.[221] Finally, MGEX's suggestion to require such data on an as-needed basis does not further the objective of enhanced risk surveillance, given that the purpose of gathering the data is to identify and address potential problems at the earliest possible time.

OCC expressed concern that the reporting requirements make no accommodation for clearing members that are FCM/BDs, with respect to their securities positions. In response to OCC's comment, the Commission is adding a new paragraph (ii) to § 39.19(c)(1) to clarify the limited applicability of the daily reporting requirements to securities positions. The final rule provides that ''The report shall contain the information required by paragraph (c)(1)(i) of this section for (A) all futures positions, and options on futures positions, as applicable; (B) all swaps positions; and (C) all securities positions that are held in a customer account subject to Section 4d of the Act or are subject to a cross-margining agreement.''

3. Quarterly Reporting—§ 39.19(c)(2)

The Commission is adopting § 39.19(c)(2), requirements for quarterly reporting of financial resources, as proposed.[222]

4. Annual Reporting—§ 39.19(c)(3)

Proposed § 39.19(c)(3) would require a DCO to submit a report of the CCO and an audited financial statement annually, as required by § 39.10(c). The Commission received no comments on proposed § 39.19(c)(3), and the Commission is adopting § 39.19(c)(3) as proposed.

The Commission notes that in a separate proposed rulemaking implementing Core Principle O (Governance Fitness Standards), it proposed a new § 39.24(b)(4) which would require annual verification that directors, members of the disciplinary panel and disciplinary committee, clearing members, persons with direct access, and certain affiliates of a DCO, satisfy applicable fitness standards.[223] In connection with this, the Commission subsequently proposed to cross-reference this annual reporting obligation as a renumbered § 39.19(c)(3)(iii). At such time as the Commission may adopt the verification requirement as a final rule, § 39.19(c)(3) will be amended accordingly.

5. Event-Specific Reporting—§ 39.19(c)(4)

a. Decrease in Financial Resources—§ 39.19(c)(4)(i)

Under proposed § 39.19(c)(4)(i), a DCO would be required to report to the

[217] This requirement would apply to options transactions only to the extent a DCO uses futures-style margining for options.

[218] *See* further discussion of reports of beneficial ownership in section IV.D.6.h.(2), above.

[219] MGEX noted that it is already ''internally performing these tasks'' in reference to the several daily reporting requirements. KCC has also noted that it already submits trading activity and positions by each clearing member by origin on a daily basis in file formats prescribed by the Commission.

[220] The Commission notes that its staff is in the process of developing a plan for uniform submission of DCO reports.

[221] *See* further discussion of the costs and benefits of the reporting requirements in section VII.J, below.

[222] *See* further discussion of the quarterly reporting requirement under § 39.11(f) in section IV.B.10, above.

[223] *See* 76 FR at 736 (Jan. 6, 2011) (Governance).

Commission a 10 percent decrease in the total value of the financial resources required to be maintained by the DCO under § 39.11(a), either from the last quarterly report. or from the value as of the close of the previous business day. Such notification would alert the Commission of potential strain on the DCO's financial resources, either gradual or precipitous.

The Commission invited comments regarding possible alternatives as to what would be considered a significant drop in the value of financial resources. Although many commenters opposed using the 10 percent threshold as a barometer for a ''significant'' decrease, no commenter questioned the Commission's objective in obtaining this type of information in a timely manner.

MGEX commented that 10 percent is an arbitrary threshold and it is not uncommon for financial resources to fluctuate by 10 percent even in a stable market. Similarly, OCC and KCC stated that the threshold is arbitrary and would most likely be crossed on a frequent basis during the ordinary course of business.[224] In addition, KCC suggested that this requirement is duplicative, as a material drop in financial resources would already be required to be reported by the proposed requirement to report all material adverse changes (Material Adverse Change Reporting Requirement).[225]

OCC, Better Markets, and Mr. Barnard were also concerned about the types of financial resources to consider when calculating a decrease. OCC suggested it is counterproductive to report a decrease in financial resources as a result of a decrease in margin requirements, which is a sign of risk reduction. Similarly, Better Markets suggested that coincidental increases in margin-based financial resources, which could fluctuate substantially, could offset decreases by more important financial resources. In addition, Mr. Barnard raised concerns regarding: (1) Grouping all types of financial resources together for purposes of calculating decreases, and (2) whether only requiring a report of a decrease in financial resources is sufficient.

Several commenters proposed using a different threshold: (1) OCC suggested 25 percent; (2) MGEX suggested allowing a DCO to determine what constitutes a material decrease or, as an alternative, adopting a threshold of 30 percent over a five-day period and 25 percent when compared to the previous quarter; and (3) Better Markets suggested adopting a threshold of 5 percent of non-margin-based financial resources. NYPC recommended taking an approach similar to the FCM ''early warning'' reporting requirement.[226]

To compensate for an upwards adjustment of the financial resources requirement, Better Markets suggested also requiring a report if the ratio of financial resources to minimum required levels decreases to 1 to 1. Mr. Barnard suggested splitting financial resources into two groups: (1) The more ''robust'' financial resources (a DCO's own capital and guaranty fund), and (2) market or risk-related items (margins); and requiring a report for a decrease in either amount or a decrease in the total of both amounts. Mr. Barnard also suggested requiring a DCO to report a calculation of its ''solvency ratio'' (available financial resources/financial resources requirements) and a 5 percent or more drop in such ratio.

In response to commenters' objections to setting the level at 10 percent, the Commission is setting the reporting threshold at a level of 25 percent for both the daily and quarterly financial resources decreases. As noted, OCC suggested 25 percent while MGEX suggested 25 percent for the quarterly and 30 percent for a report covering any 5-day period. MGEX did not explain why there should be a distinction between the percentage decrease triggering the quarterly and shorter-term reports. The Commission believes that a 25 percent level addresses the commenters' concerns about ''noise'' while providing the Commission with notification of material decreases.

The Commission is not excluding certain financial resources from the decrease calculation as suggested by several commenters. Although there are certain financial resources that may fluctuate in the ordinary course of business, the Commission believes that setting the reporting threshold level higher should resolve many of these issues because fewer fluctuations that occur in the ordinary course of business would trigger the higher 25 percent threshold. Additionally, the purpose of the financial resources requirement in Core Principle B and as codified in the Commission's regulations is to ensure that a DCO has adequate resources to cover the default of the clearing member with the largest exposure. Financial resources are looked at in the aggregate. Thus, fluctuations during the ordinary course of business, even coincidental decreases in financial resources, all reflect the financial health of the DCO at that time.

The Commission is not replacing the financial resources percentage decrease reporting requirement with a requirement similar to the FCM ''early warning'' reporting requirement, as suggested by NYPC. While FCMs do have an ''early warning'' reporting requirement, this is only in addition to an FCM's requirement to also report decreases of 20 percent pursuant to § 1.12(g)(1).[227] In fact, even with the new financial resources reporting requirement for DCOs, DCOs still have a lesser reporting requirement than FCMs in this regard: DCOs are only required to report 25 percent decreases, while FCMs are required to report 20 percent decreases in addition to reporting decreases below certain thresholds (the ''early warning'' requirement).

The Commission is adopting the modified § 39.19(c)(4)(i) reporting requirement described herein. The Commission does not consider it to be duplicative of the Material Adverse Change Reporting Requirement, or the quarterly financial resource reporting requirement under § 39.11(f), as suggested by KCC. Each reporting requirement, including the financial resources reporting requirement, relates to specific circumstances that the Commission has determined to be material and which, based on its experience in conducting financial risk surveillance, the Commission believes warrants notification. The Material Adverse Change Reporting Requirement is intended to cover more unusual changes that are not readily identifiable in advance but would nonetheless be of interest to Commission staff in conducting its oversight of a DCO. The Commission is also not requiring the solvency ratio decrease reporting requirement suggested by Mr. Barnard. The Commission believes that receiving reports regarding financial resources decreases will serve the purpose of alerting the Commission to possible financial distress at a DCO, without

[224] KCC mentioned that changes in the level of excess permanent margin deposited by clearing members, changes in the minimum margin requirements on contracts or in the level of the guarantee pool requirements, and changes in the level of assessments that can be levied against clearing members in the event of a default, could cause financial resources to drop more than 10 percent within the ordinary course of business. OCC stated it would cross the 10 percent threshold on an almost monthly basis, *i.e.,* the day after monthly expirations occur.

[225] *See* discussion of proposed § 39.19(c)(4)(xiv) (finalized as § 39.19(c)(4)(xii)) in section IV.J.5.k, below.

[226] Section 1.12(b)(2) requires an FCM to give 24 hours notice to the Commission if it ''knows or should have known'' that its adjusted net capital is at any time less than 110 percent of the amount required by the Commission's net capital rule.

[227] Section 1.12(g)(1) requires an FCM to provide written notice within two business days of a substantial reduction in capital as compared to that last reported in a financial report if there is a reduction in net capital of 20 percent or more.

unnecessarily burdening a DCO with additional reporting requirements.

NYPC pointed out that the proposed rule language referring to a decrease in the ''total value of financial resources'' could be read to refer to the total combined default and operating resources. It also raised a question as to whether the reference to financial resources ''required to be maintained * * * under § 39.11(a)'' referred to the minimum amount ''required'' or if it was intended to encompass all financial resources ''available to satisfy'' the requirements.

The Commission intends the reporting requirement in § 39.19(c)(4)(i) to refer only to financial resources available to cover a default in accordance with § 39.11(a)(1). A significant change in the amount of financial resources available to meet operating expenses is addressed by § 39.19(c)(4)(iv).[228] In response to the interpretive issues raised by NYPC, the Commission is revising the language in § 39.19(c)(4)(i) to clarify that the decrease in financial resources refers to a decrease in resources ''available to satisfy the requirements under § 39.11(a)(1)'' so it is clear that the reporting requirement applies only to default resources and refers to those resources available to the DCO to satisfy the default resource requirements, even if the amount of those resources exceeds the minimum amount that is required by § 39.11(a)(1).[229]

The Commission notes that it should be apprised when a DCO experiences a 25 percent decrease in the value of its default resources from the value as of the close of the previous business day, even if their value has increased substantially since the last quarterly report. Such a change could signal a significant change in a DCO's risk profile and early reporting will enable the Commission to take appropriate measures to facilitate proper risk management at the DCO.

b. Decrease in Ownership Equity—§ 39.19(c)(4)(ii)

Proposed § 39.19(c)(4)(ii) would require a DCO to report an expected 20 percent decrease in ownership equity two business days prior to the event (or two business days following the event, if the DCO does not and reasonably should not have known prior to the event). Such report must include pro forma financial statements (or current financial statements) reflecting the anticipated condition of the DCO following the decrease (or current condition). The report is intended to alert the Commission of major planned events that would significantly affect ownership equity, most of which are events of which the DCO would have advance knowledge, such as a reinvestment of capital, dividend payment, or a major acquisition.

Better Markets commented that a decrease in ownership equity is an extraordinary event which would warrant notification for even a 5 percent decrease, the threshold the SEC uses for triggering reporting of acquisition of beneficial ownership of a class of shares. While a decrease in ownership equity can have a significant effect on the financial resources of a DCO, the Commission determined that 20 percent is a level that would represent a significant decrease and yet would not occur on a frequent basis. The Commission believes that setting the threshold lower than 20 percent would unnecessarily increase the potential burden on DCOs as well as on the Commission, which could then be responsible for reviewing a larger number of reports.

Better Markets also suggested that five business days advance notice is more appropriate and would not pose a significant burden for DCOs. While changing the requirement to five business days does not itself pose an additional burden on a DCO, the Commission is adopting the two-day notification requirement, as proposed. The Commission has determined that requiring the report two days prior to such an event is sufficient for its purposes in reviewing the transaction, particularly given the confidential nature of such a transaction.

OCC expressed concern that it would be problematic to provide the necessary financial statements within the time frame required; OCC stated that it runs financial statements on a monthly basis, thus it would not have them readily available within two days. Rather, OCC suggested keeping the notification time frame at two days, but allowing up to 30 days, or when the financial statements are ready, whichever occurs first, to provide the financial statements. The Commission is adopting the two-day requirement, as proposed. A 20 percent decrease in ownership equity is generally a major, planned event and the Commission believes it would be highly unusual for a DCO not to have financial statements prepared in connection with such a transaction.

The Commission is adopting § 39.19(c)(4)(ii) as proposed.

c. Six-Month Liquid Asset Test—§ 39.19(c)(4)(iii)

Proposed § 39.19(c)(4)(iii) would require immediate notice of a deficit in the six months of liquid assets required by § 39.11(e)(2). CME expressed concern with other ''immediate notice'' events,[230] stating that this would require a DCO to immediately notify the Commission, in the specific form and manner requested, even before the DCO attends to the situation and gathers all the relevant information. CME recommended only requiring ''prompt'' notice, which would require the DCO to notify the Commission ''quickly and expeditiously,'' while allowing the DCO to first attend to the situation at hand and ensure that the information reported to the Commission is correct and accurate. CME also suggested ''prompt'' notice for the Material Adverse Change Reporting Requirement.

The Commission is adopting the rule as proposed and retaining the ''immediate'' reporting requirement for both § 39.19(c)(4)(iii) and the Material Adverse Change Reporting Requirement.[231] While the Commission appreciates that in such situations a DCO would be busy attending to the matter at hand, the burden to contact the Commission is minimal. The Commission does not specify a particular form or manner of delivery, so as to minimize the burden on the DCO. Moreover, the Commission is concerned that using a time frame of ''prompt'' would leave too much open to interpretation by the DCO and could lead to untimely notices.

d. Change in Working Capital (Current Assets)—§ 39.19(c)(4)(iv)

Proposed § 39.19(c)(4)(iv) would require a DCO to report to the Commission no later than two business days after working capital is negative. The report must include a current balance sheet of the DCO. Better Markets commented that allowing a DCO two days to report negative working capital is too much time, given the potential gravity of the situation, and that anything less than a requirement of immediate notification is ''simply indefensible.''

[228] *See* discussion of § 39.19(c)(4)(iv) in section IV.J.5.d, below.

[229] As a technical matter, ICE Clear sought clarification in the rule text regarding the reference to § 39.11(a), pointing out that § 39.11(a) sets the standard for financial resources and § 39.11(b) lists the financial resources available to satisfy those standards. ICE Clear recommended that § 39.19(c)(4)(i) be revised to refer to both §§ 39.11(a) and (b). The Commission declines to include a reference to § 39.11(b) as the purpose of the cross-reference is to incorporate by reference the standard, not the means for satisfying the standard.

[230] CME referred to the immediate notice required under proposed §§ 39.19(c)(4)(v)–(ix).

[231] *See* further discussion of the Material Adverse Change Reporting Requirement in section IV.J.5.k, below.

As with the ownership equity decrease reporting requirement, OCC commented that it is problematic to submit a balance sheet in two business days. OCC suggested keeping the notification requirement at two days, but allowing up to 30 days (or sooner if ready) to provide a balance sheet.

The Commission is adopting § 39.19(c)(4)(iv) as proposed, except that it is revising certain terminology to clarify the intended meaning of the term ''working capital.'' While the Commission agrees that negative working capital is a serious matter, immediate reporting is not necessary to further the Commission's purpose in obtaining this information. The Commission is allowing up to two days for notification because immediate notification would require a DCO to put in place a potentially expensive system to allow for real-time tracking of working capital. Nonetheless, a DCO is expected to have a general knowledge of the level of its working capital at all times. By allowing two days for notification, a DCO will have time to compute whether working capital is negative if it has reason to believe that this may be the case, without being required to implement a real-time notification system. Thus, the purpose of the two business days is actually to give a DCO time to become aware of its obligation to report, not to allow the DCO to wait two days after it becomes aware of the situation.

The Commission is also requiring the DCO to submit a balance sheet within two business days of the DCO experiencing negative working capital. Given that a DCO would be expected to update its balance sheet upon realizing that it has negative working capital, the Commission does not believe this requirement imposes an additional burden on the DCO.

As ''working capital'' is not a defined term, the Commission is substituting the term ''current assets'' for ''working capital'' for purposes of clarification. Thus, ''negative working capital'' now refers to a situation when current liabilities exceed current assets. Section 39.19(c)(4)(iv) now reads as follows: ''*Change in current assets.* No later than two business days after current liabilities exceed current assets; the notice shall include a balance sheet that reflects the derivatives clearing organization's current assets and current liabilities and an explanation as to the reason for the negative balance.''

e. Intraday Initial Margin Calls—§ 39.19(c)(4)(v)

Proposed § 39.19(c)(4)(v) would require a DCO to report to the Commission any intraday margin call to a clearing member, no later than one hour following the margin call. Several commenters stated that the requirement is unnecessary and a burden on DCOs, while other commenters requested certain modifications to the proposal.

The Commission is not adopting the intraday margin call reporting requirement in proposed § 39.19(c)(4)(v). While such information could provide early notice of potential problems at a DCO, the Commission has concluded that the requirement would be overly burdensome to DCOs given the amount of work commenters indicated it would entail. In addition, the Commission will still receive much of the same information as part of each DCO's daily reporting under § 39.19(c)(1), and unusual intraday initial margin calls that reflect a material adverse change will still be reported under the Material Adverse Change Reporting Requirement.

f. Issues Related to Clearing Members—§§ 39.19(c)(4)(vi)–(ix)

Proposed §§ 39.19(c)(4)(vi)–(ix) would require a DCO to report the following issues related to clearing members: (1) A delay in collection of initial margin; (2) a request to clearing members to reduce positions; (3) a determination by the DCO to transfer or liquidate a clearing member position; and (4) a default of a clearing member. The Commission received comments suggesting that these reporting requirements are unnecessary or, at the very least, require some modification. KCC suggested not adopting these requirements altogether, because notification of these events would still be required under the Material Adverse Change Reporting Requirement.

The Commission has concluded that delays in the collection of initial margin are not necessarily signs of a financial problem at either the DCO or its clearing members. The Commission therefore is not adopting the requirement to report such delays under proposed § 39.19(c)(4)(vi). Nonetheless, if a delay is evidence of a material adverse change in the financial condition of a clearing member, it would still have to be reported under the Material Adverse Change Reporting Requirement.

The Commission is adopting the remainder of these reporting requirements as proposed. However, it is redesignating proposed §§ 39.19(c)(4)(vii)–(ix) as §§ 39.19(c)(4)(v)–(vii). These reporting requirements relate to events that occur infrequently but can be of significance to the Commission's risk surveillance program even if they do not rise to the level of having ''a material adverse financial impact'' on the DCO or represent ''a material adverse change in the financial condition of any clearing member'' under the Material Adverse Change Reporting Requirement. Thus, with respect to these reports, the Commission is not relying on the Material Adverse Change Reporting Requirement as suggested by KCC.

In connection with these proposed requirements, the Commission also proposed removing § 1.12(f)(1) in light of the fact that its requirements were substantially similar to those being proposed as § 39.19(c)(4)(viii). The Commission did not receive any comments on this proposal and is removing § 1.12(f)(1) as proposed.

g. Change in Ownership or Corporate or Organizational Structure—§ 39.19(c)(4)(x)

Proposed § 39.19(c)(4)(x) would require a DCO to report certain changes in ownership or corporate or organizational structure. In general, such reports must be submitted to the Commission three months in advance of the anticipated change. With the exception of the change discussed below, the Commission is adopting § 39.19(c)(4)(x) as proposed, redesignated as § 39.19(c)(4)(viii).

Proposed § 39.19(c)(4)(x)(A)(2) (redesignated as § 39.19(c)(4)(viii)(A)(2)) would require a DCO to report the creation of a new subsidiary, or the elimination of a current subsidiary, of the DCO or its parent company. CME commented that the creation or elimination of a separate subsidiary of the DCO's parent company would not serve the Commission's purpose of conducting effective oversight of the DCO or enhance the Commission's ability to conduct timely analysis of a DCO's activities. CME added that the plans of a DCO's parent company to create (or eliminate) a subsidiary may be highly confidential.[232] CME urged the Commission to eliminate such reporting requirement, asserting that ''the value of this information to the [Commission] is questionable, and the burdens associated with providing it may be substantial.'' CME did not provide any explanation as to why the burden of reporting might be substantial.

While information about corporate changes that potentially impact a DCO's

[232] MGEX also commented on the highly confidential nature of changes in ownership, corporate or organizational structure. The Commission believes MGEX's concerns are addressed by the Commission's procedures for nonpublic records and confidential treatment requests set forth in Part 145 of the Commission's regulations.

financial standing or operations is helpful to the Commission in its oversight of a DCO, to avoid creating an unintended burden on DCOs and Commission staff, particularly where a DCO is part of a complex corporate structure, the Commission is modifying § 39.19(c)(4)(viii)(A)(2) to eliminate the requirement to report a change in subsidiaries of the DCO's parent company. Thus, § 39.19(c)(4)(viii)(A) now requires only that a DCO report ''[a]ny anticipated change in the ownership or corporate or organizational structure of the [DCO] or its parent(s) that would: * * * (2) Create a new subsidiary or eliminate a current subsidiary of the [DCO]. * * * [233]

h. Change in Key Personnel—§ 39.19(c)(4)(xi)

Proposed § 39.19(c)(4)(xi) would require a DCO to report the departure or addition of any person who qualifies as ''key personnel,'' as defined in § 39.2, no later than two business days following the change. KCC suggested requiring a report ''within a reasonable period of time.'' The Commission notes that key personnel are not likely to change often, and KCC did not provide any explanation as to why the two business day notification period is inappropriate. The Commission is adopting § 39.19(c)(4)(xi) as proposed, but redesignated as § 39.19(c)(4)(ix).

i. Change in Credit Facility Funding Arrangement—§ 39.19(c)(4)(xii)

Proposed § 39.19(c)(4)(xii) would require a DCO to report no later than one business day after a DCO changes an existing credit facility funding arrangement, is notified that such arrangement has changed, or knows or reasonably should have known that the arrangement will change. KCC commented that this requirement is duplicative: such reports would already be required by the Material Adverse Change Reporting Requirement. CME had no objection to the requirement to report such changes, but opposed the requirement to notify the Commission when it knows that the arrangement will change in the future, stating that it serves little purpose to notify the Commission without knowing what will change. CME suggested that the requirement should be to report to the Commission after the terms have changed. Conversely, Better Markets opposed several components of the proposed rule, asserting that it is ''too narrow and too loose,'' allowing one business day is too long, and the standard of reporting when the DCO ''knows or reasonably should have known'' is insufficient. Better Markets suggested expanding the reporting requirement to cover alternative sources of liquidity such as access to commercial paper and repurchase agreement markets. It also suggested requiring such a report (i) immediately, and (ii) when ''there is a reasonable likelihood that the arrangement may change.''

The Commission is modifying the rule as suggested by CME by removing the following: ''or knows or reasonably should have known that the arrangement will change.'' Thus, a DCO is required to report a change in a credit facility funding arrangement no later than one business day after it changes the arrangement or is notified that such arrangement has changed. The provision is also being redesignated as § 39.19(c)(4)(x). The Commission is not adopting KCC's suggestion to rely on the Material Adverse Change Reporting Requirement because a change in a credit facility funding arrangement would be of specific interest to the Commission in its conduct of DCO oversight, but such a change is not likely to rise to the level of being a material adverse change. The Commission also is declining to adopt Better Markets' recommendations because they would result in the filing of multiple reports, many of limited usefulness, which, on balance, would place an unnecessary burden on DCOs and Commission staff. Nonetheless, the Commission notes that unusual market conditions such as those that might limit a DCO's access to commercial paper or ability to enter into repurchase agreements, thereby adversely affecting the DCO's liquidity, could constitute a material adverse change that would have to be reported under the Material Adverse Change Reporting Requirement.

j. Rule Enforcement—§ 39.19(c)(4)(xiii)

Proposed § 39.19(c)(4)(xiii) would require a DCO to report the initiation of a rule enforcement action against a clearing member or the imposition of sanctions against a clearing member, no later than two business days after the DCO takes such action. Several commenters observed that this would result in multiple reports with little useful information. They further noted that the DCO would otherwise inform the Commission about serious financial issues, as a matter of current practice and pursuant to the Material Adverse Change Reporting Requirement. MGEX recommended that the Commission not adopt the rule enforcement reporting requirement. OCC and CME recommended that the Commission not adopt the enforcement reporting requirement as proposed.

MGEX commented that requiring notification of the initiation of rule enforcement is unnecessary and premature, noting that many investigations are unrelated to financial risk and many are routine. OCC made a similar comment. MGEX expressed concern about the harm such a report could cause to a clearing member's reputation by notifying the Commission before there has been any determination of any guilt. MGEX also noted that the Commission is already routinely informed or is aware of ongoing or potential actions.

OCC stated that the proposed enforcement reports would serve no purpose because if there were serious financial issues, the DCO would already have been in regular contact with the Commission long before the DCO reached the stage of initiating a rule enforcement action. Thus, OCC believes these reports would not serve as an effective early warning sign. OCC further opposed this reporting requirement because a clearing member could appeal a decision after a sanction is imposed. OCC recommended notification to the Commission within 30 days after a final decision on a disciplinary matter.

CME believes it is unclear when the notification requirement would be triggered, and that there are situations when it is unclear when an enforcement action is considered to be initiated.

The Commission is adopting the rule with modifications. While the Commission considers information about enforcement actions to be useful in its oversight of a DCO's rule enforcement program under Core Principle H, and more broadly in its oversight of a DCO's overall risk management program, the Commission has concluded that the requirement, as proposed, could result in the reporting of many events that are not material to the Commission's oversight of a DCO.[234] The Commission recognizes that many enforcement actions may be based on relatively minor offenses and are

[233] As proposed, the provision referred to the DCO's ''parent company.'' The Commission is adopting a technical amendment to refer to the ''parent(s)'' to clarify that there could be more than one parent, such as in the case of a DCO owned by a joint venture, and the parent need not have any particular corporate form. For purposes of these reporting requirements, a ''parent'' is a direct parent, not an entity further up the chain of ownership.

[234] Core Principle H provides in relevant part that ''each derivatives clearing organization shall * * * (iii) report to the Commission regarding rule enforcement activities and sanctions imposed against members and participants. * * * '' *See also* discussion of § 39.17 in section IV.H, above.

unlikely to have a significant impact on a DCO's ability to manage risk related to the provision of clearing and settlement services.

Therefore, the Commission is adopting the regulation with a modification such that it would only require the reporting of sanctions against clearing members, no later than two business days after the DCO takes such action, and would not require the reporting of the initiation of rule enforcement actions. The Commission is also redesignating the provision as § 39.19(c)(4)(xi). The Commission notes that events or circumstances that rise to the level of having a material adverse impact on a DCO's ability to comply with the requirements of Part 39, or relate to a material adverse change in the financial condition of any clearing member, whether or not they form the basis of an enforcement action, will have to be formally reported under § 39.19(c)(4)(xii)(B) or (C), respectively.

Last, OCC requested clarification as to whether the rule enforcement reporting requirement applies to DCO enforcement activities involving a clearing member that is only registered as a BD. The Commission confirms that the requirement to report the imposition of sanctions against clearing members does not apply to a DCO's clearing members that are registered as BDs only and engaged solely in securities-based transactions. However, insofar as such a clearing member's actions might have a material adverse impact on the DCO's ability to comply with the requirements of Part 39 or would constitute a material adverse change in the financial condition of a clearing member, the DCO would be required to submit a Material Adverse Change Report, as discussed below.

k. Financial Condition and Events (Material Adverse Change Reporting Requirement)—§ 39.19(c)(4)(xiv)

Proposed § 39.19(c)(4)(xiv) would require a DCO to immediately notify the Commission after the DCO knows or reasonably should have known of certain material adverse changes, *i.e.,* the institution of any legal proceedings which may have a material adverse financial impact on the DCO; any event, circumstance or situation that materially impedes the DCO's ability to comply with part 39 of the Commission's regulations and is not otherwise required to be reported; or a material adverse change in the financial condition of any clearing member that is not otherwise required to be reported.[235]

CME and OCC are opposed to this ''catch-all'' requirement. In particular, CME is concerned that the requirement is too broad and thus would include a reporting requirement for anything that is technically in violation of Part 39, *e.g.,* even if the DCO's email or Web site goes down temporarily. OCC also commented that the requirement is unnecessary because the Commission will be receiving adequate reporting as a result of other reporting requirements in Part 39 and the reporting requirements for FCMs. Alternatively, CME suggested requiring ''prompt'' notice, rather than ''immediate'' notice.

The Commission is adopting § 39.19(c)(4)(xiv) as proposed, but redesignated as § 39.19(c)(4)(xii). CME's concerns are unwarranted as the reporting requirement would only require reporting incidents that could have a material adverse effect on the DCO. A Web site temporarily going down would not necessarily be expected to have a ''material'' adverse effect on the DCO. However, if it did have a material adverse impact, the Commission would expect it to be reported. The Commission recognizes that it is requiring a DCO to exercise its discretion in the first instance to determine what events trigger this reporting requirement, but the Commission considers this to be an appropriate responsibility for a DCO.

Moreover, while the Commission will be getting information as a result of other Part 39 and FCM reporting requirements, there may be certain conditions or events that could materially impact a DCO that the Commission could not anticipate, yet about which it would still be important for the Commission to be notified. This is especially important in light of the Commission's decision not to adopt certain proposed reporting requirements, as discussed above.

The Commission is also keeping the timing of the reporting requirement as ''immediate'' rather than ''prompt,'' as these are material changes for which immediate notification is essential and for which the more ambiguous ''prompt'' is not appropriate.[236]

l. Financial Statements Material Inadequacies—§ 39.19(c)(4)(xv)

Proposed § 39.19(c)(4)(xv) would require a DCO to report material inadequacies in its financial statements. The Commission received no comments on this requirement, and the Commission is adopting § 39.19(c)(4)(xv) as proposed (redesignated as § 39.19(c)(4)(xiii)), with the exception of a technical revision to add a reference to ''in a financial statement'' so that the language now reads ''If a derivatives clearing organization discovers or is notified by an independent public accountant of the existence of any material inadequacy in a financial statement, such derivatives clearing organization shall give notice. * * *''[237]

m. Action of Board of Directors or Risk Management Committee—§ 39.19(c)(4)(xvi)

In a separate proposed rulemaking that would implement Core Principle P (Conflicts of Interest), the Commission proposed § 39.25(b), which would require a DCO to report when the board of directors of a DCO rejects a recommendation or supersedes an action of the DCO's Risk Management Committee, or when the Risk Management Committee rejects a recommendation or supersedes an action of its subcommittee.[238] In connection with this, the Commission subsequently proposed to cross reference this reporting obligation in proposed § 39.19(c)(4)(xvi). At such time as the Commission may adopt the reporting requirement in § 39.25(b) as a final rule, § 39.19(c)(4) will be amended accordingly.

n. Election of Board of Directors—§ 39.19(c)(4)(xvii)

In a separate proposed rulemaking that would implement Core Principles P (Conflicts of Interest) and Q (Composition of Governing Boards), the Commission proposed § 40.9(b)(1)(iii), which would require a DCO to report certain information to the Commission after each election of its board of directors.[239] In connection with this, the Commission subsequently proposed to cross-reference this reporting obligation in proposed § 39.19(c)(4)(xvii). At such time as the Commission may adopt the reporting requirement in § 40.9(b)(1)(iii) as a final rule, § 39.19(c)(4) will be amended accordingly.

o. System Safeguards—§ 39.19(c)(4)(xviii)

Proposed § 39.19(c)(4)(xviii) would require a DCO to report certain exceptional events and planned changes as required by § 39.18(g) and § 39.18(h),

[235] Because of the potential impact on a DCO of an adverse change in the financial condition of a clearing member, this reporting requirement would apply to ''any'' clearing member, including one that is solely a BD engaging in securities activities.

[236] *See* discussion of timing requirements in section IV.J.5.c, above.

[237] The Commission is also making a technical non-substantive change by substituting the word ''shall'' for the word ''must'' to conform this provision with other provisions in § 39.19.

[238] *See* 76 FR at 736 (Jan. 6, 2011) (Governance).

[239] *Id.*

respectively. The Commission received no comments on this reporting requirement, and the Commission is adopting § 39.19(c)(4)(xviii), redesignated as § 39.19(c)(4)(xvi), as proposed.[240]

K. Core Principle K—Recordkeeping—§ 39.20

Core Principle K,[241] as amended by the Dodd-Frank Act, requires a DCO to maintain records of all activities related to the business of the DCO as a DCO, in a form and manner that is acceptable to the Commission and for a period of not less than 5 years. The Commission proposed § 39.20 to establish requirements that a DCO would have to meet in order to comply with Core Principle K.

Under proposed § 39.20(b), a DCO would have to maintain records of all activities related to its business as a DCO ''for a period of not less than 5 years,'' except for swap data that must be maintained in accordance with the SDR rules in part 45 of the Commission's regulations. Mr. Barnard expressed the view that limiting record retention to five years is insufficient and records should be required to be kept indefinitely.

The Commission is adopting § 39.20 as proposed. The Commission believes that codifying the statutory minimum requirement of five years is appropriate, noting that a five-year minimum is consistent with other Commission recordkeeping requirements.[242] In addition, the exception for swap data recordkeeping addresses situations where the Commission has previously determined that a five-year minimum may not be sufficient.[243]

L. Core Principle L—Public Information—§ 39.21

Core Principle L,[244] as amended by the Dodd-Frank Act, requires a DCO to provide market participants sufficient information to enable the market participants to identify and evaluate accurately the risks and costs associated with using the DCO's services. More specifically, a DCO is required to make available to market participants information concerning the rules and operating and default procedures governing its clearing and settlement systems and also to disclose publicly and to the Commission the terms and conditions of each contract, agreement, and transaction cleared and settled by the DCO, each clearing and other fee charged to members,[245] the DCO's margin-setting methodology, daily settlement prices, and other matters relevant to participation in the DCO's clearing and settlement activities.

Proposed § 39.21 would require a DCO to provide market participants with sufficient information to enable the market participants to identify and evaluate accurately the risks and costs associated with using the services of the DCO. In particular, proposed §§ 39.21(c)(2), (3) and (4) would require a DCO to disclose publicly and to the Commission information concerning its margin-setting methodology and the size and composition of the financial resource package available in the event of a clearing member default.

KCC, MGEX, and NGX variously commented that DCO fees and charges, margin methodology and financial resource information are confidential and should not be required to be publicly disclosed for the following reasons: (1) It is intellectual property, (2) there is no correlation between the availability of such information and the decision whether to invest in or trade with a DCO, and (3) privately held companies (or non-intermediated DCOs in the case of NGX) should not have to disclose such information. MGEX also suggested that making margin methodology information available to the public could lead to market manipulation by those who might attempt to influence the margin level. MGEX suggested that the rule should only require making the financial resource package information available upon request by a clearing member that has signed the DCO's confidentiality agreement. Conversely, Better Markets believes that § 39.21 does not go far enough and that many of the DCO reports required by § 39.19 should also be required to be disclosed to the public, as the Dodd-Frank Act requires that market participants and the public be informed of the risks and other potential consequences of transacting with a DCO.[246] Similarly, Mr. Barnard suggested requiring public disclosure of all items of public interest, including event-specific reports under § 39.19(c)(4), except for those that would expose business-specific confidential issues.

The Commission is adopting § 39.21 as proposed, except for proposed § 39.21(c)(7), which would require the public disclosure of information related to governance and conflicts of interest in accordance with provisions that were proposed in a separate rulemaking. At such time as the Commission adopts those provisions, § 39.21 will be amended accordingly. The requirement to publicly disclose clearing and other fees charged by the DCO, margin methodology and financial resources information comes directly from Core Principle L. Moreover, the Commission believes that concerns regarding the confidential nature of this information are unfounded because such information would seem to be fundamental to a clearing member or potential clearing member's assessment of the strengths and weaknesses of a DCO. This does not necessarily require disclosure of proprietary information; certain DCOs, *e.g.,* CME, already disclose this type of information on their Web sites.

The Commission is not revising the rule to incorporate Better Markets' or Mr. Barnard's proposals. From a practical standpoint, some of the information Better Markets and Mr. Barnard have requested to be publicly disclosed is otherwise going to be public information, particularly if the DCO is a public company, and thus subject to SEC filing requirements. Regardless, the Commission does not interpret Core Principle L as requiring disclosure of all of the financial workings of a DCO.

M. Core Principle M—Information Sharing—§ 39.22

Core Principle M,[247] as amended by the Dodd-Frank Act, requires a DCO to enter into and abide by the terms of each appropriate and applicable domestic and international information-sharing agreement and to use relevant information obtained under such agreements in carrying out its risk management program. The Commission proposed § 39.22 to codify the statutory requirement.

Proposed § 39.22 would require a DCO to enter into certain information-sharing agreements and use relevant information obtained from those

[240] *See* discussion of system safeguards reporting in section IV.I, above.

[241] Section 5b(c)(2)(K) of the CEA, 7 U.S.C. 7a–1(c)(2)(K).

[242] *See, e.g.,* § 1.31 of the Commission's regulations.

[243] *See* 75 FR 76574 (Dec. 8, 2010) (Swap Data Recordkeeping and Reporting Requirements).

[244] Section 5b(c)(2)(L) of the CEA, 7 U.S.C. 7a–1(c)(2)(L).

[245] The statutory language refers to fees charged to ''members and participants,'' and the Commission interprets this phrase to mean fees charged to ''clearing members.''

[246] In particular, Better Markets stated that, at a minimum, a DCO should be required to publicly disclose (i) the adequacy of its financial resources, measured by the required level of financial resources under Commission rules, and (ii) to the extent they must be reported to the Commission, a reduction in financial resources, decrease in ownership equity, or change in ownership or corporate structure.

[247] Section 5b(c)(2)(M) of the CEA, 7 U.S.C. 7a–1(c)(2)(M).

agreements in carrying out the risk management program of the DCO. MGEX is opposed to sharing confidential information such as proprietary intellectual property. MGEX also asked for further clarity to be able to comment further on this requirement.

The Commission is adopting § 39.22 as proposed. The provision purposely lacks specific details to allow each DCO the discretion to make its own determination as to which information-sharing agreements are necessary and appropriate, including taking into account confidentiality concerns. DCOs may seek further guidance from Commission staff if they have specific questions about existing or potential information-sharing arrangements.

N. Core Principle N—Antitrust Considerations—§ 39.23

Core Principle N,[248] as amended by the Dodd-Frank Act, conforms the standard for DCOs with the standard applied to DCMs under Core Principle 19.[249] Proposed § 39.23 would codify Core Principle N. CME commented that the proposed regulation is adequate, and the Commission is adopting the rule as proposed.

O. Core Principle R—Legal Risk—§ 39.27

Section 725(c) of the Dodd-Frank Act sets forth a new Core Principle R (Legal Risk).[250] Core Principle R requires a DCO to have a well-founded, transparent, and enforceable legal framework for each aspect of the DCO's activities. Proposed § 39.27 would set forth the required elements of such a legal framework. The Commission solicited comment as to the legal risks addressed in proposed § 39.27 and whether the rule should address additional legal risks.

CME commented that proposed § 39.27(c)(1), which would require a DCO that provides clearing services outside the United States to identify and address all conflict of law issues, should only require a DCO to identify and address any ''material'' conflict of law issues. The Commission agrees with CME that a DCO should not be burdened to identify non-material conflict of law issues and has revised § 39.27(c)(1) to provide that such a DCO must identify and address ''any material conflict of law issues.'' The Commission is otherwise adopting the rule as proposed.

[248] Section 5b(c)(2)(N) of the CEA, 7 U.S.C. 7a–1(c)(2)(N).

[249] *See* Section 5(d)(19) of the CEA, 7 U.S.C. 7(d)(19) (DCM Core Principle 19).

[250] Section 5b(c)(2)(R) of the CEA, 7 U.S.C. 7a–1(c)(2)(R).

P. Special Enforcement Authority for SIDCOs

Under Section 807(c) of the Dodd-Frank Act, for purposes of enforcing the provisions of Title VIII, a SIDCO is subject to, and the Commission has authority under the provisions of subsections (b) through (n) of Section 8 of, the Federal Deposit Insurance Act [251] in the same manner and to the same extent as if the SIDCO were an insured depository institution and the Commission were the appropriate Federal banking agency for such insured depository institution. Proposed § 39.31 would codify this special authority. The Commission did not receive any comments on this provision. Nevertheless, as discussed above in connection with the proposals relating to SIDCO financial resources and system safeguards for SIDCOs, the Commission is not finalizing the rules relating to SIDCOs at this time. The Commission expects to consider all the proposals relating to SIDCOs together in the future.

V. Part 140 Amendments—Delegations of Authority

Under § 140.94, the Commission delegates the authority to perform certain functions that are reserved to the Commission to the Director of the Division of Clearing and Risk. In connection with the regulations the Commission is adopting herein, as well as previously adopted § 39.5, the Commission is amending § 140.94 to delegate authority to perform certain functions to the Director of the Division of Clearing and Risk, as discussed below.

With respect to DCO applications, under § 140.94(a)(6), the Commission is delegating authority to determine whether a DCO application is materially complete under § 39.3(a)(2), and to request that an applicant submit supplemental information in order for the Commission to process a DCO application under § 39.3(a)(3).

In addition to the authority delegated to the Director of the Division of Clearing and Risk in connection with the Commission's final rulemaking for § 39.5,[252] § 140.94(a)(7) delegates authority to request specific additional information as part of a DCO's swap submission under § 39.5(b)(3)(ix).

Section 140.94(a)(8) delegates authority to grant an extension of time for a DCO to file its annual compliance report under § 39.10(c)(4)(iv).

With respect to financial resources requirements for DCOs, § 140.94(a)(9) delegates authority to: (1) determine whether a particular financial resource may be used to satisfy the requirements of § 39.11(a)(1) under § 39.11(b)(1)(vi); (2) determine whether a particular financial resource may be used to satisfy the requirements of § 39.11(a)(2) under § 39.11(b)(2)(ii); (3) review the methodology used to compute the requirements of § 39.11(a)(1) and require changes as appropriate under § 39.11(c)(1); (4) review the methodology used to compute the requirements of § 39.11(a)(2) and require changes as appropriate under § 39.11(c)(2); (5) request financial reporting from a DCO (in addition to the quarterly reports) under § 39.11(f)(1); and (6) grant an extension of time for a DCO to file its quarterly financial report under § 39.11(f)(4).

Section 140.94(a)(10) delegates authority to request the periodic financial reports of a DCO's clearing members that are not FCMs under § 39.12(a)(5)(i)(B).

With respect to risk management requirements, § 140.94(a)(11) delegates authority to: (1) Review percentage levels for customer initial margin requirements and require different percentage levels if levels are deemed insufficient under § 39.13(g)(8)(ii); (2) review methods, thresholds, and financial resources and require the application of different methods, thresholds, and financial resources as appropriate (relating to risk limits on clearing members) under § 39.13(h)(1)(i)(C); (3) review the amount of additional initial margin required of a clearing member permitted to exceed its risk threshold and require a different amount as appropriate under § 39.13(h)(1)(ii); (4) review the selection of accounts and methodology used in daily stress testing of large trader positions and require changes as appropriate under § 39.13(h)(3)(i); (5) review methodology for weekly stress testing of clearing member accounts and swap portfolios and require changes as appropriate under § 39.13(h)(3)(ii); and (6) request clearing member information and documents regarding their risk management policies, procedures, and practices under § 39.13(h)(5)(i)(A).

With respect to rule submissions and 4d petitions relating to the commingling of futures, options on futures, and cleared swaps in a cleared swaps

[251] 12 U.S.C. 1818.

[252] The Commission has already delegated authority to the Director of the Division of Clearing and Risk to: (1) consolidate multiple swap submissions from one DCO or subdivide a submission as appropriate for review under § 39.5(b)(2); and request information from a DCO to assist the Commission's review of a clearing requirement that has been stayed under § 39.5(d)(3). *See* 76 FR at 44474 (July 26, 2011) (Process for Review of Swaps for Mandatory Clearing; final rule).

account or futures account, respectively, § 140.94(a)(12) delegates authority to request additional information in support of a rule submission, under § 39.15(b)(2)(iii)(A), and to request additional information in support of a 4d petition, under § 39.15(b)(2)(iii)(B).

With respect to DCO reporting requirements, § 140.94(a)(13) delegates authority to: (1) Grant an extension of time for filing of reports required to be filed annually under § 39.19(c)(3)(iv); (2) request that a DCO file information related to its business as a clearing organization, including information relating to trade and clearing details, under § 39.19(c)(5)(i); (3) request that a DCO file a written demonstration that the DCO is in compliance with one or more core principles and relevant rule provisions under § 39.19(c)(5)(ii); and (4) request that a DCO file, for each clearing member, by customer origin, the end-of day positions for each beneficial owner under § 39.19(c)(5)(iii).

Finally, § 140.94(a)(14) delegates authority to permit a DCO to refrain from publishing on its Web site information that is otherwise required to be published under § 39.21(d).

VI. Effective Dates

For purposes of publication in the Code of Federal Regulations, all of the rules adopted herein will have an effective date of 60 days after publication in the **Federal Register**. The Commission received a number of comments, however, that discussed a DCO's need for time to develop appropriate systems and procedures to come into compliance with some of the rules. The Commission is extending the date by which DCOs must come into compliance for certain rules as follows:

DCOs must comply with the following rules 180 days after publication in the **Federal Register**: Financial resources—§ 39.11; participant and product eligibility—§ 39.12; risk management—§ 39.13 (except gross margin—§ 39.13(g)(8)(i)); and settlement procedures—§ 39.14.

DCOs must comply with the following rules 1 year after publication in the **Federal Register**: chief compliance officer—§ 39.10(c); gross margin—§ 39.13(g)(8)(i); system safeguards—§ 39.18; reporting—§ 39.19; and recordkeeping—§ 39.20.

VII. Section 4(c)

Proposed §§ 39.15(b)(2)(i) and 39.15(b)(2)(ii) would establish procedures for permitting futures and options on futures to be carried in a cleared swaps account (subject to Section 4d(f) of the CEA), and for cleared swaps to be carried in a futures account (subject to Section 4d(a) of the CEA), respectively. In connection with proposing those rules, the Commission proposed to grant an exemption under Section 4(c) of the CEA and requested comment on its proposed exemption.[253]

Section 4(c) of the CEA provides that, in order to promote responsible economic or financial innovation and fair competition, the Commission, by rule, regulation or order, after notice and opportunity for hearing, may exempt any agreement, contract, or transaction, or class thereof, including any person or class of persons offering, entering into, rendering advice or rendering other services with respect to, the agreement, contract, or transaction, from the contract market designation requirement of Section 4(a) of the CEA, or any other provision of the CEA other than certain enumerated provisions, if the Commission determines that the exemption would be consistent with the public interest.[254]

Proper treatment of customer funds requires, among other things, segregation of customer money, securities and property received to margin, guarantee, or secure positions in futures or options on futures, in an account subject to Section 4d(a) of the CEA (i.e., a futures account), and segregation of customer money, securities and property received to margin, guarantee, or secure positions in cleared swaps, in an account subject to Section 4d(f) of the CEA (*i.e.,* a cleared swaps account). Customer funds required to be held in a futures account cannot be commingled with non-customer funds and cannot be held in an account other than an account subject to Section 4d(a), absent Commission approval in the form of a rule, regulation or order. Section 4d(f) of the CEA mirrors these limitations as applied to customer positions in cleared swaps.

Under the proposed exemption, a DCO and its clearing members would be exempt from complying with the segregation requirements of Section 4d(a) when holding customer segregated funds in a cleared swaps account subject to Section 4d(f) of the CEA, instead of a futures account; and similarly, a DCO and its clearing members would be exempt from complying with the segregation requirements of Section 4d(f) when holding customer funds related to cleared swap positions in a futures account subject to Section 4d(a) of the CEA, instead of a cleared swaps account. For the reasons discussed below, the Commission has determined to grant the exemption under Section 4(c) of the CEA.

In the notice of proposed rulemaking, the Commission expressed its view that the adoption of proposed §§ 39.15(b)(2)(i) and 39.15(b)(2)(ii) would promote responsible economic and financial innovation and fair competition, and would be consistent with the ''public interest,'' as that term is used in Section 4(c) of the CEA. However, the Commission solicited public comment on whether the proposed regulations would satisfy the requirements for exemption under Section 4(c) of the CEA.

The Commission received one comment. CME supported the Commission's conclusion, agreeing that in appropriate circumstances, the commingling of customer positions in futures, options on futures, and cleared swaps could achieve important benefits with respect to greater capital efficiency resulting from margin reductions for correlated positions. CME believes that adoption of a regulation permitting such commingling would be consistent with the public interest, adding that ''[h]aving positions in a single account can also enhance risk management practices and systemic risk containment by allowing the customer's portfolio to be handled in a coordinated fashion in a transfer or liquidation scenario.''

In light of the foregoing, the Commission finds that permitting the commingling of positions pursuant to §§ 39.15(b)(2)(i) and 39.15(b)(2)(ii) will promote responsible economic and financial innovation and fair competition, and is consistent with the ''public interest,'' as that term is used in Section 4(c) of the CEA.

VIII. Considerations of Costs and Benefits

Section 15(a) of the CEA requires the Commission to ''consider the costs and benefits'' of its actions before promulgating a regulation.[255] In particular, these costs and benefits must be evaluated in light of five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. In conducting its evaluation, the Commission may, in its discretion, give greater weight to any one of the five enumerated areas and it may determine that, notwithstanding

[253] *See* 76 FR at 3715–3716 (Jan. 20, 2011) (Risk Management).

[254] 7 U.S.C. 6(c).

[255] 7 U.S.C. 19(a).

costs, a particular rule is necessary to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the CEA.[256]

In the following discussion, the Commission presents its considerations of the costs and benefits of the final rulemaking in light of the comments it received, other relevant data and information, and the five broad areas of market and public concern as required by section 15(a) of the CEA.

A. Background

A derivatives clearing organization (DCO) is an entity registered with the Commission through which derivatives transactions are cleared and settled. A DCO acts as a central counterparty, serving principally to ensure performance of the contractual obligations of the original counterparties to derivatives transactions and to manage and mitigate counterparty risk and systemic risk in the markets they serve. This is accomplished by interposing the DCO between the counterparties so that the DCO becomes the buyer to every seller and the seller to every buyer. Upon novation by the original parties to a transaction, the contractual obligations of the original parties to one another are extinguished and replaced by a pair of equal and opposite transactions between the DCO and the counterparties or their agents.

The DCO's role as central counterparty potentially exposes the DCO itself to risk from every user whose transactions are cleared through the DCO. Conversely, if a DCO itself fails or suffers a risk of failure, the consequences for the market at large are likely to be serious and widespread. Effective risk management, therefore, is critical to the functioning of a marketplace in which swaps are cleared through DCOs.

Clearing members are the entities that deal directly with DCOs. They may be acting on their own behalf or as agents. DCOs establish rules and risk management requirements for their clearing members, which typically include specified levels of financial resources, operational capacity, and risk management capability; deposit of risk-based initial margin and payment of daily variation margin sized to cover current and potential losses of the member; and contribution to a guaranty fund that can be used in the event of a clearing member default. These requirements lower systemic risk by reducing the likelihood of a clearing member default and, in the event a clearing member default does occur, reducing the likelihood that it will result in the default of other market participants.

Additionally, unlike bilateral derivatives transactions where parties do not know the exposures their counterparties have to other market participants, as a result of the multilateral nature of centralized clearing, DCOs have a real-time, more complete picture of each clearing member's risk exposure to multiple parties. Thus the DCO can more effectively and quickly identify developing risk exposures for individual clearing members and better manage these risks if clearing members become distressed.

B. General Comments and Considerations

The Dodd-Frank Act is intended to facilitate stability in the financial system of the United States by reducing risk, increasing transparency, and promoting market integrity. To accomplish these objectives, among other things, the Dodd-Frank Act provides for the mandatory clearing of certain swaps by DCOs and explicitly authorizes the Commission to promulgate rules to establish appropriate standards for DCOs in carrying out their risk mitigation function. Regulatory standards for DCOs will serve to assure market participants that credit and other risks associated with cleared swap transactions are being appropriately managed by DCOs. This, in turn, can promote the use of cleared swaps. Regulatory standards also can foster market confidence in the integrity of the derivatives clearing system.

In this final rulemaking, the Commission is adopting regulations to implement 15 DCO core principles: A (Compliance), B (Financial Resources), C (Participant and Product Eligibility), D (Risk Management), E (Settlement Procedures), F (Treatment of Funds), G (Default Rules and Procedures), H (Rule Enforcement), I (System Safeguards), J (Reporting), K (Recordkeeping), L (Public Information), M (Information Sharing), N (Antitrust Considerations), and R (Legal Risk). In addition, the Commission is adopting regulations to implement the Chief Compliance Officer provisions of Section 725 of the Dodd-Frank Act, and to update the regulatory framework for DCOs to reflect standards and practices that have evolved over the past decade since the enactment of the CFMA.

This rulemaking process has generated an extensive record, which is discussed at length throughout this notice as it relates to the substantive provisions in the final rules. A number of commenters expressed the view that there would be significant costs associated with implementing and complying with proposed rules. The Commission also received comments from KCC, CME, and OCC who stated generally that the cost-benefit analysis presented in the proposed rulemakings was insufficient. The Commission has carefully considered alternatives suggested by commenters, and in a number of instances, for reasons discussed in detail above, has adopted such alternatives or modifications to the proposed rules where, in the Commission's judgment, the alternative or modified standard accomplishes the same regulatory objective in a more cost-effective manner.

The Commission invited comments on the comprehensive or ''systemic'' costs and benefits of the proposed rules. MFA and Better Markets addressed this issue stating that the Commission's cost-benefit analyses presented in the notices of proposed rulemaking may have understated the benefits of the proposed rules.[257] MFA commented that the costs to market participants would be substantial if the Commission does not adopt the proposed regulations. Better Markets commented that the only reasonable way to consider costs and benefits of any of the Commission's rule proposals under Dodd-Frank is to view them as a whole. According to Better Markets:

> It is undeniable that the Proposed Rules are intended and designed to work as a system. Costing-out individual components of the Proposed Rules inevitably double counts costs which are applicable to multiple individual rules. It also prevents the consideration of the full range of benefits that arise from the system as a whole that provides for greater stability, reduces

[256] *See, e.g., Fisherman's Doc Co-op., Inc* v. *Brown,* 75 F.3d 164 (4th Cir. 1996); *Center for Auto Safety* v. *Peck,* 751 F.2d 1336 (D.C. Cir. 1985) (noting that an agency has discretion to weigh factors in undertaking cost-benefit analysis). Section 3 of the CEA states the purposes of the Act:

> It is the purpose of this Act to serve the public interests described in subsection (a) through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission. To foster these public interests, it is further the purpose of this Act to deter and prevent price manipulation or any other disruptions to market integrity; to ensure the financial integrity of all transactions subject to this Act and the avoidance of systemic risk; to protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets; and to promote responsible innovation and fair competition among boards of trade, other markets and market participants.

[257] *See* Letter from Better Markets dated June 3, 2011; Letter from MFA dated March 21, 2011 (comment file for 76 FR 3698 (Risk Management)).

systemic risk and protects taxpayers and the public treasury from future bailouts.

Better Markets believes that the benefits must include the avoided risk of a new financial crisis and the best measure of this benefit is the cost of the 2008 financial crisis, which is still accumulating. It cited Andrew G. Haldane, Executive Director, Financial Stability of the Bank of England, who estimated that the worldwide cost of the crisis in terms of lost output was between $60 trillion and $200 trillion, depending primarily on the long term persistence of the effects.

The Commission agrees with Better Markets that the DCO rules operate in an integrated, systemic manner to ensure that the risks associated with cleared swap transactions are being appropriately managed or addressed by DCOs. When implemented in their entirety, these rules have the potential to significantly change not only the aggregate risk profile of the entire derivatives clearing industry, but also the allocation of risks among DCOs, clearing firms, and market participants. The final rules require DCOs to admit firms as clearing members that may differ substantially from existing members with respect to size, risk profiles, specializations, and risk management abilities. The rules also help create an environment in which DCOs will compete for the business of clearing trades of different sizes, and of many different derivatives products—both futures and swaps. In a potentially much more diverse range of both participants and products, these final rules will allow, and in some cases require, DCOs to make use of a number of risk management tools, including, among others, periodic valuation of financial resources; a potentially more rigorous design for margins; stress testing and back testing for financial resources and margin, respectively; and additional rules and procedures designed to allow for management of events associated with a clearing member defaulting on its obligations to the DCO. These rules help reduce the potential for DCO default, and the potential follow-on effects on financial markets as a whole. In addition, the daily, quarterly, annual, and event-specific reporting requirements for DCOs enhance the tools available to the Commission in conducting its financial risk surveillance in connection with derivatives clearing by DCOs.

Certain of the regulations promulgated in this final rulemaking merely codify the requirements of the CEA, as amended by the Dodd-Frank Act, *e.g.,* §§ 39.10(a) and (b) (compliance with core principles); 39.17 (rule enforcement); 39.22 (information sharing); and 39.23 (antitrust considerations). For such provisions, the Commission has not considered alternatives to the statute's prescribed requirements, even though a DCO may incur costs to comply with these provisions. As these requirements are imposed by the Dodd-Frank Act, any associated costs and benefits are the result of statutory directives, as previously determined by the Congress, that govern DCO activities independent of the Commission's regulations. By its terms, CEA Section 15(a) requires the Commission to consider and evaluate the prospective costs and benefits of regulations and orders of the Commission prior to their issuance; it does not require the Commission to evaluate the costs and benefits of the actions or mandates of the Congress.

In its notice of proposed rulemaking, the Commission requested data or other information in connection with its cost-benefit considerations. The Commission received only a few comments providing quantitative information on the costs of the proposed rules. It received two comments on the benefits of the proposed rules.

The Commission invited but did not receive public comments specific to, or related to, its consideration of costs and benefits for proposed §§ 1.3, 39.1, 39.2, 39.4, 39.9, 39.16, 39.18, 39.20, 39.21, and 39.27. However, the Commission received comments on substantive provisions of those proposed rules and such comments are addressed above.

The following discussion summarizes the Commission's consideration of the costs and benefits of the final rules pursuant to CEA Section 15(a).

C. Form DCO—§ 39.3(a)(2)

Section 5b(c)(1) of the CEA provides that ''[a] person desiring to register as a derivatives clearing organization shall submit to the Commission an application in such form and containing such information as the Commission may require for the purpose of making the determinations required for approval under paragraph (2).'' Paragraph (2), which sets forth the 18 core principles applicable to DCOs, further provides in paragraph (i) that ''[t]o be registered and to maintain registration as a derivatives clearing organization, a derivatives clearing organization shall comply with each core principle described in this paragraph and any requirement that the Commission may impose by rule or regulation pursuant to section 8a(5) [of the CEA].'' Accordingly, the standard for approval of DCO registration is the applicant's ability to satisfy the DCO core principles.

Proposed § 39.3(a)(2) would require that any person seeking to register as a DCO submit a completed Form DCO, which would be provided as an appendix to part 39 of the Commission's regulations. The Form DCO, composed of a cover sheet and list of exhibits, would replace the general guidance contained in Appendix A to Part 39, ''Application Guidance and Compliance With Core Principles'' (Guidance), which was adopted by the Commission in 2001. In accordance with Section 5b(c) of the Act, the Form DCO is designed to elicit a demonstration that an applicant can satisfy each of the DCO core principles. Toward this end, the Form DCO requires submission of extensive information about an applicant's intended operations. This information has been required of applicants under the previous Guidance, and the use of the Form DCO does not represent a departure in substance from the Commission's practices over the past decade.

Rather, as explained in the proposed rulemaking, the Form DCO was designed to standardize and clarify the information that the Commission has required from DCO applicants in the past, in an effort to facilitate a more streamlined and efficient application process. The Commission has learned from experience that the general guidance contained in the previous Appendix A did not provide sufficiently specific instructions to applicants. As a result, the registration process has been prolonged in some cases because of the need for Commission staff to provide applicants with additional guidance about the nature of the information that the Commission requires to conclude that the applicant has demonstrated its ability to comply with the core principles.

The Commission did not receive comments specifically with respect to its cost-benefit analysis of proposed § 39.3(a)(2) or to its Paperwork Reduction Act estimate that the cost of preparing a completed application would be $100,000. The Commission notes that applicants for DCO registration will incur direct costs associated with the preparation of the completed Form DCO. However, because the Form DCO to a large extent captures information that has already been required by the Commission under the Guidance or, with respect to new core principles, captures information that tracks the statutory

requirements,[258] the use of the Form DCO will not impose greater costs than have been imposed in the past. In fact, by providing greater clarity as to what is expected from an applicant and by reducing the need for Commission staff to request, and the applicant to provide, supplementary information, the Form DCO should reduce costs for applicants.

As discussed in more detail in this notice of final rulemaking, the Commission received two comment letters that addressed the proposed Form DCO.[259] The comments did not oppose the concept of the Form DCO. The comments were directed at the large amount of information required and the necessity of submitting certain specific information. One of the comment letters focused on the use of the Form DCO for amending an existing DCO registration, and the Commission has provided a clarification to address that commenter's concerns. The Commission has determined to adopt the final Form DCO largely as proposed, but it has modified several of the exhibits in response to specific comments.

The Commission has evaluated the costs and benefits of the required use of Form DCO, under § 39.3(a)(2), in light of the specific considerations identified in Section 15(a) of the CEA as follows:

1. Protection of Market Participants and the Public

Costs

Applicants currently incur costs in demonstrating compliance with the core principles. As described above, based on the staff's experience in processing DCO applications over the last ten years, the Commission believes that use of the Form DCO will not increase, and often may decrease, the time and expense associated with applying for registration as a DCO for future applicants.

Benefits

The Commission expects that use of the Form DCO will promote the protection of market participants and the public. Given the critical role that DCOs play in providing financial integrity to the markets for which they clear—which now include swaps as well as futures markets—it is essential that the Commission conduct a comprehensive and thorough review of all DCO applications. Such review is essential for the protection of market participants and the public insofar as it serves to limit the performance of DCO functions to only those entities that have provided adequate demonstration that they are capable of satisfying the core principles.

2. Efficiency, Competitiveness, and Financial Integrity

Costs

As noted, the Commission believes that use of the Form DCO will not increase, and often may decrease, the time and expense associated with applying for registration as a DCO for future applicants.

Benefits

The Commission expects that use of the Form DCO will promote efficiency, competitiveness, and financial integrity. As discussed above, the CEA requires that prospective DCO registrants submit an application and comply with the core principles. In connection with these requirements, in 2001, the Commission adopted the Guidance to assist applicants in preparing application materials. However, the Commission's experience with protracted reviews of draft applications and materially incomplete final submissions has indicated a need for streamlining the application process.

By requiring the use of Form DCO, the Commission is promoting increased efficiency by providing greater clarity to applicants before they undertake the application process, thereby facilitating the submission of a materially complete final application in the first instance. This will also reduce the need for submission of supplemental materials and consultation between applicants and the Commission staff. The result will be more cost effective and expeditious review and approval of applications. This will benefit applicants as well as free Commission staff to handle other regulatory matters.

In addition, use of the Form DCO makes available to the public the Commission's informational requirements so that all prospective applicants have a heightened understanding of what is involved in the preparation and processing of an application. It promotes greater transparency in the process and will enhance competition among DCOs by making it easier for qualified applicants to undertake and navigate the application process in a timely manner.

The Form DCO is designed to address an applicant's ability to comply with the core principles. Compliance with the core principles is essential to ensure the financial integrity of the derivatives clearing process and of derivatives markets, generally. In particular, the required information in Form DCO Exhibits B (financial resources), D (risk management), E (settlement procedures), F (treatment of funds), G (default rules and procedures) and I (system safeguards) elicits important information supporting the applicant's ability to operate a financially sound clearing organization that can provide reliable clearing and settlement services and appropriately manage the risks associated with its role as a central counterparty.

3. Price Discovery

The Commission does not anticipate that use of the Form DCO will impact the price discovery process.

4. Sound Risk Management Practices

Costs

As noted, the Commission believes that use of the Form DCO will not increase, and often may decrease, the time and expense associated with applying for registration as a DCO for future applicants.

Benefits

The Commission expects that use of the Form DCO will promote sound risk management practices. Use of the Form DCO will reinforce sound risk management by requiring an applicant to examine its proposed risk management program through the preparation of a series of detailed exhibits. The submission of exhibits relating to risk management also make it easier for Commission staff to analyze and evaluate an applicant's ability to comply with Core Principle D (risk management, which includes monitoring and addressing credit exposure through margin requirements and other risk control mechanisms). Sound risk management practices are required by the CEA and Commission regulations, and are essential to the effective functioning of a DCO.

5. Other Public Interest Considerations

Costs

As noted, the Commission believes that use of the Form DCO will not increase, and often may decrease, the time and expense associated with applying for registration as a DCO for future applicants.

Benefits

There are considerable benefits to the public in standardizing and streamlining the DCO application process in terms of more efficient use of Commission resources and more cost-effective and transparent requirements for applicants. DCOs play a key role in

[258] Exhibits O, P, and Q, relating to the requirements of Core Principles O (Governance Fitness Standards), P (Conflicts of Interest), and Q (Composition of Governing Boards), respectively.

[259] *See* discussion in Section III.C.1, above.

supporting the financial integrity of derivatives markets, and this role takes on even greater significance with the Dodd-Frank requirements for swaps clearing. A coherent and comprehensive approach to DCO registration is needed to ensure that only qualified applicants will be approved and that they are capable of satisfying the requirements of the core principles and Commission regulations.

D. Chief Compliance Officer—§ 39.10(c)

Section 725(b) of the Dodd-Frank Act added a new paragraph (i) to Section 5b of the CEA to require each DCO to designate an individual as its CCO, responsible for the DCO's compliance with the CEA and Commission regulations and the filing of an annual compliance report.

The provisions regarding the CCO in proposed § 39.10(c) would largely codify Section 5b(i) of the CEA. There are certain provisions, however, that effectuate or implement the statutory requirements. For example, the proposed rules would require that the CCO have the appropriate background and skills for the position and not be disqualified from registration under Sections 8a(2) or 8a(3) of the CEA; meet with the board of directors or the senior officer at least once a year to discuss the DCO's compliance program; and perform duties including establishing a code of ethics. In addition, with respect to the annual report, the proposed rules would set forth certain content requirements (*e.g.,* discussing areas for compliance program improvement and listing any material changes to compliance policies and procedures since the last annual report) and procedural requirements (*e.g.,* submitting the annual report to the board of directors or senior officer prior to submitting the report to the Commission, and submitting the annual report not more than 90 days after the end of the DCO's fiscal year unless the Commission grants an extension of time.)

As discussed in detail above, the Commission received a number of comments that supported the proposed rules for CCOs and the annual compliance report, and other comments that suggested alternatives or refinements to the Commission's proposed rules. Commenters did not provide any quantitative data regarding the costs to either DCOs or market participants and the public. The Commission addressed those comments above and, where appropriate, the final rules reflect commenters' suggestions.

One commenter, MGEX, expressed concerns that relate to the Commission's implementation of the compliance framework established by Congress. MGEX stated that the regulations regarding organizational structure and reporting lines seem ''excessive and beyond what was contemplated by the passage of the Dodd-Frank Act.'' It also believes that the regulations do not ''guarantee improved market protection, which is one of the main goals of the Dodd-Frank Act.''

The Commission does not agree with MGEX that the rules exceed what was contemplated by Congress. To a great extent the rules codify the relevant provisions of the CEA, as amended, and it was Congress, not the Commission, that specified the compliance framework that the Commission is now implementing. The additional requirements set forth by the rules are designed to increase the CCO's effectiveness and ensure that the annual report is a useful compliance and oversight tool.

MGEX also commented that ''the rules will impose a cost and burden on the market that will be passed along to the market participants which decreases the overall efficiency and risk mitigation.'' MGEX did not provide any details to support its conclusion.

The Commission disagrees with MGEX that the Commission's rules will impose such a significant burden on the market and market participants. The principal costs of the CCO requirement result from the statutory provisions of the CEA which, as amended by the Dodd-Frank Act, requires each DCO to designate a CCO and submit an annual compliance report. Although the Commission's rules would impose certain additional costs in order to implement this statutory requirement, these additional costs are not expected to significantly increase costs to the DCO or market participants. For example, a DCO may incur higher costs to the extent that it needs to pay a higher salary to a person who has the qualifications set forth in the rule to perform the statutory and regulatory duties of the CCO.[260] The Commission believes that such costs are appropriate because it has determined that a CCO should have these qualifications to be effective, and notes that the standards are general enough to provide reasonable discretion to the DCO in its designation of a CCO.[261] Similarly, a DCO may have to incur higher costs in terms of staff time to prepare an annual report that contains the information required by § 39.10(c)(3), as opposed to a less comprehensive annual report. However, the Commission believes that the annual report must contain adequate information if it is to be useful to the DCO and the Commission. The Commission does not anticipate that these costs of hiring a qualified CCO, or of preparing a more detailed annual report, will be significantly higher than the costs to the DCO imposed by the basic statutory requirements for the CCO.[262]

For purposes of the Paperwork Reduction Act, the notice of proposed rulemaking estimated the cost of preparing the annual report to be $8000 to $9000 per year. The Commission received no comments on this estimate. The Commission received comments that the annual report should be more limited than proposed. The Commission notes that those comments did not suggest limiting the annual report to achieve a more favorable cost-benefit ratio, and the Commission addressed those comments above.

The Commission has evaluated the costs and benefits of § 39.10(c) in light of the specific considerations identified in Section 15(a) of the CEA as follows:

1. Protection of Market Participants and the Public

Costs

As discussed above, there are likely to be direct costs to DCOs in connection with designating a qualified CCO and annually preparing a comprehensive compliance report. To the extent that the Commission's regulations impose more specific or supplemental requirements when compared to those requirements explicitly imposed by Section 5b(i) of the CEA, those incremental costs are not likely to be significant. While it is possible that those incremental costs will be passed along to clearing members and market participants in the form of increased clearing fees, the size of those incremental costs, when spread across recipients of clearing services, are likely to be negligible.

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[260] The Commission believes that even in the absence of this specific rule many DCOs would employ well-qualified persons to perform the responsibilities of the statutorily-required CCO. In such circumstances this rule would not result in any additional costs for a DCO.

[261] As noted in section IV.A.3, above, the rules do not require that the person designated as the CCO hold that position, exclusively. A CCO may have dual responsibilities so long as the CCO can effectively carry out his or her duties as the CCO. Accordingly, depending on the skills and background of the personnel within a particular DCO, a DCO may be able to use an existing staff member to perform the duties of the CCO.

[262] In light of the variations that exist today among DCO compliance programs, including the qualifications of DCO compliance personnel, the Commission does not believe it is feasible to quantify the incremental costs associated with § 39.10(c).

Benefits

The Commission believes that the CCO rules will protect market participants and the public by promoting compliance with the core principles and Commission regulations through the designation and effective functioning of the CCO, and the establishment of a framework for preparation of a meaningful annual review of a DCO's compliance program. While there may be incremental costs associated with imposition of the Commission's regulatory standards, those costs may be mitigated by the countervailing benefits of an effective compliance program that fosters financial integrity of the clearing process and responsible risk management practices to protect the public from the adverse consequences that would result from a DCO failure.

The annual compliance report, in particular, will help the DCO and the Commission to assess whether the DCO has mechanisms in place to adequately address compliance issues and whether the DCO remains in compliance with the core principles and the Commission's regulations. Such compliance will protect market participants and the public.

2. Efficiency, Competitiveness, and Financial Integrity

Costs

The Commission believes that designation of a qualified CCO who will effectively perform required duties, including the preparation of an annual compliance report, will not increase costs and is likely to lead to reduction of costs, in terms of the efficiency, competitiveness, and financial integrity of the derivatives markets.

Benefits

Clearing is a critical component of the efficient, competitive, and financially sound functioning of derivatives markets. The financial integrity of these markets, in particular, is achieved through layers of protection. Requirements for an effective DCO compliance program will add a new layer of protection to ensure that the DCO remains compliant with the CEA and Commission regulations, especially relating to Core Principles B (financial resources), D (risk management), E (settlement procedures), F (treatment of funds), G (default rules and procedures), I (system safeguards), and N (antitrust considerations).

An effective CCO will provide benefits to DCOs and the markets they serve by implementing measures that enhance the safety and efficiency of DCOs and reduce systemic risk. Reliable and financially sound DCOs are essential for the stability of the derivatives markets they serve, and for the greater public which benefits from a sound financial system.

3. Price Discovery

The Commission does not anticipate that § 39.10(c) will impact the price discovery process.

4. Sound Risk Management Practices

Costs

The Commission does not believe that the CCO provisions will impose costs in terms of sound risk management practices. To the contrary, the Commission perceives there to be benefits that will result from its CCO implementing regulations.

Benefits

The regulatory provisions that interpret or implement the statutory requirements for the CCO and annual report serve to enhance the standards for a DCO's compliance program which will necessarily emphasize risk management compliance because of its significance to the overall purpose and functioning of the DCO. Compliance with Core Principle D (risk management) and related regulations encompasses, among other things, measurement and monitoring of credit exposures to clearing members, implementation of effective risk-based margin methodologies, and appropriate calculation and back testing of margin levels. It is the responsibility of the CCO to ensure that the DCO is compliant with Core Principle D and the regulations thereunder, and is otherwise engaged in appropriate risk management activities in accordance with the DCO's own rules, policies and procedures.

5. Other Public Interest Considerations

The Commission does not believe that the rule will have a material effect on public interest considerations other than those identified above.

E. Financial Resources—§ 39.11

Section 5b(c)(2)(B) of the CEA, Core Principle B, as amended by the Dodd-Frank Act, requires a DCO to possess financial resources that, at a minimum, exceed the total amount that would enable the DCO to meet its financial obligations to its clearing members notwithstanding a default by the clearing member creating the largest financial exposure for the DCO in extreme but plausible market conditions, and to cover its operating costs for a period of one year, calculated on a rolling basis.

Proposed § 39.11 would codify these requirements and set forth additional standards for the types of financial resources that are acceptable (§ 39.11(b)); computation of the amount of financial resources required to satisfy the statutory default and operational resources requirements (§ 39.11(c)); valuation of financial resources (§ 39.11(d)); liquidity of financial resources (§ 39.11(e)); and quarterly reporting of financial resources (§ 39.11(f)).[263]

As discussed in more detail above, the Commission received comment letters requesting further clarity as to the proposed requirements. The Commission also received comment letters that discussed how the proposed rules might impose costs or burdens on DCOs.[264] Two commenters objected to the requirement that DCOs must monitor ''on a continual basis'' a clearing member's ability to meet potential assessments, which one of the commenters characterized as ''overly burdensome and difficult to administer.'' Regarding the proposed restrictions on the use of assessment powers, another commenter stated that the inclusion of assessment powers as a financial resource is necessary for it to meet its obligations in the event of a default. Two commenters recommended that the Commission permit letters of credit to be considered in the financial resources computation. Finally, several DCOs urged the Commission to allow U.S. Treasuries, in addition to cash, as a financial resource sufficient to meet the proposed financial resource liquidity requirement.

As discussed above, in proposing that a DCO ''monitor, on a continual basis, the financial and operational capacity of its clearing members to meet potential assessments,'' the Commission did not intend to require real-time monitoring of clearing members. Rather, the purpose of the provision was to require a DCO to monitor often enough to enable it to become aware of any potential problems in a timely manner. The Commission has modified § 39.11(d)(2)(ii) to remove the ''continual basis'' standard, leaving the DCO to exercise its discretion in determining the appropriate frequency of periodic reviews or more frequent reviews as circumstances warrant in connection with particular clearing members.

The Commission is permitting DCOs to include potential clearing member

[263] The Commission also proposed § 39.29 which would apply certain stricter requirements to SIDCOs. As discussed above, the Commission is not taking action on those proposed rules as part of this final rulemaking.

[264] *See* discussion in Section IV.B, above.

assessments in calculating default financial resources, as proposed, subject to the limitations of § 39.11(d)(2)(iii) (30 percent haircut) and § 39.11(d)(2)(iv) (DCO may count the value of assessments, after the haircut, to meet up to 20 percent of its default resources requirement). The comments on this proposal were varied. Some commenters stated that the Commission had proposed an appropriate, balanced approach; others stated that the limitations on assessments were too strict; and still others stated that the Commission should not permit assessments to count at all.

It is the Commission's view that, in light of recent market events and as a general matter, it is not prudent to permit a DCO to rely on letters of credit. However, for the reasons discussed above, the Commission would consider permitting letters of credit to be included as a DCO financial resource on a very limited case-by-case basis.

Finally, the Commission is revising § 39.11(e)(1) so that, in addition to cash, a DCO may use U.S. Treasury obligations and high quality, liquid, general obligations of a sovereign nation to satisfy financial resource liquidity requirements. This revised standard reflects the current practices of U.S. and foreign-based DCOs.

The Commission has evaluated the costs and benefits of § 39.11 in light of the specific considerations identified in Section 15(a) of the CEA as follows:

1. Protection of Market Participants and the Public

Costs

The regulations require DCOs to take specific actions to ensure that they are able to meet the statutory requirements for covering default and operating expenses. These actions include monthly stress testing to calculate what those financial obligations are, and quarterly reporting to the Commission to demonstrate the adequacy of financial resources in terms of dollar amount and liquidity. DCOs will incur direct costs related to staffing and technology programming to calculate, monitor, and report financial resources.

Existing DCOs will have already implemented certain practices and systems for tracking and managing financial resources in order to comply with Core Principle B, as originally enacted in 2000. Given the staffing and operational differences among DCOs, the Commission is unable to accurately estimate or quantify the additional costs DCOs may incur to comply with the new financial resource rules.[265] Moreover, the cost-effects of new cleared products and new market participants clearing those products are too speculative and uncertain for the Commission to be able to quantify or estimate at this time. Such costs or benefits will depend upon a number of variables that are not estimable or quantifiable at this time, such as the nature and number of the new products that become subject to clearing, the nature and number of market participants that enter into transactions involving such products, and the resulting costs or benefits to such market participants from the clearing of such products.

As to costs associated with restrictions the Commission is imposing on the types and valuation of financial resources that may be counted as financial resources for purposes of satisfying Core Principle B, those too will vary among DCOs. For example, for DCOs that do not include potential clearing member assessments in their calculations of financial resources, the limitations on assessments will not result in increased costs. For DCOs that to any extent rely on potential assessments, the new limitations might require revisions to their default management plans, an increase in guaranty fund requirements, or an infusion of additional capital. The same would apply to letters of credit that cannot be considered to be financial resources for purposes of complying with Core Principle B, absent relief. Again, because of the range of circumstances of different DCOs, it is not feasible to estimate or quantify the costs of the safeguards imposed by the Commission's financial resource rules.

Benefits

The financial resource rules establish uniform standards that further the goals of avoiding market disruptions and financial losses to market participants and the general public, and avoiding systemic problems that could arise from a DCO's failure to maintain adequate default or operating resources. While it is not possible to estimate or quantify the benefits to market participants and the public in facilitating the financial soundness of a DCO, the Commission believes that a DCO failure, regardless of the size of the DCO, could adversely affect the financial markets, market participants, and the public.

[265] Commenters did not provide the Commission with quantitative data regarding such costs.

2. Efficiency, Competitiveness, and Financial Integrity

Costs

As discussed in connection with factor 1 above, quantification or estimation of these costs and benefits is not readily feasible. For some DCOs, the financial resource rules will have little or no direct or indirect impact. For others, the impact may be more substantial. Although there may be disparate impact among DCOs, overall the rules are not expected to impose significant costs in terms of efficiency, competitiveness, or financial integrity of derivatives markets.

Benefits

The regulations promote financial strength and stability, thereby fostering efficiency and a greater ability to compete in the broader financial markets. The regulations promote competition by preventing DCOs that lack adequate financial safeguards from expanding in ways that may ultimately harm the broader financial market. The regulations promote efficiency insofar as DCOs that operate with adequate financial resources are less likely to fail. The regulations are designed to ensure that DCOs can meet their financial obligations to market participants, thus contributing to the financial integrity of the derivatives markets as a whole.

As highlighted by recent events in the global financial markets, maintaining sufficient financial resources is a critical aspect of any financial entity's risk management system, and ultimately contributes to the goal of stability in the broader financial markets. Therefore, the Commission believes it is prudent to include financial resources requirements for entities applying to become or operating as DCOs. Finally, Congress has determined that a DCO must comply with Core Principle B to achieve the purposes of the CEA and the Commission has determined that § 39.11 sets forth the minimum standards for a DCO to do so.

3. Price Discovery

The Commission does not believe that this rule will have a material effect on price discovery.

4. Sound Risk Management Practices

Costs

Adequate financial resources are a corollary to strong risk management. To the extent that the financial resource rules result in additional costs, these costs are associated with implementing the practices and procedures that are necessary to ensure a DCO has adequate financial resources.

Benefits

The regulations, by setting specific standards with respect to how DCOs should assess, monitor, and report the adequacy of their financial resources, contribute to DCOs' maintenance of sound risk management practices and further the goal of minimizing systemic risk. The reporting requirements, in particular, will enable the Commission to conduct more thorough and meaningful oversight of DCOs that will contribute to improved risk management by DCOs overall.

5. Other Public Interest Considerations

Costs

The Commission has not identified any public interest considerations that would be negatively affected by the provisions of the financial resource rules that effectuate or implement the statutory requirements of Core Principle B (financial resources).

Benefits

The benefits to the public of a DCO maintaining adequate financial resources are discussed above.

F. Participant and Product Eligibility—§ 39.12

Participant Eligibility

Section 5b(c)(2)(C) of the CEA, Core Principle C, as amended by the Dodd-Frank Act, requires each DCO to establish appropriate admission and continuing eligibility standards for members of, and participants in, the DCO, including sufficient financial resources and operational capacity to meet the obligations arising from participation. Core Principle C further requires that such participation and membership requirements be objective, be publicly disclosed, and permit fair and open access. Core Principle C also requires that each DCO establish and implement procedures to verify compliance with each participation and membership requirement, on an ongoing basis.

As discussed above, the Commission crafted the provisions of proposed § 39.12(a) and related rules to establish a regulatory framework that accomplishes two goals: (1) to provide for fair and open access, while (2) limiting risk to the DCO and its clearing members. The provisions in § 39.12(a)(1) provide for fair and open access in a number of ways. A DCO is prohibited from adopting restrictive clearing member standards if less restrictive requirements that would not materially increase risk to the DCO or clearing members could be adopted (§ 39.12(a)(1)(i)); a DCO must allow all market participants who satisfy participation requirements to become clearing members (§ 39.12(a)(1)(ii)); the standards must be non-discriminatory (§ 39.12(a)(1)(iii)); and they may not require clearing members to be swap dealers (§ 39.12(a)(1)(iv)), or clearing members to maintain a swap portfolio of any particular size or meet a swap transaction volume threshold (§ 39.12(a)(1)(v)).

Section 39.12(a)(2) facilitates greater participation by requiring that capital requirements for clearing members be based on objective, transparent, and commonly accepted standards that appropriately match capital to risk (§ 39.12(a)(2)(i)); and by setting the minimum capital requirement at not more than $50 million (§ 39.12(a)(2)(ii)).

A number of commenters supported the proposed rules. They asserted that increased access to clearing would stimulate competition and diversify risk. A number of other commenters opposed aspects of the proposed rules, particularly the $50 million capital standard. They argued that these provisions could increase risk by providing access to firms with insufficient financial resources or operational capacity.

The Commission did not receive any comments that quantified the costs associated with the proposed participation rules. Instead, commenters focused on qualitative considerations, including how the proposed rules would affect market participants, market risk, efficiency, competitiveness, the financial integrity of futures markets, and price discovery.

The Commission is adopting these provisions essentially as proposed.

The Commission has evaluated the costs and benefits of the proposed regulations in light of the specific considerations identified in Section 15(a) of the CEA, as follows:

1. Protection of Market Participants and the Public

Costs

The participant eligibility rules may result in costs beyond those incurred in the normal course of operating a DCO or clearing firm, but such potential costs are, at this time, speculative in nature and impossible to estimate or quantify. By providing access to clearing to additional firms, the rules could impose costs on DCOs, other clearing members, or customers if a firm admitted to clearing membership in a DCO pursuant to these rules failed to meet its obligations. Any such costs depend upon a number of factors that are not presently knowable, quantifiable, or estimable.

It is not possible to estimate or quantify these costs in a reliable way for a number of reasons. The historical record prior to the enactment of the Dodd-Frank Act with respect to the operation of clearing organizations provides little guidance as to the costs that may be incurred in the future in the unlikely event of a default at a DCO. Defaults at DCOs are very rare and the circumstances of each one are unique. Moreover, the Dodd-Frank Act and implementing regulations will alter the landscape significantly. Existing DCOs and FCMs will be clearing new products. New DCOs and FCMs will enter the market. Mandatory clearing will bring new products and participants to DCOs and FCMs. The interaction of all these factors creates a wide range of uncertainty as to the nature of the potential consequences of a default under the new regulatory regime. In sum, the Commission believes that the possible future circumstances leading to and potential resulting consequences of a DCO default are too speculative and uncertain to be able to quantify or estimate the resulting costs to DCOs, clearing members, or market participants with any precision or degree of magnitude.

Whatever these potential costs, the Commission believes that the participant eligibility rules will reduce the risk that clearing members will in fact incur such costs. First, increased access to clearing membership should reduce concentration at any one clearing member and diversify risk. Second, the rules contain risk management provisions specifically designed to minimize the likelihood and extent of defaults. The provisions in § 39.12(a)(2) set forth requirements that mandate DCOs: Require that all clearing members have sufficient financial resources to meet obligations arising from participation in the DCO (§ 39.12(a)(2)(i)); establish capital requirements that are scalable so that they are proportional to the risks posed by clearing members (§ 39.12(a)(2)(ii)); require that clearing members have adequate operational capacity to meet obligations arising from participation in the DCO (§ 39.12(a)(3)); verify the compliance of each clearing member with the requirements of the DCO (§ 39.12(a)(4)); satisfy certain reporting requirements (§ 39.12(a)(5)); and have the ability to enforce participation requirements (§ 39.12(a)(6)).

For reasons similar to those described above, it is also not feasible to quantify or estimate this reduction in costs with any confidence. Based on its judgment and experience with the regulation and operation of clearing organizations, the

Commission believes that these rules will lower the risk that clearing members will in fact incur such costs. However, the possible future circumstances leading to and potential resulting consequences of a future default are too speculative and uncertain to quantify or estimate, either under the current regulatory regime or under the rules being adopted by the Commission.

Benefits

Greater access to clearing should benefit market participants by increasing competition among clearing members. Allowing more firms to clear should increase competition among clearing firms on both price and service which should, in turn, reduce costs to market participants. Further, the safeguards in § 39.12(a)(2) will benefit DCOs, clearing members, and market participants by reducing risk. Reductions in risk also benefit the general public by decreasing the probability of a systemic failure.

For the reasons described above in connection with costs, it is also impractical to quantify or estimate these benefits associated with reductions in risk to clearing members, market participants, and the public.

2. Efficiency, Competitiveness, and Financial Integrity

Costs

The considerations under this factor are very similar to the considerations under the previous factor with respect to participant eligibility requirements. Quantification or estimation of these costs and benefits is not feasible for the reasons set forth under the first factor. The potential increase in risk of default resulting from open access is mitigated by the decrease in risk resulting from diversification of risk, increased competition, and the safeguards set forth in § 39.12(a)(2).

Benefits

By opening access the rules should increase competition among clearing members thereby resulting in increased efficiency in the provision of clearing services. The safeguards in the rules such as the requirement that DCOs impose risk limits on clearing members will enhance the financial integrity of the DCO and its clearing members.

3. Price Discovery

Costs

The Commission has not identified any way in which the rules will impair price discovery.

Benefits

Increased competition among clearing members could bring more participants into the markets which could result in more competitive pricing and enhanced price discovery.

4. Sound Risk Management Practices

Costs

According to some commenters, the open access rules could hinder sound risk management practices by admitting clearing members unable to participate in the default management process. Other commenters assert that the rules provide appropriate protections and will facilitate sound risk management practices. The Commission believes that the open access rules, when coupled with the default management rules discussed below, will not impair sound risk management practices. Under the rules, clearing members will be required to demonstrate that they have operational capacity to carry out their responsibilities as well as sufficient financial resources to meet their obligations.

Benefits

As explained above, the provisions in § 39.12(a)(2) require that DCOs establish a risk management framework with respect to their members. In addition, open access should lead to diversification of risk at DCOs and allow additional firms to assist in the resolution of any defaults.

5. Other Public Interest Considerations

Costs

The Commission has not identified any other public interest considerations that would be negatively affected by the potential costs of the eligibility requirements.

Benefits

The CEA, as amended by the Dodd-Frank Act, requires DCOs to allow for open access and, therefore, broader participation. The Commission believes that greater participation in clearing could increase liquidity in the markets. This could help prevent price manipulation or other anti-competitive practices because it will be harder to organize concerted efforts to achieve such ends. Finally, Congress has determined that a DCO must comply with Core Principle C to achieve the purposes of the CEA and the Commission has determined that § 39.12(a) sets forth the minimum standards for a DCO to comply with the CEA's participation requirements.

Product Eligibility

Core Principle C also requires a DCO to establish ''appropriate standards for determining the eligibility of agreements, contracts, or transactions submitted to the [DCO] for clearing.'' Section 39.12(b) implements this provision.

Proposed § 39.12(b)(1) would require a DCO to establish requirements for determining product eligibility taking into account the DCO's ability to manage risks associated with the product. Proposed §§ 39.12(b)(2) and (b)(3) would codify section 2(h)(1)(B) of the CEA. Proposed § 39.12(b)(4) would prohibit a DCO from requiring an executing party to be a clearing member in order for the product to be eligible for clearing. Proposed § 39.12(b)(5) would require a DCO to select contract units for clearing purposes that maximize liquidity, facilitate transparency, promote open access, and allow for effective risk management. Proposed § 39.12(b)(6) would require novation upon acceptance of a swap. Finally, proposed § 39.12(b)(8) would require a DCO to confirm the terms of a swap at the time the swap is accepted for clearing.[266]

The Commission did not receive any comments directly addressing cost-benefit considerations. The Commission did receive several comments on substantive provisions that bear on those considerations. One commenter suggested that § 39.12(b)(4) may be an impediment to the development of new DCOs. Several commenters suggested that it would be impractical or inappropriate for a DCO to establish unit sizes for clearing that differ from the unit size at execution (§ 39.12(b)(5)).

The Commission also received several comments requesting clarification of certain provisions. As discussed above, the Commission has made changes to these rules that are responsive to the comments.

The Commission is adopting § 39.12(b) largely as proposed with several clarifying amendments as discussed above.

The Commission has evaluated the costs and benefits of § 39.12(b) in light of the specific considerations identified in Section 15(a) of the CEA, as follows:

1. Protection of Market Participants and the Public

Costs

The Commission has not identified any new costs arising out of §§ 39.12(b)(1), 39.12(b)(6), or

[266] Proposed § 39.12(b)(7) will be addressed in a separate rulemaking.

39.12(b)(8). DCOs currently perform risk analysis before accepting new products for clearing, currently novate trades upon acceptance, and currently issue confirmations to clearing members.

As noted, one commenter suggested that prohibiting a DCO from requiring one of the original executing parties to be a clearing member in order for a contract to be eligible for clearing may be an impediment to the development of new DCOs. The Commission believes that, to the contrary, such restrictions on product eligibility for clearing increase overall costs for market participants, and that prohibiting such restrictions will lead to lower overall costs. Such restrictions deny the availability and benefits of clearing to non-clearing members. Open access will enable non-clearing members to obtain the benefits of clearing and increase competition in clearing and trading, thereby increasing liquidity, and reducing costs.

The commenters who questioned the unit size provision did not elaborate on the costs. It is not feasible to quantify these costs for a number of reasons. The rule provides DCOs with significant flexibility in selecting unit sizes. Different DCOs may select different sizes for the same or similar products. Numerous SEFs will also be making judgments concerning unit size which will influence the decisions of DCOs and traders. Some products will be subject to mandatory clearing and others to voluntary clearing. The unpredictable interaction of these variables creates a wide range of uncertainty as to the nature of the consequences of the selection of unit sizes by DCOs. Similar considerations apply to the other provisions of § 39.12(b). In sum, the Commission believes that the possible future circumstances leading to, and the potential resulting consequences of, the implementation of § 39.12(b) are too speculative and uncertain to be able to quantify or estimate resulting costs with any precision or degree of magnitude.

Benefits

The Commission believes that § 39.12(b) will protect market participants and the public in many ways. First, these provisions are likely to facilitate the standardization of swaps, thereby eliminating differences between the terms of a swap as cleared at the DCO level and as carried at the customer level. Any such outstanding differences would raise both customer protection and systemic risk concerns. From a customer protection standpoint, if the terms of the swap at the customer level differ from those at the clearing level, then the customer still has a bilateral position opposite its counterparty. The customer is still exposed to the credit risk of the counterparty and the position would not be able to be offset against other positions at the DCO. Similarly, from a systemic perspective, any differences in terms between the trades would eliminate the possibility of multilateral offset and thereby diminish liquidity.

Second, § 39.12(b) can promote liquidity by permitting more parties to trade the product and by permitting more clearing members to clear the product. Third, it can enhance risk management by enabling a DCO, in the event of a default, to have more potential counterparties for liquidation.

Fourth, these provisions will support the requirement in section 2(h)(1)(B) of the CEA and proposed § 39.12(b)(2) that a DCO must adopt rules providing that all swaps with the same terms and conditions submitted to the DCO are economically equivalent within the DCO and may be offset with each other.

Fifth, clearing will eliminate the need for a counterparty to ascertain the credit-worthiness of each of its counterparties. This will promote liquidity, competition, and financial integrity to the benefit of all market participants.

2. Efficiency, Competitiveness, and Financial Integrity

Costs

The Commission has not identified any ways in which the proposals would reduce efficiency, competitiveness, or financial integrity.

Benefits

The rules should increase participation by clearing members, which should increase competition among clearing members to provide services to customers. In addition, the rules will lead to standardization of products. Finally, the rules will allow for more clearing through novation, which should result in increased open interest and liquidity. In turn, this should lead to more competitive and efficient markets. As noted above, smaller units can promote liquidity and encourage prospective clearing members to bid on positions and enable them to accept a forced allocation in the event of a clearing member's default. This facilitates open access, and at same time promotes risk management by enabling a DCO, in the event of a default, to be able to rely on more potential counterparties for liquidation.

3. Price Discovery

Costs

The Commission has not identified any ways in which the rules would reduce price discovery.

Benefits

As discussed above, the rules will increase competition, which should enhance price discovery by bringing more participants into the markets. In addition, standardization means that prices observed on different trades are more directly comparable, which can improve price discovery.

4. Sound Risk Management Practices

Costs

The Commission has not identified any ways in which the rules would impair sound risk management practices.

Benefits

The rules require DCOs to establish appropriate standards for determining the eligibility of contracts submitted to the DCO for clearing taking into account the DCO's ability to manage risks associated with the product. Such standards are a sound risk management practice.

5. Other Public Interest Considerations

Costs

The Commission has not identified any ways in which the rules would harm any other public interest considerations.

Benefits

As discussed above, open access, increased competition, greater liquidity, improved price discovery, and greater financial integrity are all benefits of the rules. All these factors will benefit the general public, which may not participate in these markets directly but may feel their impact on the larger economy.

G. Risk Management—§ 39.13

In General

Core Principle D,[267] as amended by the Dodd-Frank Act, requires each DCO to ensure that it possesses the ability to manage the risks associated with discharging the responsibilities of the DCO through the use of appropriate tools and procedures. It further requires each DCO to measure its credit exposures to each clearing member not less than once during each business day and to monitor each such exposure

[267] Section 5b(c)(2)(D) of the CEA; 7 U.S.C. 7a–1(c)(2)(D).

periodically during the business day. Core Principle D also requires each DCO to limit its exposure to potential losses from defaults by clearing members, through margin requirements and other risk control mechanisms, to ensure that its operations would not be disrupted and that non-defaulting clearing members would not be exposed to losses that non-defaulting clearing members cannot anticipate or control. Finally, Core Principle D provides that a DCO must require margin from each clearing member sufficient to cover potential exposures in normal market conditions and that each model and parameter used in setting such margin requirements must be risk-based and reviewed on a regular basis.

The Commission proposed § 39.13 to establish requirements that a DCO would have to meet in order to comply with Core Principle D. For a number of provisions of proposed § 39.13, the Commission did not receive any comments on the associated costs or on cost-benefit analysis. The Commission discussed in the notice of proposed rulemaking and above why it believes a DCO must satisfy each of those provisions to be in compliance with the Core Principle D and why it is appropriate for market participants to incur any costs associated with implementing each of those provisions. The Commission also addressed comments that suggested alternative standards, frameworks, or procedures. Where appropriate, the Commission revised the proposed rules. To avoid repetition, the Commission incorporates by reference the above discussion of § 39.13.

Commenters raised concerns about the costs of §§ 39.13(g)(2)(ii) (minimum liquidation time), 39.13(g)(2)(iii) (margin confidence level), 39.13(g)(8)(i) (gross margin), 39.13(h)(1)(i) (risk limits), 39.13(h)(2) (large trader reports), and 39.13(h)(5)(ii) (clearing member risk review) or the Commission's cost-benefit analysis relating to these rules. The Commission's consideration of the costs and benefits associated with these rules is discussed in greater detail below.

Minimum Liquidation Time

As proposed, § 39.13(g)(2)(ii) would require a DCO to use a liquidation time that is a minimum of five business days for cleared swaps that are not executed on a DCM, and a liquidation time that is a minimum of one business day for all other products that it clears, although it would be required to use longer liquidation times, if appropriate, based on the unique characteristics of particular products or portfolios.

Numerous commenters objected to the proposed difference in requirements that would subject swaps that were either executed bilaterally or executed on a SEF to a minimum five-day liquidation time, while permitting equivalent swaps that were executed on a DCM to be subject to a minimum one-day liquidation time. The Commission did not receive any comments that quantified the costs of this rule.

As to the actual periods proposed, commenters variously contended that a liquidation time of five business days may be excessive for some swaps, a one-day liquidation period is too short, a one-day liquidation period is appropriate for swaps executed on a DCM or a SEF, and a two-day liquidation period is appropriate for cleared swaps.

Some commenters encouraged the Commission to permit a DCO to determine the appropriate liquidation time for all products that it clears based on the unique characteristics and liquidity of each relevant product or portfolio. Two commenters recommended that if the Commission were to mandate minimum liquidation times in the final rules, it should allow DCOs to apply for exemptions for specific groups of swaps if market conditions prove that such minimum liquidation times are excessive.

Upon consideration of the comments, the Commission is adopting § 39.13(g)(2)(ii) with a number of modifications. First, the final rule requires a DCO to use the same liquidation time for a product whether it is executed on a DCM, a SEF, or bilaterally. Second, the final rule provides that the minimum liquidation time for swaps based on certain physical commodities, *i.e.,* agricultural commodities, energy, and metals, as well as futures and options, is one day. For all other swaps, the minimum liquidation time is five days. Third, to provide further flexibility, the Commission is adding a provision specifying that, by order, the Commission may provide for a different minimum liquidation time for particular products or portfolios.

The Commission has evaluated the costs and benefits of the proposed regulations in light of the specific considerations identified in Section 15(a) of the CEA, as follows:

1. Protection of Market Participants and the Public

Costs

The Commission anticipates that using only one criterion—*i.e.,* the characteristic of the commodity underlying a swap—to determine liquidation time could result in less-than-optimal margin calculations. For some products, a five-day minimum may prove to be excessive and tie up more funds than are strictly necessary for risk management purposes. For other products, a one-day or even a five-day period may be insufficient and expose a DCO and market participants to additional risk.

The Commission believes that it is not feasible to estimate or quantify these costs reliably. In addition to the liquidation time frame, the margin requirements for a particular instrument depend upon a variety of characteristics of the instrument and the markets in which it is traded, including the risk characteristics of the instrument, its historical price volatility, and liquidity in the relevant market. Determining such margin requirements does not solely depend upon such quantitative factors, but also requires expert judgment as to the extent to which such characteristics and data may be an accurate predictor of future market behavior with respect to such instruments, and applying such judgment to the quantitative results. Thousands of different swap products may be subject to clearing. Determining the risk characteristics, price volatility, and market liquidity of even a sample for purposes of determining a liquidation time specifically for such instrument would be a formidable task for the Commission to undertake and any results would be subject to a range of uncertainty. Reliable data is not readily available for many swaps that prior to the Dodd-Frank Act were executed in unregulated markets.

Given the amount of uncertainty in estimating margin requirements using either a five-day liquidation time or a one-day liquidation time, the amount of uncertainty in estimating the cost of using one rather than the other is compounded. For all the reasons stated in the previous paragraph, the possible range within which the size of the difference would fall is very large. In sum, in the absence of a reasonably feasible and reliable methodology at the present time for the Commission to use in calculating the appropriate margin requirements for swaps with either five-day or one-day liquidation times,[268] the

[268] The Commission notes that ''[t]he existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data'' is one of the factors the Commission must consider in reviewing whether a swap or group or class of swaps is subject to the mandatory clearing requirement in CEA Section 2(h)(1). *See* Section 2(h)(2)(D) of the CEA. To enable the Commission to make this determination, the Commission requires DCOs that

Commission believes that possible future circumstances surrounding margin levels are too speculative and uncertain to be able to quantify or estimate the resulting costs to DCOs, clearing members, or the public from the rule with any precision or degree of magnitude.

Moreover, any potential costs of this rule may be mitigated by the provision that allows DCOs to request, or the Commission on its own initiative to make, a determination that the liquidation time for a particular contract is too long or too short. As markets evolve, it may become appropriate to ease the requirement for certain swaps subject to the five-day minimum. Conversely, analysis may reveal that for other products or portfolios the five-day or one-day minimum is insufficient. This procedure could serve to reduce costs that may arise from application of the rule.

Benefits

A minimum liquidation time is a standard input in value-at-risk models used by DCOs to compute a confidence interval to estimate their risk. The value-at-risk confidence interval protects DCOs, their clearing members, market participants, and the public by fixing the probability that a default will occur and the position cannot be liquidated in time.

The five-day/one-day distinction for different types of swaps is based on the ease of liquidation of different product groups and is consistent with existing requirements that reflect the risk assessments DCOs have made over the course of their experience clearing these types of swaps. Several DCOs have determined that these are the appropriate standards for these instruments and apply it to their margin requirements. The Commission believes that this is a reasonable and prudent judgment.

A minimum standard is designed to prevent DCOs from competing by offering lower margin requirements than other DCOs and, as a result, taking on more risk than is prudent. In addition, the Commission is concerned that a DCO may misjudge the appropriate liquidation time frame because of limited experience with clearing and managing the risks of financial swaps. A minimum liquidation time frame should prevent DCOs from taking on too much risk.

While it is not possible to estimate or quantify the benefits to market participants and the public in facilitating the financial soundness of DCOs, the Commission believes that a DCO failure, regardless of the size of the DCO, could adversely affect the financial markets, market participants, and the public. This rule will diminish the chances that such a failure will occur.

2. Efficiency, Competitiveness, and Financial Integrity

Costs

The considerations under this factor are similar to the considerations under the first factor.

Benefits

The rule will promote efficiency, competitiveness and financial integrity by establishing a minimum standard for all DCOs. While a DCO will still have considerable latitude in setting risk-based margin levels, the Commission has determined that establishing a minimum liquidation time will provide legal certainty for an evolving marketplace, will offer a practical means for assuring that the thousands of different swaps that are going to be cleared subject to the Commission's oversight will have prudent minimum margin requirements, and will help prevent a potential ''race to the bottom'' by competing DCOs. Competition among DCOs will be channeled to other areas such as level of service.

The Commission believes that default by a clearing member could have a significant, adverse effect on market participants or the public. Market participants may have to incur the costs of making up any shortfall in margin through guaranty fund deposits and/or assessments, and any costs associated with participation in an auction or allocation of the positions of a defaulting clearing member. In a worst case scenario, a default by a clearing member may undermine the financial integrity of the DCO, which could have serious and widespread consequences for the U.S. financial markets. This rule protects market participants and the public from bearing these costs by requiring a DCO to follow certain minimum standards in establishing margin requirements.

3. Price Discovery

The Commission does not believe that this rule will have a material effect on price discovery.

4. Sound Risk Management Practices

Costs

Because the rule simply establishes minimums, it will not hinder the exercise of sound risk management practices. The rule specifically requires DCOs to use longer liquidation times if appropriate for particular products.

Benefits

As discussed under the first two factors, the rule will foster sound risk management practices.

5. Other Public Interest Considerations

The Commission has not identified any costs or benefits beyond those discussed under the first factor.

Margin Confidence Level

As proposed, § 39.13(g)(2)(iii) would require a DCO's initial margin models to meet an established confidence level of at least 99% based on data from an appropriate historical period.

A number of commenters stated that each DCO should have discretion to establish confidence levels based on the particular characteristics of the products and portfolios it clears and their underlying markets. However, a number of other commenters stated that a 99% confidence level was the proper minimum.

The Commission is adopting the rule as proposed.

The Commission has evaluated the costs and benefits of the proposed regulation in light of the specific considerations identified in Section 15(a) of the CEA, as follows:

1. Protection of Market Participants and the Public

Costs

A 99% confidence level will require that more money be held as margin as compared to a lower confidence level. There is an opportunity cost to clearing members holding this money as margin.

The Commission believes that it is not feasible to estimate or quantify this cost reliably. In addition to the confidence level, the margin requirements for a particular instrument depend upon a variety of characteristics of the instrument and the markets in which it is traded, including the risk characteristics of the instrument, its historical price volatility, and liquidity in the relevant market. Determining such margin requirements does not solely depend upon such quantitative

submit swaps to the Commission for a mandatory clearing determination to submit data and other information that would enable the Commission to effectively consider this factor. *See* § 39.5(b)(3)(ii)(A), 76 FR at 44473 (July 26, 2011) (Process for Review of Swaps for Mandatory Clearing; final rule). Not only is this type of information needed for the Commission to consider the statutory factors and make the determinations as to which swaps should be subject to mandatory clearing, but it also would be needed to calculate appropriate margin amounts for such swaps, were the Commission to attempt such calculations.

factors, but also requires expert judgment as to the extent to which such characteristics and data may be an accurate predictor of future market behavior with respect to such instruments, and applying such judgment to the quantitative results. Thousands of different swap products may be subject to clearing. Determining the risk characteristics, price volatility, and market liquidity of even a sample for purposes of determining a confidence level specifically for such instrument would be a formidable task for the Commission to undertake and any results would be subject to a range of uncertainty. Reliable data is not readily available for many swaps that prior to the Dodd-Frank Act were executed in unregulated markets. In sum, in the absence of a reasonably feasible and reliable methodology at the present time for the Commission to use in calculating the margin requirements for swaps,[269] the Commission believes that possible future circumstances surrounding margin levels are too speculative and uncertain to be able to quantify or estimate the resulting costs to DCOs, clearing members, or the public from the rule with any precision or degree of magnitude.

Benefits

A minimum confidence level is essential to protect market participants and the public. A minimum confidence level will prevent DCOs from competing with respect to how much risk they are willing to take on or from misjudging the amount of risk they would take on if they operated under lower standards. In addition, it will provide assurance to market participants that every DCO has sufficient margin to effectively manage a default.

Some DCOs currently apply the 99 percent standard. Others use 95–99 percent for some contracts depending on facts and circumstances. International standards currently recommend 99 percent.[270] In view of the increased risk that DCOs will face as a result of clearing swaps, the Commission believes that protection of market participants and the public dictates that the minimum standard on this key risk management element should be set in accordance with current best practices among DCOs and international standards.

2. Efficiency, Competitiveness, and Financial Integrity

Costs

The considerations under this factor are very similar to the considerations under the first factor.

Benefits

The rule will promote efficiency, competitiveness and financial integrity by establishing a minimum standard for all DCOs. While a DCO will still have considerable latitude in setting risk-based margin levels, the Commission has determined that establishing a minimum confidence level will provide legal certainty for an evolving marketplace, will offer a practical means for assuring that the thousands of different swaps that are going to be cleared subject to the Commission's oversight will have prudent minimum margin requirements, and will prevent a potential ''race to the bottom'' by competing DCOs. As noted above, the Commission is adopting a 99% standard in order to conform to current best practices among DCOs as well as international standards. Competition among DCOs will be channeled to other areas such as level of service.

The Commission believes that default by a clearing member could have a significant, adverse effect on market participants and the public. Market participants may have to incur the costs of making up any shortfall in margin through guaranty fund deposits and/or assessments, and any costs associated with participation in an auction or allocation of the positions of a defaulting clearing member. In a worst case scenario, a default by a clearing member may undermine the financial integrity of the DCO, which could have significant negative consequences for the financial stability of U.S. financial markets. As highlighted by recent events in the global financial markets, the ability to manage the risks associated with clearing is critical to the goal of stability in the broader financial markets. This rule protects market participants and the public from bearing these costs by requiring a DCO to follow certain minimum standards in establishing margin requirements.

3. Price Discovery

The Commission does not believe that this rule will have a material effect on price discovery.

4. Sound Risk Management Practices

Costs

Because the rule simply establishes minimums, it will not hinder the exercise of sound risk management practices. The rule specifically requires DCOs to use higher confidence levels if appropriate for particular products.

Benefits

As discussed under the first two factors, the rule will foster sound risk management practices.

5. Other Public Interest Considerations

The Commission does not believe that the rule will have a material effect on public interest considerations other than those identified above.

Gross Margin

As proposed, § 39.13(g)(8)(i) would require a DCO to collect initial margin on a gross basis for customer accounts.

Two commenters supported the proposal. Several commenters stated that the provision of individual customer position information to DCOs may entail significant, costly, and time-consuming changes to systems infrastructure at the clearing member level and the DCO level.

In light of the various concerns regarding the operational and technology changes that would be needed and related costs of requiring a DCO to obtain individual customer position information from its clearing members and to use such information to calculate the margin requirements for each individual customer, the Commission is modifying § 39.13(g)(8)(i). As amended, the rule provides a DCO with the discretion to either calculate customer gross margin requirements based on individual customer position information that it obtains from its clearing members or based on the sum of the gross positions of all of a clearing member's customers that the clearing member provides to the DCO, without forwarding individual customer position information to the DCO.

The Commission has evaluated the costs and benefits of the proposed regulation in light of the specific considerations identified in Section 15(a) of the CEA, as follows:

1. Protection of Market Participants and the Public

Costs

Three kinds of costs could result from a change from net to gross margining, for those DCOs that currently use net margining.[271] First, gross margining could change the loss that customers of a clearing member may face in the event

[269] *Id.*

[270] *See* CPSS–IOSCO Consultative Report, Principle 6: Margin, Key Consideration 3, at 40; EMIR, Article 39, paragraph 1, at 46.

[271] As discussed in section IV.D.6.h.(1), above, certain DCOs already use a version of gross margining, in which case the costs of complying with § 39.13(g)(8)(i) would be considerably less.

of default by a fellow customer of that clearing member. Under net margining, a greater portion of customer margin is held at the clearing member and thereby insulated from the DCO, so that non-defaulting customers face lower risk of losing their margin deposits to the DCO if a fellow customer defaults. Gross margining gives a DCO access to the margin deposits of non-defaulting customers of a defaulting FCM.[272] In this sense, gross margining could shift a portion of the default risk from the DCO to fellow customers.[273]

It is not possible to estimate or quantify these costs—which would only arise in the event of a default of a customer—in a reliable way for a number of reasons. The historical record prior to the enactment of the Dodd-Frank Act with respect to the operation of clearing organizations provides little guidance as to the costs that may be incurred in the future in the unlikely event of a default at a DCO. Defaults at DCOs are very rare and the circumstances of each one are unique. Moreover, the Dodd-Frank Act and implementing regulations will alter the landscape significantly. Existing DCOs and FCMs will be clearing new products. New DCOs and FCMs will enter the market. Mandatory clearing will bring new products and participants to DCOs and FCMs. The interaction of all these factors creates a wide range of uncertainty as to the nature of the potential consequences of a default under the new regulatory regime. In sum, the Commission believes that the possible future circumstances leading to and potential resulting consequences of a future default are too speculative and uncertain to be able to quantify or estimate the resulting costs to clearing members with any precision or degree of magnitude.

Second, because gross margining means that more customer margin is held at the DCO, rather than the FCM, gross margining also means that any return on this margin (*e.g.,* interest earned) is earned by the DCO, rather than the FCM. This is largely a transfer between those parties. If there is no offsetting change in other terms of the relationship between customers, FCMs and DCOs, gross margining leads to a cost for FCMs and a benefit to DCOs from this change.

Third, gross margining could result in changes in operating costs for DCOs and clearing members. Gross margining could require the DCO to possess more detailed information about customer positions. The provision of individual customer position information to DCOs may entail significant, costly, and time-consuming changes to systems infrastructure at the clearing firm level and the DCO level. For example, NYPC stated that its preliminary cost estimate for compliance with the customer gross margin and large trader report requirements contained in proposed §§ 39.13(g)(8)(i) and 39.13(h)(2) was approximately 128,650 hours and $14.5 million.

In order to reduce the potential costs, the Commission has revised § 39.13(g)(8)(i) to allow a DCO to permit an FCM to provide the DCO with the sum of the gross positions of all of its customers so that the DCO may calculate the applicable gross margin requirement based on that sum. Under this scenario, a DCO will not have to establish a framework to receive each customer's position information and calculate the initial margin requirement applicable to each customer's positions. The Commission believes this alternative framework will be significantly less expensive for market participants. Whether a DCO chooses to make the calculation based on individual customer position information or the sum of customers' gross positions submitted by the clearing member, the clearing member's customer gross margin requirement will be the same.

NYPC also commented that such implementation costs could significantly deter new clearinghouses like NYPC from launching. However, NYPC did not provide an estimate for the costs of a new clearinghouse system capable of gross margining in relation to the cost of retrofitting an existing net margin system. The Commission believes that retrofitting an existing system may be more expensive than implementing a new system from scratch, and that it is unclear whether additional implementation costs would deter any new clearinghouses.

Benefits

The Commission believes that the clearing of swaps will increase the risk that DCOs face. Gross margining will increase the amount of money that DCOs hold. Under gross margining, the amount of margin at the DCO more accurately approximates the risks posed to a DCO by its clearing members' customers than net margining and increases the financial resources available to a DCO in the event of a customer default.

A DCO may not be able to collect initial customer margin from an FCM if the FCM defaults. This could have a serious adverse impact on the financial stability of a DCO, non-defaulting customers, and potentially wider markets. In this regard, a significant customer default leading to an FCM default could strain a DCO's financial resources, causing it to exhaust the initial margin available to cover the default and forcing other clearing members and/or the DCO to incur related costs. In the worst case, an FCM default resulting from a large customer default could cause a DCO to fail if its financial resources are inadequate to cover the losses it incurs as a result of the default. Gross margining provides the DCO with a larger financial cushion that can be tapped in the event of a default. Initial margin is the DCO's first ''line of defense'' in managing a default, and a larger initial margin held at the DCO will help compensate for the DCO's inability to collect additional margin from a defaulting clearing member. This rule protects market participants and the public from bearing these costs by requiring a DCO to hold additional margin.

2. Efficiency, Competitiveness, and Financial Integrity

Costs

The considerations under this factor are very similar to the considerations under the first factor.

Benefits

The rule promotes efficiency, competitiveness, and financial integrity by providing that the amount of margin at the DCO more accurately approximates the risks posed to a DCO by its clearing members' customers and by increasing the financial resources available to a DCO in the event of a customer default.

3. Price Discovery

The Commission does not believe that this rule will have a material effect on price discovery.

4. Sound Risk Management Practices

The considerations relating to sound risk management practices are very similar to the considerations under the first factor.

5. Other Public Interest Considerations

The Commission does not believe that the rule will have a material effect on

[272] Offsetting this effect is the potential for a failing FCM to misappropriate customer funds. That potential is greater under net margining.

[273] The Commission has proposed rules that would not permit this in the case of swaps. *See* 76 FR 33818 (June 9, 2011) (Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions).

public interest considerations other than those identified above.

Risk Limits

As proposed, § 39.13(h)(1)(i) would require a DCO to impose risk limits on each clearing member, by customer origin and house origin, in order to prevent a clearing member from carrying positions where the risk exposure of those positions exceeds a threshold set by the DCO relative to the clearing member's financial resources, the DCO's financial resources, or both.

Several commenters supported the rule as an appropriate risk management procedure. Two commenters suggested that the rule is overly prescriptive. The Commission did not receive any comments that quantified the costs of this rule.

The Commission is adopting § 39.13(h)(i) as proposed.

The Commission has evaluated the costs and benefits of the proposed regulation in light of the specific considerations identified in Section 15(a) of the CEA, as follows:

1. Protection of Market Participants and the Public

Costs

Some DCOs already set limits and will not incur any costs. Others will incur the costs of calculating limits for each clearing member. Such costs will be incremental because all DCOs currently have procedures for monitoring clearing member risk and may already have informal triggers or alerts in place. For clearing members, the rule would impose opportunity costs to the extent the limits constrain their activities.

Under the rule each DCO would have discretion to set limits for each clearing member. It would be pure conjecture for the Commission to estimate what levels DCOs would set for their clearing members and how much that would constrain such clearing members. Each DCO would rely on the informed judgment of its risk management committee and/or risk management staff to assess the risks and resources of each clearing member and arrive at the applicable limits for each one. Estimating the extent to which this would constrain clearing members is even more speculative. That would entail a guess as to the risk appetite of each clearing member. In sum, the Commission believes that possible future circumstances surrounding risk limits are too speculative and uncertain to be able to quantify or estimate the resulting costs to DCOs, clearing members, or the public with any precision or degree of magnitude.

Benefits

The rule will benefit market participants by reducing the ability of clearing members and their customers to assume excessive risks. This will diminish the chances of default with all the attendant consequences previously discussed.

2. Efficiency, Competitiveness, and Financial Integrity

Costs

The considerations under this factor are very similar to the considerations under the first factor.

Benefits

Because the rule provides DCOs the discretion to tailor the limits for each clearing member in accordance with the DCO's assessment of the risk that the clearing member poses, it will foster efficiency and competitiveness in the markets. Because it will decrease the chance of default it will foster financial integrity.

The Commission believes that default by a clearing member could have a significant, adverse effect on market participants or the public. Market participants may have to incur the costs of making up any shortfall in margin through guaranty fund deposits and/or assessments, and any costs associated with participation in an auction or allocation of the positions of a defaulting clearing member. In a worst case scenario, a default by a clearing member may undermine the financial integrity of the DCO, which could have serious and widespread consequences for the stability of U.S. financial markets. This rule protects market participants and the public from bearing these costs by requiring a DCO to analyze the risk posed by each clearing member and impose appropriate limits.

3. Price Discovery

The Commission does not believe that this rule will have a material effect on price discovery.

4. Sound Risk Management Practices

Costs

The considerations under this factor are very similar to the considerations under the first factor.

Benefits

Risk limits are a sound risk management practice currently employed by several DCOs. The rule will extend the practice across all DCOs.

5. Other Public Interest Considerations

The Commission does not believe that the rule will have a material effect on public interest considerations other than those identified above.

Large Trader Reports

As proposed, § 39.13(h)(2) would require a DCO to obtain from its clearing members, copies of all reports that such clearing members are required to file with the Commission pursuant to part 17 of the Commission's regulations, *i.e.,* large trader reports. Proposed § 39.13(h)(2) would further require a DCO to review the large trader reports that it receives from its clearing members on a daily basis to ascertain the risk of the overall portfolio of each large trader.

One commenter supported the proposal. One commenter argued that the proposed requirement that DCOs obtain large trader reports from clearing members is duplicative because a DCO receives large trader information from the exchange. One commenter stated that a DCO would need new technology to implement the rule. One commenter stated that a DCO would need additional surveillance staff.

The Commission is modifying § 39.13(h)(2) to require a DCO to obtain large trader reports either from its clearing members or from a DCM or a SEF for which it clears.

The Commission has evaluated the costs and benefits of the proposed regulations in light of the specific considerations identified in Section 15(a) of the CEA, as follows:

1. Protection of Market Participants and the Public

Costs

The Commission notes that some DCOs already receive large trader reports from DCMs and review large trader reports for risk surveillance purposes on a daily basis. For them, this rule imposes no additional cost. For other DCOs, the receipt and analysis of large trader information may entail significant, costly, and time-consuming changes to systems infrastructure. Clearing members could also incur costs to provide large trader reports to DCOs. For example, NYPC stated that its preliminary cost estimate for compliance with the customer gross margin and large trader report requirements contained in proposed §§ 39.13(g)(8)(i) and 39.13(h)(2) was approximately 128,650 hours and $14.5 million.

In order to reduce costs, the Commission modified § 39.13(h)(2) to permit a DCO to obtain large trader reports either from its clearing members or from a DCM or a SEF for which it clears. The latter approach would

eliminate duplicative reporting for clearing members and would significantly reduce costs for DCOs by enabling them to obtain the data from a single source.

Benefits

Currently, at some DCOs, the receipt and analysis of large trader reports is an integral part of their risk management programs. Extension of this practice to all DCOs would benefit market participants and the public. Proactive analysis of this information allows DCOs to identify and to address incipient problems in customer accounts before they get out of hand. In particular, large trader reports are an essential part of a rigorous risk management system because they provide information that is required for stress testing.

A default by a clearing member could have a significant, adverse effect on market participants or the public. Market participants may have to incur the costs of making up any shortfall in margin through guaranty fund deposits and/or assessments, and any costs associated with participation in an auction or allocation of the positions of a defaulting clearing member. In a worst case scenario, a default by a clearing member may undermine the financial integrity of the DCO, which could have serious and widespread consequences for the stability of U.S. financial markets. This rule protects market participants and the public by requiring a DCO to analyze the potential risks at an earlier stage.

2. Efficiency, Competitiveness, and Financial Integrity

The considerations under this factor are very similar to the considerations under the first factor.

3. Price Discovery

The Commission does not believe that this rule will have a material effect on price discovery.

4. Sound Risk Management Practices

The considerations under this factor are very similar to the considerations under the first factor.

5. Other Public Interest Considerations

The Commission does not believe that the rule will have a material effect on public interest considerations other than those identified above.

Clearing Member Risk Review

As proposed, § 39.13(h)(5)(ii) would require each DCO to review the risk management policies, procedures, and practices of each of its clearing members on a periodic basis.

Several commenters asserted that the review would be burdensome for such clearing members. The Commission did not receive any comments that quantified the costs of this rule.

The Commission is adopting the rule with two modifications. These changes clarify that a DCO's review need only cover those procedures of a clearing member which address the risks that such clearing member may pose to the DCO.

The Commission has evaluated the costs and benefits of § 39.13(h)(5)(ii) in light of the specific considerations identified in Section 15(a) of the CEA, as follows:

1. Protection of Market Participants and the Public

Costs

Those DCOs that currently conduct risk reviews of their clearing members are not likely to incur any additional costs as a result of the rule.[274] Those DCOs that do not currently have such a program will incur costs to build on existing procedures for reviewing applicants for clearing membership in order to develop programs for ongoing review of clearing members. Clearing members will incur costs in working with the DCOs that review them. Commission staff intends to work with the DCOs to develop arrangements designed to avoid duplicative efforts without compromising the requirement that each DCO maintain an understanding of the risks of each of its clearing members.

In recognition that each DCO has a unique product mix and set of rules, the rule does not prescribe the specific frequency, depth, or methodology of such reviews, nor does it specify when an on-site audit may or may not be appropriate. Nevertheless, based on the Commission's experience overseeing DCOs that currently conduct risk reviews of clearing members, the Commission estimates the approximate costs of this rule as follows.[275]

The Commission estimates that a risk review by a large DCO typically would require on the order of 100 person-hours of work by a supervisor and several risk analysts. This includes preparation, an on-site visit, and drafting the report. The Commission also estimates that a large DCO would perform, on average, 40 risk reviews a year, although the number would vary depending on the number of clearing members a particular DCO has, and other circumstances. The Commission estimates compensation costs on the order of $150 an hour for risk analysts, and $250 an hour for a supervisor. Based on these estimates, the Commission estimates that the annual cost to a large DCO would be roughly on the order of $700,000.[276] Costs for particular DCOs are likely to vary from this amount based on the size of the DCO, the DCO's management and compensation practices, and the DCO's exercise of the flexibility allowed by the rule provision. In light of the potential consequences of risk management failures by clearing members discussed below, and of the Commission's judgment that DCOs are the market participants in the best position to review clearing member risk management programs, the Commission believes that the benefits of this provision would justify the costs even if costs proved to be substantially larger than the Commission's estimate.

Benefits

Rigorous risk management programs at clearing members benefit market participants by providing safeguards to prevent default. Clearing members are at the front line of risk management. The Commission believes that risk reviews are important to ensure that each clearing member's risk management framework is sufficient and properly implemented. The Commission believes that a clearing member's DCO should undertake the review because that DCO is in the best position to review the risk management policies, procedures, and practices of its clearing members in the context of the clearing members' obligations under the DCO's rules.

2. Efficiency, Competitiveness, and Financial Integrity

Costs

The considerations under this factor are very similar to the considerations under the first factor.

Benefits

Ensuring that each clearing member has proper risk management procedures for each DCO at which it clears will promote efficiency and competitiveness in the clearing process by ensuring that the clearing member is in compliance

[274] To the extent that some DCOs would conduct risk reviews in the absence of a rule, the incremental benefits of the rule are reduced. Even for these DCOs, however, a rule provides the market with the benefit of greater certainty that risk reviews of members will be continued in the future.

[275] Figures used in the estimate are based on the judgment of Commission staff with experience overseeing DCO reviews of clearing member risk.

[276] For example, 20 hours supervisor time per review × $250/hr plus 80 hours analyst time per review × $150/hr = $17,000 × 40 reviews = $680,000.

with each such DCO's rules and encouraging the exercise of best practices. The rule will foster financial integrity for the reasons set forth under the first factor.

The Commission believes that default by a clearing member could have a significant, adverse effect on market participants and the public. Market participants may have to incur the costs of making up any shortfall in margin through guaranty fund deposits and/or assessments, and any costs associated with participation in an auction or allocation of the positions of a defaulting clearing member. In a worst case scenario, a default by an FCM may undermine the financial integrity of the DCO, which could have serious and widespread consequences for the stability of U.S. financial markets. This rule protects market participants and the public from bearing these costs by requiring a DCO to periodically review the risk management procedures of each of its clearing members.

3. Price Discovery

The Commission does not believe that this rule will have a material effect on price discovery.

4. Sound Risk Management Practices

The considerations under this factor are similar to the considerations under the first factor.

5. Other Public Interest Considerations

The Commission does not believe that the rule will have a material effect on public interest considerations other than those identified above.

H. Settlement Procedures—§ 39.14(c)(3)

Section 5b(c)(2)(E) of the CEA, Core Principle E, as amended by the Dodd-Frank Act, requires a DCO to: (1) complete money settlements on a timely basis, but not less frequently than once each business day; (2) employ money settlement arrangements to eliminate or strictly limit its exposure to settlement bank risks (including credit and liquidity risks from the use of banks to effect money settlements); (3) ensure that money settlements are final when effected; (4) maintain an accurate record of the flow of funds associated with money settlements; (5) possess the ability to comply with the terms and conditions of any permitted netting or offset arrangement with another clearing organization; (6) establish rules that clearly state each obligation of the DCO with respect to physical deliveries; and (7) ensure that it identifies and manages each risk arising from any of its obligations with respect to physical deliveries.

The Commission proposed § 39.14 to implement Core Principle E. With the exception of proposed § 39.14(c), the commenters did not address the costs of the proposed rule or the Commission's consideration of costs and benefits.

Proposed § 39.14(c)(3) would require a DCO to ''monitor the full range and concentration of its exposures to its own and its clearing members' settlement banks and assess its own and its clearing members' potential losses and liquidity pressures in the event that the settlement bank with the largest share of settlement activity were to fail.'' It would further require that a DCO (i) maintain settlement accounts at additional settlement banks; (ii) approve additional settlement banks for use by its clearing members; (iii) impose concentration limits with respect to its own or its clearing members' settlement banks; and/or (iv) take any other appropriate actions reasonably necessary in order to eliminate or strictly limit such exposures.

As discussed above, several commenters expressed concern that these provisions would impose costly requirements that are unnecessary or could have unintended adverse consequences. In this regard, one commenter claimed that the requirement to monitor clearing members' exposure to their settlement banks could result in a duplication of effort that would be burdensome for a DCO. Commenters also stated that there are a limited number of banks that are qualified and willing to serve as settlement banks; as such, it may be difficult for smaller DCOs to maintain more than one settlement bank given the associated costs. Further, commenters stated that imposing concentration limits could increase systemic risk because a DCO would need to distribute funds across multiple banks and as settlement funds increased, highly rated banks would eventually reach the applicable concentration limit, potentially forcing DCOs to open accounts with lower rated banks.

None of the commenters provided quantitative data or information to support their assertions as to the potential costs and burdens of compliance with § 39.14(c)(3), and none addressed the benefits of the rule.

As discussed above, the Commission believes that there are risks associated with a DCO concentrating all its funds in a single settlement bank. Bank failure in such a circumstance could have adverse consequences for the DCO, its clearing members, and their customers. However, the Commission also acknowledges the concerns expressed by commenters, particularly given the settlement practices and procedures that DCOs currently maintain in the absence of such a regulation.

Accordingly, the Commission is modifying § 39.14(c)(3) to eliminate any implied requirement that all DCOs must maintain settlement accounts at more than one bank, and is retaining the requirement that a DCO monitor exposure to its settlement bank(s) and those of its clearing members, including an ongoing assessment of the effect to the DCO of a failure of the settlement bank that has the largest share of settlement activity. It is also clarifying its intent to qualify the need to take actions set forth in § 39.14(c)(3)(i)–(iv) (such as imposing concentration limits) ''to the extent that any such action or actions are reasonably necessary in order to eliminate or strictly limit such exposures.'' Thus, the Commission is providing DCOs with more flexibility than would have been provided under the proposed rule which, in turn, should reduce the costs associated with compliance.

The Commission has evaluated the costs and benefits of § 39.14(c)(3) in light of the specific considerations identified in Section 15(a) of the CEA, as follows:

1. Protection of Market Participants and the Public

Costs

A DCO's monitoring of its exposure to its settlement bank(s) and those of its clearing members is a sound business practice in which a DCO should be engaged notwithstanding the rule. Nevertheless, the Commission believes the rule will require commitment of DCO staff resources, the costs of which could be passed along to clearing members and market participants as part of the DCO's clearing fees. Such costs could vary significantly across DCOs given differences in operational and risk management procedures, settlement arrangements, and fee pricing practices. Given these circumstances, the Commission is unable to quantify the costs attributable to the Commission's rule, and no commenter provided an estimate. As a general matter, however, the Commission is mindful that the measures set forth in § 39.14(c)(3)(i)–(iv), specifically the requirement that DCOs take actions that are ''reasonably necessary in order to eliminate or strictly limit'' exposure to settlement banks, could cause DCOs to incur costs. Such costs could include, for example, the costs of establishing an account at an additional settlement bank, which would entail evaluating the bank to ensure that it meets the DCO's

criteria for a settlement bank, reviewing account agreements, and establishing connectivity to the bank. There may also be fees charged by a bank for standby services if the bank is not used as the primary settlement bank, or there may be other account-related fees. The Commission is unable to ascertain the specific amount of any such costs for DCOs because of the varying nature of settlement bank arrangements across DCOs.

Benefits

Use of multiple settlement banks by DCOs, as well as imposition of concentration limits and other safeguards provided for in § 39.14(c)(3)(i)–(iv), when reasonably necessary, could help insulate the DCO and its members from the risk of default by a settlement bank. This in turn could provide market participants and the public with greater protection from disruption of markets, as well as the clearing and settlement system.

Affording a DCO flexibility in managing its settlement bank arrangements and, to a lesser degree, those of its clearing members, benefits market participants and the public by reducing the costs and potential inefficiencies associated with maintaining settlement arrangements with multiple settlement banks when that might not yield a concomitant benefit in the form of risk reduction. The rule sets forth general standards while permitting each DCO to tailor its settlement bank arrangements to its unique circumstances and risk tolerances.

2. Efficiency, Competitiveness, and Financial Integrity

Costs

Quantification or estimation of costs to efficiency, competitiveness, and financial integrity of markets are not readily ascertainable, and no commenter provided an estimate.

Benefits

The rule permits DCOs to obtain settlement services from a single bank if the size and needs of the DCO, as well as the availability of suitable settlement bank services, makes the use of more than one settlement bank cost-prohibitive and it is not reasonably necessary to have more than one settlement bank in order to eliminate or strictly limit the DCO's exposures. More efficient use of DCO resources can result in enhanced efficiency and financial integrity of the markets for which the DCO clears. Particularly for smaller DCOs, it may not be practical to obtain settlement services from more than one settlement bank because of the costs of evaluating a bank's suitability to perform settlement functions, reviewing account agreements, and establishing connectivity to the bank. There also may be account-related fees charged by a bank, including fees for standby services, if the bank is used as a back-up settlement bank and not the primary settlement bank.

3. Price Discovery

The Commission has not identified any ways in which § 39.14(c)(3) could affect price discovery.

4. Sound Risk Management Practices

Costs

The Commission has not identified any ways in which § 39.14(c)(3) could impair sound risk management practices.

Benefits

The Commission regards an effective settlement framework as a sound risk management practice because it reduces the risks associated with a bank's potential failure to make timely settlement. The requirements that a DCO monitor risk exposures to settlement banks and address diversification concerns, as reasonably necessary, are important adjuncts to a DCO's overall risk management practices.

5. Other Public Interest Considerations.

The Commission has not identified any other costs or benefits that should be taken into account.

I. Treatment of Funds—§ 39.15

Core Principle F, as amended by the Dodd-Frank Act, requires a DCO to: (i) Establish standards and procedures that are designed to protect and ensure the safety of its clearing members' funds and assets; (ii) hold such funds and assets in a manner by which to minimize the risk of loss or of delay in the DCO's access to the assets and funds; and (iii) only invest such funds and assets in instruments with minimal credit, market, and liquidity risks.[277]

Proposed § 39.15 would establish minimum standards for DCO compliance with Core Principle F. Among other things, it would set forth standards for the types of assets that could be accepted as initial margin. In this regard, proposed § 39.15(c)(1) would require a DCO to limit the assets it accepts as initial margin to those that have minimal credit, market, and liquidity risk. It would further specify that a DCO may not accept letters of credit as initial margin.

The Commission received comments on substantive aspects of the proposed rules, and it has addressed those comments above. The Commission also received several comments on potential costs associated with the proposed § 39.15(c)(1) prohibition on the acceptance of letters of credit as initial margin.[278] CME asserted that the prohibition is unnecessary because letters of credit provide an absolute assurance of payment and, therefore, the issuing bank must honor the demand even in circumstances where the beneficiary is unable to reimburse the bank for its payment. Other commenters suggested that letters of credit should be acceptable if they are subject to appropriate conditions. Finally, several commenters warned of the potential risks associated with prohibiting letters of credit, including higher costs for clearing members and their customers, the potential placement of U.S. DCOs at a disadvantage as compared to foreign clearing houses, and increased systemic risk as a result of decreased voluntary clearing.

Taking into account both the strong track record of letters of credit in connection with cleared futures and options on futures and the potentially greater risks of cleared swaps, the Commission has determined to modify the rule to permit letters of credit in connection with cleared futures and options on futures but to retain the prohibition on letters of credit as initial margin for swaps. Certain DCOs have accepted letters of credit as initial margin for futures and options on futures for a number of years without incident and continue to do so. On the other hand, letters of credit are only a promise by a bank to pay, not an asset that can be sold. The Commission is concerned that the potential losses that swap market participants could incur may be of a greater magnitude than potential losses with respect to futures and options. Initial margin is the first financial resource that a DCO will apply in the event of a clearing member default. If a DCO were to need to draw on a letter of credit posted by a clearing member whose customers had suffered such losses, the larger the amount that it would need to draw, the greater the risk that the issuing bank may be unable to pay under the terms of the letter of credit. Accordingly, the Commission is modifying the proposal as described.

[277] Section 5b(c)(2)(F) of the CEA; 7 U.S.C. 7a–1(c)(2)(F) (Core Principle F).

[278] The Commission notes that proposed 39.15(c)(1) regarding types of assets that can be accepted as initial margin has been redesignated as § 39.13(g)(10) under the risk management rules.

The Commission has evaluated the costs and benefits of § 39.13(g)(10) in light of the specific considerations identified in Section 15(a) of the CEA, as follows:

1. Protection of Market Participants and the Public

Costs

The prohibition on accepting letters of credit as initial margin for swaps may impose higher costs for clearing members because they will have to deposit cash or other assets that have minimal credit, market, and liquidity risk for those products. This could increase costs for market participants and decrease capital efficiency. It may also place U.S. DCOs at a disadvantage to those foreign clearing houses that permit letters of credit to be used as initial margin for swaps. The Commission notes, however, that in response to the comments it has modified the rule to permit letters of credit for futures. Therefore, futures market participants will not incur any costs as a result of this provision.

It is not possible to estimate or quantify these costs for a number of reasons. The Dodd-Frank Act and implementing regulations will significantly affect the manner in which swaps are developed, traded, executed, and cleared. Existing DCOs and FCMs will be clearing new products. New DCOs and FCMs will enter the market. Mandatory clearing will bring new products and participants to DCOs and FCMs. The interaction of all these factors creates a wide range of uncertainty as to which products will be cleared, what their margin requirements will be, and the extent to which clearing members would post letters of credit as margin if permitted. Under these circumstances, the potential opportunity costs that may arise from the deposit of cash or other assets rather than letters of credit depends on a variety of future circumstances and actions of market participants that cannot be known or predicted at the present time. In sum, the Commission believes that the possible future circumstances involving the posting of letters of credit as margin is too speculative and uncertain to be able to quantify or estimate the resulting costs to clearing members with any precision or degree of magnitude.

Benefits

One of the primary functions of a DCO is to guarantee financial performance, which includes performing daily variation settlement. Daily pays are made in cash, and to the extent a DCO relies on margin deposits to meet its end-of-day obligations, it must have access to sufficient cash or highly liquid assets. Similarly, initial margin may be tapped by a DCO in the event of a clearing member default. By limiting the use of letters of credit, the DCO will avoid the possibility that a letter of credit would be dishonored when presented to the issuing bank.

Thus, requiring initial margin in the form of assets that can be immediately sold provides greater financial protection to the DCO, clearing members, and market participants.

2. Efficiency, Competitiveness, and Financial Integrity

Costs

As noted above, there could be competitive disadvantages to DCOs if foreign competitors do not impose similar restrictions on initial margin deposits. In addition, the prospect of increased costs may reduce voluntary clearing of swaps, which would be inconsistent with the goals of the Dodd-Frank Act and could potentially lead to systemic risk.

Benefits

A DCO can be more efficient in facilitating payments if it has readily available liquid assets as opposed to a conditional obligation that must be presented for payment. Holding actual assets provides greater assurance of financial integrity to the clearing process, as the DCO will not have to bear the costs of possible default on the part of the issuing bank. Even an irrevocable letter of credit can be dishonored, with the DCO's only recourse being a lawsuit.

3. Price Discovery

The Commission does not believe this rule will have a material effect on price discovery.

4. Sound Risk Management Practices

Costs

The Commission does not believe this rule will have a material adverse impact on sound risk management practices.

Benefits

The Commission expects that prohibiting the use of letters of credit as initial margin for swaps could serve to strengthen a DCO's risk management program. It eliminates the risk of funds not being available if a letter of credit were to be dishonored, which could have a significant impact because initial margin is the first financial resource to be tapped in the event of a clearing member default.

5. Other Public Considerations

The Commission does not believe this rule will have a material impact on public interest considerations other than those discussed above.

J. Reporting—§ 39.19

Core Principle J,[279] as amended by the Dodd-Frank Act, requires a DCO to provide the Commission with all information that the Commission determines to be necessary to conduct oversight of the DCO.

The Commission proposed § 39.19 to establish minimum requirements that a DCO would have to meet in order to comply with Core Principle J. Under proposed § 39.19, certain reports would have to be made by a DCO to the Commission (1) On a periodic basis (daily, quarterly, or annually); (2) where the reporting requirement is triggered by the occurrence of a significant event; and (3) upon request by the Commission.

The rules would require DCOs to provide information that the Commission has determined is necessary to conduct oversight of DCOs. The proposed reporting regime would assist the Commission in monitoring the financial strength and operational capabilities of a DCO and in evaluating whether a DCO's risk management practices are effective. The required reports also would assist the Commission in taking prompt action as necessary to identify incipient problems and address them at an early stage. A self-reporting program of this type enhances the Commission's ability to conduct oversight given its limited resources which do not permit routine on-site surveillance of DCOs.

The proposed rules would require submission of information electronically and in a form and manner prescribed by the Commission. These general procedural standards would provide flexibility to the Commission in establishing and updating uniform format and delivery protocols that would assist the Commission in conducting timely review of submissions. In this regard, the transmission of information using a uniform format would enable Commission staff to sort and interpret data without the need to convert the data into a format that provides the necessary functionality, *e.g.,* it would be designed to provide the Commission with the ability to compare data across DCOs when necessary.

A number of commenters discussed costs associated with proposed § 39.19

[279] Section 5b(c)(2)(J) of the CEA, 7 U.S.C. 7a–1(c)(2)(J).

in the form of comments on the substantive provisions of the proposed rule. For example, a number of commenters discussed whether alternative reporting requirements might better inform the Commission of potential risks. Some commenters questioned the need for certain information and some commenters questioned the feasibility of the reporting requirements. The Commission has addressed those comments above.

The Commission also received comments that directly addressed two areas of the Commission's cost-benefit analysis of proposed § 39.19: (1) The cost of preparing and submitting daily and annual audited financial reports; and (2) the cost of reporting a 10 percent decrease in financial resources. Those comments are discussed in detail below.

a. Cost of Preparing and Submitting Daily and Annual Reports

Proposed § 39.19(c) would require a DCO to submit various periodic reports for the purposes of risk surveillance and oversight of the DCO's compliance with the core principles and Commission regulations. In the notice of proposed rulemaking, the Commission observed that the information that would be reported was information readily available to a DCO and which, in certain instances, was already being reported to the Commission. The Commission requested data or other information that could quantify or qualify costs.

Only NYPC provided an estimate of the fixed cost of implementing an automated system for daily reporting. In a comment letter submitted by NYPC, the cost was estimated at $582,000.

In a follow-up phone conversation with representatives of NYPC, Commission staff discussed the basis for NYPC's estimate that implementing an automated system for daily reporting would cost $582,000. Staff was told that NYPC already provides certain daily reports to the Commission, but that the additional data that it would have to report under the proposal (not including the proposed gross margin data or large trader data) would necessitate implementing an automated system. NYPC representatives confirmed that the estimate was for a one-time cost, not the cost of generating and transmitting the actual daily reports. NYPC also confirmed that the cost of generating and transmitting the actual daily reports would be minimal.

The Commission was able to estimate the costs of providing reports and presented this information in the Paperwork Reduction Act discussion. It estimated that daily reporting could require a DCO to expend up to $8,280 per year, and an annual report could require a DCO to expend up to $482,110 per year.

KCC and MGEX commented that the variable cost for daily reporting could be significantly more than the Commission's estimates if the Commission were to require a costly format and method of delivery. MGEX also commented that the Commission may have underestimated the cost of providing the annual report (audited financial report under § 39.19(c)(3)(ii)), and that the Commission's estimate is ''extremely excessive, particularly when most of [the annual reporting requirements do] not appear to be required by the Dodd-Frank Act.'' Finally, MGEX believes that the proposed rules will not guarantee increased market participation or improve legitimate risk management and hedging activity, and the additional costs will create barriers to entry and decrease DCO competition.

Although KCC and MGEX commented that the costs of preparing the reports may be greater than the Commission's estimates, neither DCO provided an alternative estimate. Nor did they suggest alternative reporting requirements that would achieve the purposes of the CEA with a more favorable cost-benefit ratio. As to the estimated costs of the required format and method of delivery, the Commission notes that it based its estimate on the cost of using the SHAMIS system. The Commission has no basis for concluding that the cost of using an alternative system would be less substantial and it received no comments on this.

The Commission believes that the costs that DCOs will incur to implement a system to provide such information to the Commission are necessary and justified. As explained above, the Commission has determined that the information required in the reports is necessary for the Commission to conduct adequate oversight of DCOs, particularly given its limited ability to conduct on-site reviews.

b. Reporting a 10 Percent Decrease in Financial Resources

Under proposed § 39.19(c)(4)(i), a DCO would be required to report a decrease of 10 percent in the total value of its financial resources either from (1) the value reported in the DCO's last quarterly report or (2) from the value as of the close of the previous business day. This would allow the Commission to more quickly identify and address financial problems at the DCO. As discussed above, the Commission raised the reporting threshold from 10 percent to 25 percent in response to comments that a higher percentage might yield more meaningful results. In addition, the higher threshold is likely to reduce the number of reports that might be submitted under this requirement.

NYPC commented that compliance with the proposed reporting requirement would necessitate an expenditure of approximately 15,000 hours and $1.7 million. NYPC explained that this estimate reflects implementing a system that would track default resources and working capital, combined. After talking with Commission staff, NYPC submitted a comment letter that provided a preliminary estimate of approximately 4,600 hours and $566,000 for designing, building, and testing a reporting system for a decline in default resources only.

Based on NYPC's initial comment letter, the Commission believes that the material costs associated with § 39.19(c)(4)(i) are the initial investments made by a DCO to develop and implement a system (automated or not) to alert the DCO that the valuation threshold has been met. As discussed above, it is important for the Commission to be apprised of a 25% reduction in default resources because it could indicate that the DCO's financial resources are strained and corrective action may be needed.

The Commission has evaluated the costs and benefits of § 39.19 in light of the specific considerations identified in Section 15(a) of the CEA as follows:

1. Protection of Market Participants and the Public

Costs

Section 39.19 requires DCOs to provide information that the Commission has determined is necessary for oversight of DCOs and to provide that information in a time frame, format, and delivery method that will enable effective use of the information. To the extent that DCOs do not already have an infrastructure for preparing and transmitting reports, they will incur one-time costs to put such a framework in place.

Benefits

The comprehensive regulatory reporting program will enhance protection of market participants and the public by promoting more in-depth and effective oversight by the Commission. The reports will assist the Commission's Risk Surveillance staff in monitoring clearing house risk and evaluating DCOs' management and mitigation of that risk. In addition, the

information will assist the Commission to identify incipient problems and address them at an early stage.

2. Efficiency, Competitiveness, and Financial Integrity

Costs

The Commission does not believe that the reporting requirements will adversely impact efficiency, competitiveness, or the financial integrity of derivatives markets.

Benefits

The reporting requirements will protect the financial integrity of derivatives markets because they will support effective and timely oversight of DCOs. This will help to minimize the risk of default and the impact default would have on the markets.

3. Price Discovery

The Commission does not believe that § 39.19 will have a material impact on price discovery.

4. Sound Risk Management Practices

Costs

The Commission does not believe that the reporting requirements will adversely impact sound risk management practices.

Benefits

The reporting requirements are expected to enhance sound risk management practices because the Commission will be able to more effectively evaluate a DCO's risk management practices on an on-going basis. The Commission staff can build a knowledge base that will support prompt action if there are adverse changes in trends or financial profiles.

5. Other Public Interest Considerations

The Commission does not believe this rule will have a material impact on public interest considerations other than those discussed above. Effective oversight of DCOs will enhance the safety and efficiency of DCOs and reduce systemic risk. Safe and reliable DCOs are essential not only for the stability of the derivatives markets they serve but also the public which relies on the prices formed in these markets for all manner of commerce.

IX. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (''RFA'') requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.[280] The rules adopted herein will affect only DCOs). The Commission has previously established certain definitions of ''small entities'' to be used by the Commission in evaluating the impact of its regulations on small entities in accordance with the RFA.[281] The Commission has previously determined that DCOs are not small entities for the purpose of the RFA.[282] Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that these rules will not have a significant economic impact on a substantial number of small entities. The Chairman made the same certification in the proposed rulemakings, and the Commission did not receive any comments on the RFA in relation to any of those rulemakings.

B. Paperwork Reduction Act

The Commission may not conduct or sponsor, and a registered entity is not required to respond to, a collection of information unless it displays a currently valid Office of Management and Budget (OMB) control number. The Commission's adoption of §§ 39.3 (DCO registration application requirements), 39.10 (annual compliance report and recordkeeping), 39.11 (financial resources quarterly report), 39.14 (settlement recordkeeping), 39.18 (system safeguards reporting and recordkeeping), 39.19 (periodic and event-specific reporting), and 39.20 (general recordkeeping), imposes new information collection requirements on registered entities within the meaning of the Paperwork Reduction Act.[283]

Accordingly, the Commission requested and OMB assigned control numbers for the required collections of information. The Commission has submitted this notice of final rulemaking along with supporting documentation for OMB's review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The titles for these collections of information are ''Financial Resources Requirements for Derivatives Clearing Organizations, OMB control number 3038–0066,'' ''Information Management Requirements for Derivatives Clearing Organizations, OMB control number 3038–0069,'' ''General Regulations and Derivatives Clearing Organizations, OMB control number 3038–0081,'' and ''Risk Management Requirements for Derivatives Clearing Organizations, OMB control number 3038–0076.'' Many of the responses to this new collection of information are mandatory.

The Commission protects proprietary information according to the Freedom of Information Act and 17 CFR part 145, ''Commission Records and Information.'' In addition, Section 8(a)(1) of the CEA strictly prohibits the Commission, unless specifically authorized by the Act, from making public ''data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers.'' The Commission also is required to protect certain information contained in a government system of records according to the Privacy Act of 1974, 5 U.S.C. 552a.

The regulations require each respondent to file certain information with the Commission and to maintain certain records.[284] The Commission received comments from NYPC and MGEX regarding the estimated costs of preparing and submitting daily reports. It also received comments from MGEX regarding costs associated with annual reports and the proposed rules in general.

NYPC and MGEX commented that the costs associated with the rules in the Information Management proposed rulemaking would be higher than the

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[280] 5 U.S.C. 601 *et seq.*

[281] 47 FR 18618 (Apr. 30, 1982).

[282] *See* 66 FR 45604, at 45609 (Aug. 29, 2001) (New Regulatory Framework for Clearing Organizations).

[283] 44 U.S.C. 3501 *et seq.*

[284] *See* 75 FR at 63119 (Oct. 14, 2010) (Financial Resources) (requirement to file quarterly reports); *see also* discussion of the financial resources reporting requirements in section IV.B.10, above.

See 75 FR at 77583–77584 (Dec. 13, 2010) (General Regulations) (proposed requirements: (i) For the CCO to submit an annual report to the Commission; (ii) to retain a copy of the policies and procedures adopted in furtherance of compliance with the CEA; (iii) to retain copies of materials, including written reports provided to the board of directors in connection with the board's review of the annual report; and (iv) to retain any records relevant to the annual report, including, but not limited to, work papers and other documents that form the basis of the report, and memoranda, correspondence, other documents, and records that are (a) created, sent or received in connection with the annual report and (b) contain conclusions, opinions, analyses, or financial data related to the annual report); *see also* discussion of § 39.10 in section IV.A, above.

See 75 FR at 78193 (Dec. 15, 2010) (Information Management) (proposed requirements to file specified information with the Commission (i) periodically, on a daily, quarterly, and annual basis; (ii) as specified events occur; and (iii) upon Commission request); *see also* discussion of reporting requirements in section IV.J, above.

See 75 FR at 78196 (Dec. 15, 2010) (Information Management) (proposed requirement to maintain records of all activities related to its business as a DCO, including all information required to be created, generated, or reported under part 39, including but not limited to the results of and methodology used for all tests, reviews, and calculations); see also discussion of recordkeeping requirements in section IV.K, above.

Commission estimated.[285] With respect to daily reporting, NYPC commented that designing, building, and testing the application necessary to automate the process of producing daily reports would require approximately 5,200 hours and cost $582,000.[286] MGEX commented that the cost to a DCO could be significantly more than the estimated cost if the Commission were to require a costly format and method of delivery.

With respect to annual reporting, MGEX commented that the Commission may have underestimated the associated costs because the Commission did not address the costs of building reporting methods, forms, programs, or the allocation of labor resources. In addition, MGEX believes that the estimated costs associated with the annual report are ''extremely excessive, particularly when most of [the annual report requirements do] not appear to be required by the Dodd-Frank Act.'' MGEX further commented that the proposed rules will not guarantee increased market participation or improve legitimate risk management and hedging activity, and the additional costs would create barriers to entry and decreased DCO competition.

Finally, with respect to the estimated costs identified in the Risk Management notice of proposed rulemaking,[287] MGEX noted that the Commission had estimated the total hours for the proposed collection of information to be 50 hours per year per respondent for the additional reporting requirements at an annual cost of $500 per respondent (50 hours × $10). MGEX stated its belief that these estimates, both in hours and cost, are extremely low, and that it did not appear that the Commission had accounted for the costs to implement a system; collect, forward and format data; monitor and enforce compliance; and document compliance with the proposed rulemaking. MGEX noted that the costs are not limited to reporting to the Commission for many of the proposed rules, and that reporting may be the least expensive facet. MGEX specifically identified reporting the gross position of each beneficial owner as a requirement for which the Commission did not provide any cost estimates.

Although MGEX commented that the costs of the proposed requirements may be greater than the costs the Commission set forth in the Information Management and Risk Management proposed rulemakings, and that the Commission did not estimate the costs of building reporting methods, forms, programs, or the allocation of labor resources, MGEX did not provide an estimate of these costs. Nor did MGEX suggest alternative reporting requirements that would achieve the purposes of the CEA with a more favorable cost-benefit ratio.

As to the estimated costs of the required format and method of delivery, the Commission notes that the estimates of these costs were based on the cost of using the SHAMIS system. There was no basis for concluding that the cost of using an alternative system would be more substantial and the Commission received no comment to that effect. Moreover, Core Principle J requires a DCO to provide reports to the Commission, and all DCOs will have to bear these costs in order to comply with Core Principle J. Core Principle J requires each DCO ''to provide to the Commission all information that the Commission determines to be necessary to conduct oversight of the [DCO].'' As discussed above and in the Information Management proposed rulemaking, the Commission believes that the daily and annual reporting requirements provide the Commission with information that is important to its oversight of a DCO to ensure the DCO is in compliance with the core principles. This can lead to increased market participation and improve legitimate risk management and hedging activity. Accordingly, the Commission believes the collection of information related to the reporting rules is necessary to achieve the purposes of the CEA, particularly in light of the Dodd-Frank Act clearing mandate for swaps.[288]

The Commission has considered the comments of NYPC and MGEX but is declining to revise the estimated costs. The Commission believes that its original estimates remain appropriate for PRA purposes.

List of Subjects

17 CFR Part 1

Brokers, Commodity futures, Consumer protection, Definitions, Swaps.

17 CFR Part 21

Brokers, Commodity futures, Reporting and recordkeeping requirements.

17 CFR Part 39

Definitions, Commodity futures, Reporting and recordkeeping requirements, Swaps, Business and industry, Participant and product eligibility, Risk management, Settlement procedures, Treatment of funds, Default rules and procedures, System safeguards, Enforcement authority, Application form.

17 CFR Part 140

Authority delegations (Government agencies), Conflict of interests, Organization and functions (Government agencies).

For the reasons stated in the preamble, amend 17 CFR parts 1, 21, 39, and 140 as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

■ 1. The authority citation for part 1 is revised to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 7, 7a, 7b, 8, 9, 12, 12a, 12c, 13a, 13a–1, 16, 16a, 19, 21, 23, and 24, as amended by Pub. L. 111–203, 124 Stat. 1376.

■ 2. Amend § 1.3 to revise paragraphs (c) and (d), remove and reserve paragraph (k), and add paragraphs (aaa), (bbb), (ccc), (ddd), (eee), and (fff) to read as follows:

§ 1.3 Definitions.

* * * * *

(c) *Clearing member.* This term means any person that has clearing privileges such that it can process, clear and settle trades through a derivatives clearing organization on behalf of itself or others. The derivatives clearing organization need not be organized as a membership organization.

(d) *Clearing organization or derivatives clearing organization.* This term means a clearinghouse, clearing association, clearing corporation, or similar entity, facility, system, or

[285] *See* 75 FR at 78193 (Dec. 15, 2010) (Information Management). In the Paperwork Reduction Act discussion, the Commission estimated that daily reporting would result in an aggregated cost of $8,280 initially (12 respondents × $690) and $16,800 per annum (12 respondents × $1,400). Annual reporting would result in an aggregated cost of $5,785,320 per annum (12 respondents × $482,110).

[286] In a follow-up phone conversation with representatives of NYPC, Commission staff discussed the basis for NYPC's estimate that implementing an automated system for daily reporting would cost $582,000. Commission staff was told that NYPC already provides certain daily reports to the Commission's Risk Surveillance Group, but that the additional data that it would have to report under the Information Management NPRM (not including the gross margin data or large trader data) would necessitate implementing an automated system. NYPC representatives confirmed that the estimate was for a one-time cost, not the cost of generating and transmitting the actual daily reports. NYPC also confirmed that the cost of generating and transmitting the actual daily reports would be minimal.

[287] *See* 76 FR at 3716–3717 (Jan. 20, 2011) (Risk Management).

[288] *See* further discussion of the costs and benefits associated with the reporting requirements in section VII.J, above.

organization that, with respect to an agreement, contract, or transaction—

(1) Enables each party to the agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the derivatives clearing organization for the credit of the parties;

(2) Arranges or provides, on a multilateral basis, for the settlement or netting of obligations resulting from such agreements, contracts, or transactions executed by participants in the derivatives clearing organization; or

(3) Otherwise provides clearing services or arrangements that mutualize or transfer among participants in the derivatives clearing organization the credit risk arising from such agreements, contracts, or transactions executed by the participants.

(4) *Exclusions.* The terms clearing organization and derivatives clearing organization do not include an entity, facility, system, or organization solely because it arranges or provides for—

(i) Settlement, netting, or novation of obligations resulting from agreements, contracts or transactions, on a bilateral basis and without a central counterparty;

(ii) Settlement or netting of cash payments through an interbank payment system; or

(iii) Settlement, netting, or novation of obligations resulting from a sale of a commodity in a transaction in the spot market for the commodity.

* * * * *

(k) [Reserved]

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(aaa) *Clearing initial margin.* This term means initial margin posted by a clearing member with a derivatives clearing organization.

(bbb) *Customer initial margin.* This term means initial margin posted by a customer with a futures commission merchant, or by a non-clearing member futures commission merchant with a clearing member.

(ccc) *Initial margin.* This term means money, securities, or property posted by a party to a futures, option, or swap as performance bond to cover potential future exposures arising from changes in the market value of the position.

(ddd) *Margin call.* This term means a request from a futures commission merchant to a customer to post customer initial margin; or a request by a derivatives clearing organization to a clearing member to post clearing initial margin or variation margin.

(eee) *Spread margin.* This term means reduced initial margin that takes into account correlations between certain related positions held in a single account.

(fff) *Variation margin.* This term means a payment made by a party to a futures, option, or swap to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market.

■ 3. Amend § 1.12 to remove and reserve paragraph (f)(1).

PART 21—SPECIAL CALLS

■ 4. The authority citation for part 21 is revised to read as follows:

Authority: 7 U.S.C. 1a, 2, 2a, 4, 6a, 6c, 6f, 6g, 6i, 6k, 6m, 6n, 7, 7a, 12a, 19 and 21, as amended by Pub. L. 111–203, 124 Stat. 1376; 5 U.S.C. 552 and 552(b), unless otherwise noted.

■ 5. Redesignate § 21.04 as § 21.05.

■ 6. Add a new § 21.04 to read as follows:

§ 21.04 Special calls for information on customer accounts or related cleared positions.

Upon special call by the Commission, each futures commission merchant, clearing member or foreign broker shall provide information to the Commission concerning customer accounts or related positions cleared on a derivatives clearing organization in the format and manner and within the time provided by the Commission in the special call.

■ 7. Add § 21.06 to read as follows:

§ 21.06 Delegation of authority to the Director of the Division of Clearing and Risk.

The Commission hereby delegates, until the Commission orders otherwise, the special call authority set forth in § 21.04 to the Director of the Division of Clearing and Risk to be exercised by such Director or by such other employee or employees of such Director as designated from time to time by the Director. The Director of the Division of Clearing and Risk may submit to the Commission for its consideration any matter which has been delegated in this section. Nothing in this section shall be deemed to prohibit the Commission, at its election, from exercising the authority delegated in this section to the Director.

PART 39—DERIVATIVES CLEARING ORGANIZATIONS

■ 8. Revise part 39 to read as follows:

Subpart A—General Provisions Applicable to Derivatives Clearing Organizations

Sec.
39.1 Scope.
39.2 Definitions.
39.3 Procedures for registration.
39.4 Procedures for implementing derivatives clearing organization rules and clearing new products.
39.5 Submission of swaps for Commission determination regarding clearing requirements.
39.6 [Reserved]
39.7 Enforceability.
39.8 Fraud in connection with the clearing of transactions on a derivatives clearing organization.

Subpart B—Compliance With Core Principles

39.9 Scope.
39.10 Compliance with core principles.
39.11 Financial resources.
39.12 Participant and product eligibility.
39.13 Risk management.
39.14 Settlement procedures.
39.15 Treatment of funds.
39.16 Default rules and procedures.
39.17 Rule enforcement.
39.18 System safeguards.
39.19 Reporting.
39.20 Recordkeeping.
39.21 Public information.
39.22 Information sharing.
39.23 Antitrust considerations.
39.24 [Reserved]
39.25 [Reserved]
39.26 [Reserved]
39.27 Legal risk considerations.

Appendix A to Part 39—Form DCO Derivatives Clearing Organization Application for Registrations

Authority: 7 U.S.C. 7a–1 as amended by Pub. L. 111–203, 124 Stat. 1376.

Subpart A—General Provisions Applicable to Derivatives Clearing Organizations

§ 39.1 Scope.

The provisions of this subpart A apply to any derivatives clearing organization as defined under section 1a(15) of the Act and § 1.3(d) of this chapter which is registered or deemed to be registered with the Commission as a derivatives clearing organization, is required to register as such with the Commission pursuant to section 5b(a) of the Act, or which voluntarily applies to register as such with the Commission pursuant to section 5b(b) or otherwise.

§ 39.2 Definitions.

For the purposes of this part,

Back test means a test that compares a derivatives clearing organization's initial margin requirements with historical price changes to determine the extent of actual margin coverage.

Customer means a person trading in any commodity named in the definition of commodity in section 1a(9) of the Act or in § 1.3 of this chapter, or in any swap as defined in section 1a(47) of the Act or in § 1.3 of this chapter; *Provided, however,* an owner or holder of a house

account as defined in this section shall not be deemed to be a customer within the meaning of section 4d of the Act, the regulations that implement sections 4d and 4f of the Act and § 1.35, and such an owner or holder of such a house account shall otherwise be deemed to be a customer within the meaning of the Act and §§ 1.37 and 1.46 of this chapter and all other sections of these rules, regulations, and orders which do not implement sections 4d and 4f of the Act.

Customer account or *customer origin* means a clearing member account held on behalf of customers, as that term is defined in this section, and which is subject to section 4d(a) or section 4d(f) of the Act.

House account or *house origin* means a clearing member account which is not subject to section 4d(a) or 4d(f) of the Act.

Key personnel means derivatives clearing organization personnel who play a significant role in the operations of the derivatives clearing organization, the provision of clearing and settlement services, risk management, or oversight of compliance with the Act and Commission regulations and orders. Key personnel include, but are not limited to, those persons who are or perform the functions of any of the following: chief executive officer; president; chief compliance officer; chief operating officer; chief risk officer; chief financial officer; chief technology officer; and emergency contacts or persons who are responsible for business continuity or disaster recovery planning or program execution.

Stress test means a test that compares the impact of potential extreme price moves, changes in option volatility, and/or changes in other inputs that affect the value of a position, to the financial resources of a derivatives clearing organization, clearing member, or large trader, to determine the adequacy of such financial resources.

Systemically important derivatives clearing organization means a financial market utility that is a derivatives clearing organization registered under section 5b of the Act, which has been designated by the Financial Stability Oversight Council to be systemically important and for which the Commission acts as the Supervisory Agency pursuant to section 803(8) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

§ 39.3 Procedures for registration.

(a) *Application procedures.* (1) An organization desiring to be registered as a derivatives clearing organization shall file electronically an application for registration with the Secretary of the Commission in the format and manner specified by the Commission. The Commission will review the application for registration as a derivatives clearing organization pursuant to the 180-day timeframe and procedures specified in section 6(a) of the Act. The Commission may approve or deny the application or, if deemed appropriate, register the applicant as a derivatives clearing organization subject to conditions.

(2) *Application.* Any person seeking to register as a derivatives clearing organization, any applicant amending its pending application, or any registered derivatives clearing organization seeking to amend its order of registration (applicant), shall submit to the Commission a completed Form DCO, which shall include a cover sheet, all applicable exhibits, and any supplemental materials, including amendments thereto, as provided in the appendix to this part 39 (application). An applicant, when filing a Form DCO for purposes of amending its pending application or requesting an amendment to an existing registration, is only required to submit exhibits and updated information that are relevant to the requested amendment and are necessary to demonstrate compliance with the core principles affected by the requested amendment. The Commission will not commence processing an application unless the applicant has filed the application as required by this section. Failure to file a completed application will preclude the Commission from determining that an application is materially complete, as provided in section 6(a) of the Act. Upon its own initiative, an applicant may file with its completed application additional information that may be necessary or helpful to the Commission in processing the application.

(3) *Submission of supplemental information.* The filing of a completed application is a minimum requirement and does not create a presumption that the application is materially complete or that supplemental information will not be required. At any time during the application review process, the Commission may request that the applicant submit supplemental information in order for the Commission to process the application. The applicant shall file electronically such supplemental information with the Secretary of the Commission in the format and manner specified by the Commission.

(4) *Application amendments.* An applicant shall promptly amend its application if it discovers a material omission or error, or if there is a material change in the information provided to the Commission in the application or other information provided in connection with the application.

(5) *Public information.* The following sections of all applications to become a registered derivatives clearing organization will be public: first page of the Form DCO cover sheet, proposed rules, regulatory compliance chart, narrative summary of proposed clearing activities, documents establishing the applicant's legal status, documents setting forth the applicant's corporate and governance structure, and any other part of the application not covered by a request for confidential treatment, subject to § 145.9 of this chapter.

(b) *Stay of application review.* (1) The Commission may stay the running of the 180-day review period if an application is materially incomplete, in accordance with section 6(a) of the Act.

(2) *Delegation of authority.* (i) The Commission hereby delegates, until it orders otherwise, to the Director of the Division of Clearing and Risk or the Director's designee, with the concurrence of the General Counsel or the General Counsel's designee, the authority to notify an applicant seeking designation under section 6(a) of the Act that the application is materially incomplete and the running of the 180-day period is stayed.

(ii) The Director of the Division of Clearing and Risk may submit to the Commission for its consideration any matter which has been delegated in this paragraph.

(iii) Nothing in this paragraph prohibits the Commission, at its election, from exercising the authority delegated in paragraph (b)(2)(i) of this section.

(c) *Withdrawal of application for registration.* An applicant for registration may withdraw its application submitted pursuant to paragraph (a) of this section by filing electronically such a request with the Secretary of the Commission in the format and manner specified by the Commission. Withdrawal of an application for registration shall not affect any action taken or to be taken by the Commission based upon actions, activities, or events occurring during the time that the application for registration was pending with the Commission.

(d) *Reinstatement of dormant registration.* Before listing or relisting products for clearing, a dormant registered derivatives clearing organization as defined in § 40.1 of this chapter must reinstate its registration under the procedures of paragraph (a) of this section; provided, however, that an application for reinstatement may rely

upon previously submitted materials that still pertain to, and accurately describe, current conditions.

(e) *Request for vacation of registration.* A registered derivatives clearing organization may vacate its registration under section 7 of the Act by filing electronically such a request with the Secretary of the Commission in the format and manner specified by the Commission. Vacation of registration shall not affect any action taken or to be taken by the Commission based upon actions, activities or events occurring during the time that the entity was registered by the Commission.

(f) *Request for transfer of registration and open interest.* (1) In anticipation of a corporate change that will result in the transfer of all or substantially all of a derivatives clearing organization's assets to another legal entity, the derivatives clearing organization shall submit a request for approval to transfer the derivatives clearing organization's registration and positions comprising open interest for clearing and settlement.

(2) *Timing of submission and other procedural requirements.* (i) The request shall be submitted no later than three months prior to the anticipated corporate change, or as otherwise permitted under § 39.19(c)(4)(viii)(C) of this part.

(ii) The derivatives clearing organization shall submit a request for transfer by filing electronically such a request with the Secretary of the Commission in the format and manner specified by the Commission.

(iii) The derivatives clearing organization shall submit a confirmation of change report pursuant to § 39.19(c)(4)(viii)(D) of this part.

(3) *Required information.* The request shall include the following:

(i) The underlying agreement that governs the corporate change;

(ii) A narrative description of the corporate change, including the reason for the change and its impact on the derivatives clearing organization's financial resources, governance, and operations, and its impact on the rights and obligations of clearing members and market participants holding the positions that comprise the derivatives clearing organization's open interest;

(iii) A discussion of the transferee's ability to comply with the Act, including the core principles applicable to derivatives clearing organizations, and the Commission's regulations thereunder;

(iv) The governing documents of the transferee, including but not limited to articles of incorporation and bylaws;

(v) The transferee's rules marked to show changes from the current rules of the derivatives clearing organization;

(vi) A list of products for which the derivatives clearing organization requests transfer of open interest;

(vii) A representation by the derivatives clearing organization that it is in compliance with the Act, including the core principles applicable to derivatives clearing organizations, and the Commission's regulations thereunder; and

(viii) A representation by the transferee that it understands that the derivatives clearing organization is a regulated entity that must comply with the Act, including the core principles applicable to derivatives clearing organizations, and the Commission's regulations thereunder, in order to maintain its registration as a derivatives clearing organization; and further, that the transferee will continue to comply with all self-regulatory requirements applicable to a derivatives clearing organization under the Act and the Commission's regulations thereunder.

(4) *Commission determination.* The Commission will review a request as soon as practicable, and based on the Commission's determination as to the transferee's ability to continue to operate the derivatives clearing organization in compliance with the Act and the Commission's regulations thereunder, such request will be approved or denied pursuant to a Commission order.

§ 39.4 Procedures for implementing derivatives clearing organization rules and clearing new products.

(a) *Request for approval of rules.* An applicant for registration, or a registered derivatives clearing organization, may request, pursuant to the procedures of § 40.5 of this chapter, that the Commission approve any or all of its rules and subsequent amendments thereto, including operational rules, prior to their implementation or, notwithstanding the provisions of section 5c(c)(2) of the Act, at any time thereafter, under the procedures of § 40.5 of this chapter. A derivatives clearing organization may label as, ''Approved by the Commission,'' only those rules that have been so approved.

(b) *Self-certification of rules.* Proposed new or amended rules of a derivatives clearing organization not voluntarily submitted for prior Commission approval pursuant to paragraph (a) of this section must be submitted to the Commission with a certification that the proposed new rule or rule amendment complies with the Act and rules thereunder pursuant to the procedures of § 40.6 of this chapter.

(c) *Acceptance of new products for clearing.* (1) A dormant derivatives clearing organization within the meaning of § 40.1 of this chapter may not accept for clearing a new product until its registration as a derivatives clearing organization is reinstated under the procedures of § 39.3 of this part; provided however, that an application for reinstatement may rely upon previously submitted materials that still pertain to, and accurately describe, current conditions.

(2) A derivatives clearing organization that accepts for clearing a new product that is a swap shall comply with the requirements of § 39.5 of this part.

(d) *Orders regarding competition.* An applicant for registration or a registered derivatives clearing organization may request that the Commission issue an order concerning whether a rule or practice of the organization is the least anticompetitive means of achieving the objectives, purposes, and policies of the Act.

(e) *Holding securities in a futures portfolio margining account.* A derivatives clearing organization seeking to provide a portfolio margining program under which securities would be held in a futures account as defined in § 1.3(vv) of this chapter, shall submit rules to implement such portfolio margining program for Commission approval in accordance with § 40.5 of this chapter. Concurrent with the submission of such rules for Commission approval, the derivatives clearing organization shall petition the Commission for an order under section 4d of the Act.

§ 39.5 Review of swaps for Commission determination on clearing requirement.

(a) *Eligibility to clear swaps.* (1) A derivatives clearing organization shall be presumed eligible to accept for clearing any swap that is within a group, category, type, or class of swaps that the derivatives clearing organization already clears. Such presumption of eligibility, however, is subject to review by the Commission.

(2) A derivatives clearing organization that wishes to accept for clearing any swap that is not within a group, category, type, or class of swaps that the derivatives clearing organization already clears shall request a determination by the Commission of the derivatives clearing organization's eligibility to clear such a swap before accepting the swap for clearing. The request, which shall be filed electronically with the Secretary of the Commission, shall address the derivatives clearing

organization's ability, if it accepts the swap for clearing, to maintain compliance with section 5b(c)(2) of the Act, specifically:

(i) The sufficiency of the derivatives clearing organization's financial resources; and

(ii) The derivative clearing organization's ability to manage the risks associated with clearing the swap, especially if the Commission determines that the swap is required to be cleared.

(b) *Swap submissions.* (1) A derivatives clearing organization shall submit to the Commission each swap, or any group, category, type, or class of swaps that it plans to accept for clearing. The derivatives clearing organization making the submission must be eligible under paragraph (a) of this section to accept for clearing the submitted swap, or group, category, type, or class of swaps.

(2) A derivatives clearing organization shall submit swaps to the Commission, to the extent reasonable and practicable to do so, by group, category, type, or class of swaps. The Commission may in its reasonable discretion consolidate multiple submissions from one derivatives clearing organization or subdivide a derivatives clearing organization's submission as appropriate for review.

(3) The submission shall be filed electronically with the Secretary of the Commission and shall include:

(i) A statement that the derivatives clearing organization is eligible to accept the swap, or group, category, type, or class of swaps for clearing and describes the extent to which, if the Commission were to determine that the swap, or group, category, type, or class of swaps is required to be cleared, the derivatives clearing organization will be able to maintain compliance with section 5b(c)(2) of the Act;

(ii) A statement that includes, but is not limited to, information that will assist the Commission in making a quantitative and qualitative assessment of the following factors:

(A) The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data;

(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;

(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;

(D) The effect on competition, including appropriate fees and charges applied to clearing; and

(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;

(iii) Product specifications, including copies of any standardized legal documentation, generally accepted contract terms, standard practices for managing any life cycle events associated with the swap, and the extent to which the swap is electronically confirmable;

(iv) Participant eligibility standards, if different from the derivatives clearing organization's general participant eligibility standards;

(v) Pricing sources, models, and procedures, demonstrating an ability to obtain sufficient price data to measure credit exposures in a timely and accurate manner, including any agreements with clearing members to provide price data and copies of executed agreements with third-party price vendors, and information about any price reference index used, such as the name of the index, the source that calculates it, the methodology used to calculate the price reference index and how often it is calculated, and when and where it is published publicly;

(vi) Risk management procedures, including measurement and monitoring of credit exposures, initial and variation margin methodology, methodologies for stress testing and back testing, settlement procedures, and default management procedures;

(vii) Applicable rules, manuals, policies, or procedures;

(viii) A description of the manner in which the derivatives clearing organization has provided notice of the submission to its members and a summary of any views on the submission expressed by the members (a copy of the notice to members shall be included with the submission); and

(ix) Any additional information specifically requested by the Commission.

(4) The Commission must have received the submission by the open of business on the business day preceding the acceptance of the swap, or group, category, type, or class of swaps for clearing.

(5) The submission will be made available to the public and posted on the Commission Web site for a 30-day public comment period. A derivatives clearing organization that wishes to request confidential treatment for portions of its submission may do so in accordance with the procedures set out in § 145.9(d) of this chapter.

(6) The Commission will review the submission and determine whether the swap, or group, category, type, or class of swaps described in the submission is required to be cleared. The Commission will make its determination not later than 90 days after a complete submission has been received, unless the submitting derivatives clearing organization agrees to an extension. The determination of when such submission is complete shall be at the sole discretion of the Commission. In making a determination that a clearing requirement shall apply, the Commission may impose such terms and conditions to the clearing requirement as the Commission determines to be appropriate.

(c) *Commission-initiated reviews.* (1) The Commission, on an ongoing basis, will review swaps that have not been accepted for clearing by a derivatives clearing organization to make a determination as to whether the swaps should be required to be cleared. In undertaking such reviews, the Commission will use information obtained pursuant to Commission regulations from swap data repositories, swap dealers, and major swap participants, and any other available information.

(2) Notice regarding any determination made under paragraph (c)(1) of this section will be made available to the public and posted on the Commission Web site for a 30-day public comment period.

(3) If no derivatives clearing organization has accepted for clearing a particular swap, group, category, type, or class of swaps that the Commission finds would otherwise be subject to a clearing requirement, the Commission will:

(i) Investigate the relevant facts and circumstances;

(ii) Within 30 days of the completion of its investigation, issue a public report containing the results of the investigation; and

(iii) Take such actions as the Commission determines to be necessary and in the public interest, which may include requiring the retaining of adequate margin or capital by parties to the swap, group, category, type, or class of swaps.

(d) *Stay of clearing requirement.* (1) After making a determination that a swap, or group, category, type, or class of swaps is required to be cleared, the Commission, on application of a counterparty to a swap or on its own

initiative, may stay the clearing requirement until the Commission completes a review of the terms of the swap, or group, category, type, or class of swaps and the clearing arrangement.

(2) A counterparty to a swap that wishes to apply for a stay of the clearing requirement for that swap shall submit a written request to the Secretary of the Commission that includes:

(i) The identity and contact information of the counterparty to the swap;

(ii) The terms of the swap subject to the clearing requirement;

(iii) The name of the derivatives clearing organization clearing the swap;

(iv) A description of the clearing arrangement; and

(v) A statement explaining why the swap should not be subject to a clearing requirement.

(3) A derivatives clearing organization that has accepted for clearing a swap, or group, category, type, or class of swaps that is subject to a stay of the clearing requirement shall provide any information requested by the Commission in the course of its review.

(4) The Commission will complete its review not later than 90 days after issuance of the stay, unless the derivatives clearing organization that clears the swap, or group, category, type, or class of swaps agrees to an extension.

(5) Upon completion of its review, the Commission may:

(i) Determine, subject to any terms and conditions as the Commission determines to be appropriate, that the swap, or group, category, type, or class of swaps must be cleared; or

(ii) Determine that the clearing requirement will not apply to the swap, or group, category, type, or class of swaps, but clearing may continue on a non-mandatory basis.

§ 39.6 [Reserved]

§ 39.7 Enforceability.

An agreement, contract or transaction submitted to a derivatives clearing organization for clearing shall not be void, voidable, subject to rescission, or otherwise invalidated or rendered unenforceable as a result of:

(a) A violation by the derivatives clearing organization of the provisions of the Act or of Commission regulations; or

(b) Any Commission proceeding to alter or supplement a rule under section 8a(7) of the Act, to declare an emergency under section 8a(9) of the Act, or any other proceeding the effect of which is to alter, supplement, or require a derivatives clearing organization to adopt a specific rule or procedure, or to take or refrain from taking a specific action.

§ 39.8 Fraud in connection with the clearing of transactions on a derivatives clearing organization.

It shall be unlawful for any person, directly or indirectly, in or in connection with the clearing of transactions by a derivatives clearing organization:

(a) To cheat or defraud or attempt to cheat or defraud any person;

(b) Willfully to make or cause to be made to any person any false report or statement or cause to be entered for any person any false record; or

(c) Willfully to deceive or attempt to deceive any person by any means whatsoever.

Subpart B—Compliance with Core Principles

§ 39.9 Scope.

The provisions of this subpart B apply to any derivatives clearing organization, as defined under section 1a(15) of the Act and § 1.3(d) of this chapter, which is registered or deemed to be registered with the Commission as a derivatives clearing organization, is required to register as such with the Commission pursuant to section 5b(a) of the Act, or which voluntarily registers as such with the Commission pursuant to section 5b(b) or otherwise.

§ 39.10 Compliance with core principles.

(a) To be registered and to maintain registration as a derivatives clearing organization, a derivatives clearing organization shall comply with each core principle set forth in section 5b(c)(2) of the Act and any requirement that the Commission may impose by rule or regulation pursuant to section 8a(5) of the Act; and

(b) Subject to any rule or regulation prescribed by the Commission, a registered derivatives clearing organization shall have reasonable discretion in establishing the manner by which it complies with each core principle.

(c) *Chief compliance officer*—(1) *Designation.* Each derivatives clearing organization shall establish the position of chief compliance officer, designate an individual to serve as the chief compliance officer, and provide the chief compliance officer with the full responsibility and authority to develop and enforce, in consultation with the board of directors or the senior officer, appropriate compliance policies and procedures, to fulfill the duties set forth in the Act and Commission regulations.

(i) The individual designated to serve as chief compliance officer shall have the background and skills appropriate for fulfilling the responsibilities of the position. No individual who would be disqualified from registration under sections 8a(2) or 8a(3) of the Act may serve as a chief compliance officer.

(ii) The chief compliance officer shall report to the board of directors or the senior officer of the derivatives clearing organization. The board of directors or the senior officer shall approve the compensation of the chief compliance officer.

(iii) The chief compliance officer shall meet with the board of directors or the senior officer at least once a year.

(iv) A change in the designation of the individual serving as the chief compliance officer of the derivatives clearing organization shall be reported to the Commission in accordance with the requirements of § 39.19(c)(4)(ix) of this part.

(2) *Chief compliance officer duties.* The chief compliance officer's duties shall include, but are not limited to:

(i) Reviewing the derivatives clearing organization's compliance with the core principles set forth in section 5b of the Act, and the Commission's regulations thereunder;

(ii) In consultation with the board of directors or the senior officer, resolving any conflicts of interest that may arise;

(iii) Establishing and administering written policies and procedures reasonably designed to prevent violation of the Act;

(iv) Taking reasonable steps to ensure compliance with the Act and Commission regulations relating to agreements, contracts, or transactions, and with Commission regulations prescribed under section 5b of the Act;

(v) Establishing procedures for the remediation of noncompliance issues identified by the chief compliance officer through any compliance office review, look-back, internal or external audit finding, self-reported error, or validated complaint; and

(vi) Establishing and following appropriate procedures for the handling, management response, remediation, retesting, and closing of noncompliance issues.

(3) *Annual report.* The chief compliance officer shall, not less than annually, prepare and sign a written report that covers the most recently completed fiscal year of the derivatives clearing organization, and provide the annual report to the board of directors or the senior officer. The annual report shall, at a minimum:

(i) Contain a description of the derivatives clearing organization's

written policies and procedures, including the code of ethics and conflict of interest policies;

(ii) Review each core principle and applicable Commission regulation, and with respect to each:

(A) Identify the compliance policies and procedures that are designed to ensure compliance with the core principle;

(B) Provide an assessment as to the effectiveness of these policies and procedures;

(C) Discuss areas for improvement, and recommend potential or prospective changes or improvements to the derivatives clearing organization's compliance program and resources allocated to compliance;

(iii) List any material changes to compliance policies and procedures since the last annual report;

(iv) Describe the financial, managerial, and operational resources set aside for compliance with the Act and Commission regulations; and

(v) Describe any material compliance matters, including incidents of noncompliance, since the date of the last annual report and describe the corresponding action taken.

(4) *Submission of annual report to the Commission.* (i) Prior to submitting the annual report to the Commission, the chief compliance officer shall provide the annual report to the board of directors or the senior officer of the derivatives clearing organization for review. Submission of the report to the board of directors or the senior officer shall be recorded in the board minutes or otherwise, as evidence of compliance with this requirement.

(ii) The annual report shall be submitted electronically to the Secretary of the Commission in the format and manner specified by the Commission not more than 90 days after the end of the derivatives clearing organization's fiscal year, concurrently with submission of the fiscal year-end audited financial statement that is required to be furnished to the Commission pursuant to § 39.19(c)(3)(ii) of this part. The report shall include a certification by the chief compliance officer that, to the best of his or her knowledge and reasonable belief, and under penalty of law, the annual report is accurate and complete.

(iii) The derivatives clearing organization shall promptly submit an amended annual report if material errors or omissions in the report are identified after submission. An amendment must contain the certification required under paragraph (c)(4)(ii) of this section.

(iv) A derivatives clearing organization may request from the Commission an extension of time to submit its annual report in accordance with § 39.19(c)(3) of this part.

(5) *Recordkeeping.* (i) The derivatives clearing organization shall maintain:

(A) A copy of all compliance policies and procedures and all other policies and procedures adopted in furtherance of compliance with the Act and Commission regulations;

(B) Copies of materials, including written reports provided to the board of directors or the senior officer in connection with the review of the annual report under paragraph (c)(4)(i) of this section; and

(C) Any records relevant to the annual report, including, but not limited to, work papers and other documents that form the basis of the report, and memoranda, correspondence, other documents, and records that are created, sent, or received in connection with the annual report and contain conclusions, opinions, analyses, or financial data related to the annual report.

(ii) The derivatives clearing organization shall maintain records in accordance with § 1.31 of this chapter and § 39.20 of this part.

§ 39.11 Financial resources.

(a) *General.* A derivatives clearing organization shall maintain financial resources sufficient to cover its exposures with a high degree of confidence and to enable it to perform its functions in compliance with the core principles set out in section 5b of the Act. A derivatives clearing organization shall identify and adequately manage its general business risks and hold sufficient liquid resources to cover potential business losses that are not related to clearing members' defaults, so that the derivatives clearing organization can continue to provide services as an ongoing concern. Financial resources shall be considered sufficient if their value, at a minimum, exceeds the total amount that would:

(1) Enable the derivatives clearing organization to meet its financial obligations to its clearing members notwithstanding a default by the clearing member creating the largest financial exposure for the derivatives clearing organization in extreme but plausible market conditions; Provided that if a clearing member controls another clearing member or is under common control with another clearing member, the affiliated clearing members shall be deemed to be a single clearing member for purposes of this provision; and

(2) Enable the derivatives clearing organization to cover its operating costs for a period of at least one year, calculated on a rolling basis.

(b) *Types of financial resources.* (1) Financial resources available to satisfy the requirements of paragraph (a)(1) of this section may include:

(i) Margin to the extent permitted under parts 1, 22, and 190 of this chapter and under the rules of the derivatives clearing organization;

(ii) The derivatives clearing organization's own capital;

(iii) Guaranty fund deposits;

(iv) Default insurance;

(v) Potential assessments for additional guaranty fund contributions, if permitted by the derivatives clearing organization's rules; and

(vi) Any other financial resource deemed acceptable by the Commission.

(2) Financial resources available to satisfy the requirements of paragraph (a)(2) of this section may include:

(i) The derivatives clearing organization's own capital; and

(ii) Any other financial resource deemed acceptable by the Commission.

(3) A financial resource may be allocated, in whole or in part, to satisfy the requirements of either paragraph (a)(1) or paragraph (a)(2) of this section, but not both paragraphs, and only to the extent the use of such financial resource is not otherwise limited by the Act, Commission regulations, the derivatives clearing organization's rules, or any contractual arrangements to which the derivatives clearing organization is a party.

(c) *Computation of financial resources requirement.* (1) A derivatives clearing organization shall, on a monthly basis, perform stress testing that will allow it to make a reasonable calculation of the financial resources needed to meet the requirements of paragraph (a)(1) of this section. The derivatives clearing organization shall have reasonable discretion in determining the methodology used to compute such requirements, provided that the methodology must take into account both historical data and hypothetical scenarios. The Commission may review the methodology and require changes as appropriate.

(2) A derivatives clearing organization shall, on a monthly basis, make a reasonable calculation of its projected operating costs over a 12-month period in order to determine the amount needed to meet the requirements of paragraph (a)(2) of this section. The derivatives clearing organization shall have reasonable discretion in determining the methodology used to compute such projected operating costs. The Commission may review the

methodology and require changes as appropriate.

(d) *Valuation of financial resources.* (1) At appropriate intervals, but not less than monthly, a derivatives clearing organization shall compute the current market value of each financial resource used to meet its obligations under paragraph (a) of this section. Reductions in value to reflect credit, market, and liquidity risks (haircuts) shall be applied as appropriate and evaluated on a monthly basis.

(2) If assessments for additional guaranty fund contributions are permitted by the derivatives clearing organization's rules, in calculating the financial resources available to meet its obligations under paragraph (a)(1) of this section:

(i) The derivatives clearing organization shall have rules requiring that its clearing members have the ability to meet an assessment within the time frame of a normal end-of-day variation settlement cycle;

(ii) The derivatives clearing organization shall monitor the financial and operational capacity of its clearing members to meet potential assessments;

(iii) The derivatives clearing organization shall apply a 30 percent haircut to the value of potential assessments, and

(iv) The derivatives clearing organization shall only count the value of assessments, after the haircut, to meet up to 20 percent of those obligations.

(e) *Liquidity of financial resources.* (1) (i) The derivatives clearing organization shall effectively measure, monitor, and manage its liquidity risks, maintaining sufficient liquid resources such that it can, at a minimum, fulfill its cash obligations when due. The derivatives clearing organization shall hold assets in a manner where the risk of loss or of delay in its access to them is minimized.

(ii) The financial resources allocated by the derivatives clearing organization to meet the requirements of paragraph (a)(1) of this section shall be sufficiently liquid to enable the derivatives clearing organization to fulfill its obligations as a central counterparty during a one-day settlement cycle. The derivatives clearing organization shall maintain cash, U.S. Treasury obligations, or high quality, liquid, general obligations of a sovereign nation, in an amount greater than or equal to an amount calculated as follows:

(A) Calculate the average daily settlement pay for each clearing member over the last fiscal quarter;

(B) Calculate the sum of those average daily settlement pays; and

(C) Using that sum, calculate the average of its clearing members' average pays.

(iii) The derivatives clearing organization may take into account a committed line of credit or similar facility for the purpose of meeting the remainder of the requirement under paragraph (e)(1)(ii) of this section.

(2) The financial resources allocated by the derivatives clearing organization to meet the requirements of paragraph (a)(2) of this section must include unencumbered, liquid financial assets (i.e., cash and/or highly liquid securities) equal to at least six months' operating costs. If any portion of such financial resources is not sufficiently liquid, the derivatives clearing organization may take into account a committed line of credit or similar facility for the purpose of meeting this requirement.

(3)(i) Assets in a guaranty fund shall have minimal credit, market, and liquidity risks and shall be readily accessible on a same-day basis;

(ii) Cash balances shall be invested or placed in safekeeping in a manner that bears little or no principal risk; and

(iii) Letters of credit shall not be a permissible asset for a guaranty fund.

(f) *Reporting requirements.*

(1) Each fiscal quarter, or at any time upon Commission request, a derivatives clearing organization shall:

(i) Report to the Commission;

(A) The amount of financial resources necessary to meet the requirements of paragraph (a);

(B) The value of each financial resource available, computed in accordance with the requirements of paragraph (d) of this section; and

(C) The manner in which the derivatives clearing organization meets the liquidity requirements of paragraph (e) of this section;

(ii) Provide the Commission with a financial statement, including the balance sheet, income statement, and statement of cash flows, of the derivatives clearing organization or of its parent company; and

(iii) Report to the Commission the value of each individual clearing member's guaranty fund deposit, if the derivatives clearing organization reports having guaranty funds deposits as a financial resource available to satisfy the requirements of paragraph (a)(1) of this section.

(2) The calculations required by this paragraph shall be made as of the last business day of the derivatives clearing organization's fiscal quarter.

(3) The derivatives clearing organization shall provide the Commission with:

(i) Sufficient documentation explaining the methodology used to compute its financial resources requirements under paragraph (a) of this section,

(ii) Sufficient documentation explaining the basis for its determinations regarding the valuation and liquidity requirements set forth in paragraphs (d) and (e) of this section, and

(iii) Copies of any agreements establishing or amending a credit facility, insurance coverage, or other arrangement evidencing or otherwise supporting the derivatives clearing organization's conclusions.

(4) The report shall be filed not later than 17 business days after the end of the derivatives clearing organization's fiscal quarter, or at such later time as the Commission may permit, in its discretion, upon request by the derivatives clearing organization.

§ 39.12 Participant and product eligibility.

(a) *Participant eligibility.* A derivatives clearing organization shall establish appropriate admission and continuing participation requirements for clearing members of the derivatives clearing organization that are objective, publicly disclosed, and risk-based.

(1) Fair and open access for participation. The participation requirements shall permit fair and open access;

(i) A derivatives clearing organization shall not adopt restrictive clearing member standards if less restrictive requirements that achieve the same objective and that would not materially increase risk to the derivatives clearing organization or clearing members could be adopted;

(ii) A derivatives clearing organization shall allow all market participants who satisfy participation requirements to become clearing members;

(iii) A derivatives clearing organization shall not exclude or limit clearing membership of certain types of market participants unless the derivatives clearing organization can demonstrate that the restriction is necessary to address credit risk or deficiencies in the participants' operational capabilities that would prevent them from fulfilling their obligations as clearing members.

(iv) A derivatives clearing organization shall not require that clearing members be swap dealers.

(v) A derivatives clearing organization shall not require that clearing members maintain a swap portfolio of any particular size, or that clearing members meet a swap transaction volume threshold.

(2) *Financial resources.* (i) The participation requirements shall require clearing members to have access to sufficient financial resources to meet obligations arising from participation in the derivatives clearing organization in extreme but plausible market conditions. A derivatives clearing organization may permit such financial resources to include, without limitation, a clearing member's capital, a guarantee from the clearing member's parent, or a credit facility funding arrangement. For purposes of this paragraph, ''capital'' means adjusted net capital as defined in § 1.17 of this chapter, for futures commission merchants, and net capital as defined in § 240.15c3–1of this title, for broker-dealers, or any similar risk adjusted capital calculation for all other clearing members.

(ii) The participation requirements shall set forth capital requirements that are based on objective, transparent, and commonly accepted standards that appropriately match capital to risk. Capital requirements shall be scalable to the risks posed by clearing members.

(iii) A derivatives clearing organization shall not set a minimum capital requirement of more than $50 million for any person that seeks to become a clearing member in order to clear swaps.

(3) *Operational requirements.* The participation requirements shall require clearing members to have adequate operational capacity to meet obligations arising from participation in the derivatives clearing organization. The requirements shall include, but are not limited to: the ability to process expected volumes and values of transactions cleared by a clearing member within required time frames, including at peak times and on peak days; the ability to fulfill collateral, payment, and delivery obligations imposed by the derivatives clearing organization; and the ability to participate in default management activities under the rules of the derivatives clearing organization and in accordance with § 39.16 of this part.

(4) *Monitoring.* A derivatives clearing organization shall establish and implement procedures to verify, on an ongoing basis, the compliance of each clearing member with each participation requirement of the derivatives clearing organization.

(5) *Reporting.* (i) A derivatives clearing organization shall require all clearing members, including non-futures commission merchants, to provide to the derivatives clearing organization periodic financial reports that contain any financial information that the derivatives clearing organization determines is necessary to assess whether participation requirements are being met on an ongoing basis.

(A) A derivatives clearing organization shall require clearing members that are futures commission merchants to provide the financial reports that are specified in § 1.10 of this chapter to the derivatives clearing organization.

(B) A derivatives clearing organization shall require clearing members that are not futures commission merchants to make the periodic financial reports provided pursuant to paragraph (a)(5)(i) of this section available to the Commission upon the Commission's request or, in lieu of imposing this requirement, a derivatives clearing organization may provide such financial reports directly to the Commission upon the Commission's request.

(ii) A derivatives clearing organization shall adopt rules that require clearing members to provide to the derivatives clearing organization, in a timely manner, information that concerns any financial or business developments that may materially affect the clearing members' ability to continue to comply with participation requirements.

(6) *Enforcement.* A derivatives clearing organization shall have the ability to enforce compliance with its participation requirements and shall establish procedures for the suspension and orderly removal of clearing members that no longer meet the requirements.

(b) *Product eligibility.* (1) A derivatives clearing organization shall establish appropriate requirements for determining the eligibility of agreements, contracts, or transactions submitted to the derivatives clearing organization for clearing, taking into account the derivatives clearing organization's ability to manage the risks associated with such agreements, contracts, or transactions. Factors to be considered in determining product eligibility include, but are not limited to:

(i) Trading volume;

(ii) Liquidity;

(iii) Availability of reliable prices;

(iv) Ability of market participants to use portfolio compression with respect to a particular swap product;

(v) Ability of the derivatives clearing organization and clearing members to gain access to the relevant market for purposes of creating, liquidating, transferring, auctioning, and/or allocating positions;

(vi) Ability of the derivatives clearing organization to measure risk for purposes of setting margin requirements; and

(vii) Operational capacity of the derivatives clearing organization and clearing members to address any unusual risk characteristics of a product.

(2) A derivatives clearing organization shall adopt rules providing that all swaps with the same terms and conditions, as defined by product specifications established under derivatives clearing organization rules, submitted to the derivatives clearing organization for clearing are economically equivalent within the derivatives clearing organization and may be offset with each other within the derivatives clearing organization.

(3) A derivatives clearing organization shall provide for non-discriminatory clearing of a swap executed bilaterally or on or subject to the rules of an unaffiliated swap execution facility or designated contract market.

(4) A derivatives clearing organization shall not require that one of the original executing parties be a clearing member in order for a product to be eligible for clearing.

(5) A derivatives clearing organization shall select product unit sizes and other terms and conditions that maximize liquidity, facilitate transparency in pricing, promote open access, and allow for effective risk management. To the extent appropriate to further these objectives, a derivatives clearing organization shall select product units for clearing purposes that are smaller than the product units in which trades submitted for clearing were executed.

(6) A derivatives clearing organization that clears swaps shall have rules providing that, upon acceptance of a swap by the derivatives clearing organization for clearing:

(i) The original swap is extinguished;

(ii) The original swap is replaced by an equal and opposite swap between the derivatives clearing organization and each clearing member acting as principal for a house trade or acting as agent for a customer trade;

(iii) All terms of a cleared swap must conform to product specifications established under derivatives clearing organization rules; and

(iv) If a swap is cleared by a clearing member on behalf of a customer, all terms of the swap, as carried in the customer account on the books of the clearing member, must conform to the terms of the cleared swap established under the derivatives clearing organization's rules.

(7) [Reserved]

(8) *Confirmation.* A derivatives clearing organization shall provide each

clearing member carrying a cleared swap with a definitive written record of the terms of the transaction which shall legally supersede any previous agreement and serve as a confirmation of the swap. The confirmation of all terms of the transaction shall take place at the same time as the swap is accepted for clearing.

§ 39.13 Risk management.

(a) *General.* A derivatives clearing organization shall ensure that it possesses the ability to manage the risks associated with discharging the responsibilities of the derivatives clearing organization through the use of appropriate tools and procedures.

(b) *Documentation requirement.* A derivatives clearing organization shall establish and maintain written policies, procedures, and controls, approved by its board of directors, which establish an appropriate risk management framework that, at a minimum, clearly identifies and documents the range of risks to which the derivatives clearing organization is exposed, addresses the monitoring and management of the entirety of those risks, and provides a mechanism for internal audit. The risk management framework shall be regularly reviewed and updated as necessary.

(c) *Chief risk officer.* A derivatives clearing organization shall have a chief risk officer who shall be responsible for implementing the risk management framework, including the procedures, policies and controls described in paragraph (b) of this section, and for making appropriate recommendations to the derivatives clearing organization's risk management committee or board of directors, as applicable, regarding the derivatives clearing organization's risk management functions.

(d) [Reserved]

(e) *Measurement of credit exposure.* A derivatives clearing organization shall:

(1) Measure its credit exposure to each clearing member and mark to market such clearing member's open house and customer positions at least once each business day; and

(2) Monitor its credit exposure to each clearing member periodically during each business day.

(f) *Limitation of exposure to potential losses from defaults.* A derivatives clearing organization, through margin requirements and other risk control mechanisms, shall limit its exposure to potential losses from defaults by its clearing members to ensure that:

(1) The operations of the derivatives clearing organization would not be disrupted; and

(2) Non-defaulting clearing members would not be exposed to losses that non-defaulting clearing members cannot anticipate or control.

(g) *Margin requirements.* (1) *General.* Each model and parameter used in setting initial margin requirements shall be risk-based and reviewed on a regular basis.

(2) *Methodology and coverage.* (i) A derivatives clearing organization shall establish initial margin requirements that are commensurate with the risks of each product and portfolio, including any unusual characteristics of, or risks associated with, particular products or portfolios, including but not limited to jump-to-default risk or similar jump risk.

(ii) A derivatives clearing organization shall use models that generate initial margin requirements sufficient to cover the derivatives clearing organization's potential future exposures to clearing members based on price movements in the interval between the last collection of variation margin and the time within which the derivatives clearing organization estimates that it would be able to liquidate a defaulting clearing member's positions (liquidation time); *provided, however,* that a derivatives clearing organization shall use:

(A) A minimum liquidation time that is one day for futures and options;

(B) A minimum liquidation time that is one day for swaps on agricultural commodities, energy commodities, and metals;

(C) A minimum liquidation time that is five days for all other swaps; or

(D) Such longer liquidation time as is appropriate based on the specific characteristics of a particular product or portfolio; *provided further* that the Commission, by order, may establish shorter or longer liquidation times for particular products or portfolios.

(iii) The actual coverage of the initial margin requirements produced by such models, along with projected measures of the models' performance, shall meet an established confidence level of at least 99 percent, based on data from an appropriate historic time period, for:

(A) Each product for which the derivatives clearing organization uses a product-based margin methodology;

(B) Each spread within or between products for which there is a defined spread margin rate;

(C) Each account held by a clearing member at the derivatives clearing organization, by house origin and by each customer origin; and

(D) Each swap portfolio, including any portfolio containing futures and/or options and held in a commingled account pursuant to § 39.15(b)(2) of this part, by beneficial owner.

(iv) A derivatives clearing organization shall determine the appropriate historic time period based on the characteristics, including volatility patterns, as applicable, of each product, spread, account, or portfolio.

(3) *Independent validation.* A derivatives clearing organization's systems for generating initial margin requirements, including its theoretical models, must be reviewed and validated by a qualified and independent party, on a regular basis. Such qualified and independent parties may be independent contractors or employees of the derivatives clearing organization, but shall not be persons responsible for development or operation of the systems and models being tested.

(4) *Spread and portfolio margins.* (i) A derivatives clearing organization may allow reductions in initial margin requirements for related positions if the price risks with respect to such positions are significantly and reliably correlated. The price risks of different positions will only be considered to be reliably correlated if there is a theoretical basis for the correlation in addition to an exhibited statistical correlation. That theoretical basis may include, but is not limited to, the following:

(A) The products on which the positions are based are complements of, or substitutes for, each other;

(B) One product is a significant input into the other product(s);

(C) The products share a significant common input; or

(D) The prices of the products are influenced by common external factors.

(ii) A derivatives clearing organization shall regularly review its margin reductions and the correlations on which they are based.

(5) *Price data.* A derivatives clearing organization shall have a reliable source of timely price data in order to measure the derivatives clearing organization's credit exposure accurately. A derivatives clearing organization shall also have written procedures and sound valuation models for addressing circumstances where pricing data is not readily available or reliable.

(6) *Daily review.* On a daily basis, a derivatives clearing organization shall determine the adequacy of its initial margin requirements.

(7) *Back tests.* A derivatives clearing organization shall conduct back tests, as defined in § 39.2 of this part, using an appropriate time period but not less than the previous 30 days, as follows:

(i) On a daily basis, a derivatives clearing organization shall conduct back

tests with respect to products or swap portfolios that are experiencing significant market volatility, to test the adequacy of its initial margin requirements, as follows:

(A) For that product if the derivatives clearing organization uses a product-based margin methodology;

(B) For each spread involving that product if there is a defined spread margin rate;

(C) For each account held by a clearing member at the derivatives clearing organization that contains a significant position in that product, by house origin and by each customer origin; and

(D) For each such swap portfolio, including any portfolio containing futures and/or options and held in a commingled account pursuant to § 39.15(b)(2) of this part, by beneficial owner.

(ii) On at least a monthly basis, a derivatives clearing organization shall conduct back tests to test the adequacy of its initial margin requirements, as follows:

(A) For each product for which the derivatives clearing organization uses a product-based margin methodology;

(B) For each spread for which there is a defined spread margin rate;

(C) For each account held by a clearing member at the derivatives clearing organization, by house origin and by each customer origin; and

(D) For each swap portfolio, including any portfolio containing futures and/or options and held in a commingled account pursuant to § 39.15(b)(2) of this part, by beneficial owner.

(8) *Customer margin.* (i) *Gross margin.* (A) A derivatives clearing organization shall collect initial margin on a gross basis for each clearing member's customer account(s) equal to the sum of the initial margin amounts that would be required by the derivatives clearing organization for each individual customer within that account if each individual customer were a clearing member.

(B) For purposes of calculating the gross initial margin requirement for each clearing member's customer account(s), to the extent not inconsistent with other Commission regulations, a derivatives clearing organization may require its clearing members to report the gross positions of each individual customer to the derivatives clearing organization, or it may permit each clearing member to report the sum of the gross positions of its customers to the derivatives clearing organization.

(C) For purposes of this paragraph (g)(8), a derivatives clearing organization may rely, and may permit its clearing members to rely, upon the sum of the gross positions reported to the clearing members by each domestic or foreign omnibus account that they carry, without obtaining information identifying the positions of each individual customer underlying such omnibus accounts.

(D) A derivatives clearing organization may not, and may not permit its clearing members to, net positions of different customers against one another.

(E) A derivatives clearing organization may collect initial margin for its clearing members' house accounts on a net basis.

(ii) *Customer initial margin requirements.* A derivatives clearing organization shall require its clearing members to collect customer initial margin, as defined in § 1.3 of this chapter, from their customers, for non-hedge positions, at a level that is greater than 100 percent of the derivatives clearing organization's initial margin requirements with respect to each product and swap portfolio. The derivatives clearing organization shall have reasonable discretion in determining the percentage by which customer initial margins must exceed the derivatives clearing organization's initial margin requirements with respect to particular products or swap portfolios. The Commission may review such percentage levels and require different percentage levels if the Commission deems the levels insufficient to protect the financial integrity of the clearing members or the derivatives clearing organization.

(iii) *Withdrawal of customer initial margin.* A derivatives clearing organization shall require its clearing members to ensure that their customers do not withdraw funds from their accounts with such clearing members unless the net liquidating value plus the margin deposits remaining in a customer's account after such withdrawal are sufficient to meet the customer initial margin requirements with respect to all products and swap portfolios held in such customer's account which are cleared by the derivatives clearing organization.

(9) *Time deadlines.* A derivatives clearing organization shall establish and enforce time deadlines for initial and variation margin payments to the derivatives clearing organization by its clearing members.

(10) *Types of assets.* A derivatives clearing organization shall limit the assets it accepts as initial margin to those that have minimal credit, market, and liquidity risks. A derivatives clearing organization may take into account the specific risk-reducing properties that particular assets have in a particular portfolio. A derivatives clearing organization may accept letters of credit as initial margin for futures and options on futures but shall not accept letters of credit as initial margin for swaps.

(11) *Valuation.* A derivatives clearing organization shall use prudent valuation practices to value assets posted as initial margin on a daily basis.

(12) *Haircuts.* A derivatives clearing organization shall apply appropriate reductions in value to reflect credit, market, and liquidity risks (haircuts), to the assets that it accepts in satisfaction of initial margin obligations, taking into consideration stressed market conditions, and shall evaluate the appropriateness of such haircuts on at least a quarterly basis.

(13) *Concentration limits or charges.* A derivatives clearing organization shall apply appropriate limitations or charges on the concentration of assets posted as initial margin, as necessary, in order to ensure its ability to liquidate such assets quickly with minimal adverse price effects, and shall evaluate the appropriateness of any such concentration limits or charges, on at least a monthly basis.

(14) *Pledged assets.* If a derivatives clearing organization permits its clearing members to pledge assets for initial margin while retaining such assets in accounts in the names of such clearing members, the derivatives clearing organization shall ensure that such assets are unencumbered and that such a pledge has been validly created and validly perfected in the relevant jurisdiction.

(h) *Other risk control mechanisms*—(1) *Risk limits.* (i) A derivatives clearing organization shall impose risk limits on each clearing member, by house origin and by each customer origin, in order to prevent a clearing member from carrying positions for which the risk exposure exceeds a specified threshold relative to the clearing member's and/or the derivatives clearing organization's financial resources. The derivatives clearing organization shall have reasonable discretion in determining:

(A) The method of computing risk exposure;

(B) The applicable threshold(s); and

(C) The applicable financial resources under this provision; provided however, that the ratio of exposure to capital must remain the same across all capital levels. The Commission may review such methods, thresholds, and financial resources and require the application of different methods, thresholds, or financial resources, as appropriate.

(ii) A derivatives clearing organization may permit a clearing member to exceed the threshold(s) applied pursuant to paragraph (h)(1)(i) of this section provided that the derivatives clearing organization requires the clearing member to post additional initial margin that the derivatives clearing organization deems sufficient to appropriately eliminate excessive risk exposure at the clearing member. The Commission may review the amount of additional initial margin and require a different amount of additional initial margin, as appropriate.

(2) *Large trader reports.* A derivatives clearing organization shall obtain from its clearing members or from a relevant designated contract market or swap execution facility, copies of all reports that are required to be filed with the Commission by, or on behalf of, such clearing members pursuant to parts 17 and 20 of this chapter. A derivatives clearing organization shall review such reports on a daily basis to ascertain the risk of the overall portfolio of each large trader, including futures, options, and swaps cleared by the derivatives clearing organization, which are held by all clearing members carrying accounts for each such large trader, and shall take additional actions with respect to such clearing members, when appropriate, as specified in paragraph (h)(6) of this section, in order to address any risks posed by any such large trader.

(3) *Stress tests.* A derivatives clearing organization shall conduct stress tests, as defined in § 39.2 of this part, as follows:

(i) On a daily basis, a derivatives clearing organization shall conduct stress tests with respect to each large trader who poses significant risk to a clearing member or the derivatives clearing organization, including futures, options, and swaps cleared by the derivatives clearing organization, which are held by all clearing members carrying accounts for each such large trader. The derivatives clearing organization shall have reasonable discretion in determining which traders to test and the methodology used to conduct such stress tests. The Commission may review the selection of accounts and the methodology and require changes, as appropriate.

(ii) On at least a weekly basis, a derivatives clearing organization shall conduct stress tests with respect to each clearing member account, by house origin and by each customer origin, and each swap portfolio, including any portfolio containing futures and/or options and held in a commingled account pursuant to § 39.15(b)(2) of this part, by beneficial owner, under extreme but plausible market conditions. The derivatives clearing organization shall have reasonable discretion in determining the methodology used to conduct such stress tests. The Commission may review the methodology and require changes, as appropriate.

(4) *Portfolio compression.* A derivatives clearing organization shall make portfolio compression exercises available, on a regular and voluntary basis, for its clearing members that clear swaps, to the extent that such exercises are appropriate for those swaps that it clears; *provided, however,* a derivatives clearing organization is not required to develop its own portfolio compression services, and is only required to make such portfolio compression exercises available, if applicable portfolio compression services have been developed by a third party.

(5) *Clearing members' risk management policies and procedures.* (i) A derivatives clearing organization shall adopt rules that:

(A) Require its clearing members to maintain current written risk management policies and procedures, which address the risks that such clearing members may pose to the derivatives clearing organization;

(B) Ensure that it has the authority to request and obtain information and documents from its clearing members regarding their risk management policies, procedures, and practices, including, but not limited to, information and documents relating to the liquidity of their financial resources and their settlement procedures; and

(C) Require its clearing members to make information and documents regarding their risk management policies, procedures, and practices available to the Commission upon the Commission's request.

(ii) A derivatives clearing organization shall review the risk management policies, procedures, and practices of each of its clearing members, which address the risks that such clearing members may pose to the derivatives clearing organization, on a periodic basis and document such reviews.

(6) *Additional authority.* A derivatives clearing organization shall take additional actions with respect to particular clearing members, when appropriate, based on the application of objective and prudent risk management standards including, but not limited to:

(i) Imposing enhanced capital requirements;

(ii) Imposing enhanced margin requirements;

(iii) Imposing position limits;

(iv) Prohibiting an increase in positions;

(v) Requiring a reduction of positions;

(vi) Liquidating or transferring positions; and

(vii) Suspending or revoking clearing membership.

§ 39.14 Settlement procedures.

(a) *Definitions*—(1) *Settlement.* For purposes of this section, ''settlement'' means:

(i) Payment and receipt of variation margin for futures, options, and swaps;

(ii) Payment and receipt of option premiums;

(iii) Deposit and withdrawal of initial margin for futures, options, and swaps;

(iv) All payments due in final settlement of futures, options, and swaps on the final settlement date with respect to such positions; and

(v) All other cash flows collected from or paid to each clearing member, including but not limited to, payments related to swaps such as coupon amounts.

(2) *Settlement bank.* For purposes of this section, ''settlement bank'' means a bank that maintains an account either for the derivatives clearing organization or for any of its clearing members, which is used for the purpose of any settlement described in paragraph (a)(1) above.

(b) *Daily settlements.* Except as otherwise provided by Commission order, a derivatives clearing organization shall effect a settlement with each clearing member at least once each business day, and shall have the authority and operational capacity to effect a settlement with each clearing member, on an intraday basis, either routinely, when thresholds specified by the derivatives clearing organization are breached, or in times of extreme market volatility.

(c) *Settlement banks.* A derivatives clearing organization shall employ settlement arrangements that eliminate or strictly limit its exposure to settlement bank risks, including the credit and liquidity risks arising from the use of such bank(s) to effect settlements with its clearing members, as follows:

(1) A derivatives clearing organization shall have documented criteria that must be met by any settlement bank used by the derivatives clearing organization or its clearing members, including criteria addressing the capitalization, creditworthiness, access to liquidity, operational reliability, and regulation or supervision of such bank(s).

(2) A derivatives clearing organization shall monitor each approved settlement

bank on an ongoing basis to ensure that such bank continues to meet the criteria established pursuant to paragraph (c)(1) of this section.

(3) A derivatives clearing organization shall monitor the full range and concentration of its exposures to its own and its clearing members' settlement bank(s) and assess its own and its clearing members' potential losses and liquidity pressures in the event that the settlement bank with the largest share of settlement activity were to fail. A derivatives clearing organization shall take any one or more of the following actions, to the extent that any such action or actions are reasonably necessary in order to eliminate or strictly limit such exposures:

(i) Maintain settlement accounts at one or more additional settlement banks; and/or

(ii) Approve one or more additional settlement banks that its clearing members could choose to use; and/or

(iii) Impose concentration limits with respect to one or more of its own or its clearing members' settlement banks; and/or

(iv) Take any other appropriate actions.

(d) *Settlement finality.* A derivatives clearing organization shall ensure that settlements are final when effected by ensuring that it has entered into legal agreements that state that settlement fund transfers are irrevocable and unconditional no later than when the derivatives clearing organization's accounts are debited or credited; provided, however, a derivatives clearing organization's legal agreements with its settlement banks may provide for the correction of errors. A derivatives clearing organization's legal agreements with its settlement banks shall state clearly when settlement fund transfers will occur and a derivatives clearing organization shall routinely confirm that its settlement banks are effecting fund transfers as and when required by such legal agreements.

(e) *Recordkeeping.* A derivatives clearing organization shall maintain an accurate record of the flow of funds associated with each settlement.

(f) *Netting arrangements.* A derivatives clearing organization shall possess the ability to comply with each term and condition of any permitted netting or offset arrangement with any other clearing organization.

(g) *Physical delivery.* With respect to products that are settled by physical transfers of the underlying instruments or commodities, a derivatives clearing organization shall:

(1) Establish rules that clearly state each obligation that the derivatives clearing organization has assumed with respect to physical deliveries, including whether it has an obligation to make or receive delivery of a physical instrument or commodity, or whether it indemnifies clearing members for losses incurred in the delivery process; and

(2) Ensure that the risks of each such obligation are identified and managed.

§ 39.15 Treatment of funds.

(a) *Required standards and procedures.* A derivatives clearing organization shall establish standards and procedures that are designed to protect and ensure the safety of funds and assets belonging to clearing members and their customers.

(b) *Segregation of funds and assets.* (1) *Segregation.* A derivatives clearing organization shall comply with the applicable segregation requirements of section 4d of the Act and Commission regulations thereunder, or any other applicable Commission regulation or order requiring that customer funds and assets be segregated, set aside, or held in a separate account.

(2) *Commingling of futures, options, and swaps.* (i) *Cleared swaps account.* In order for a derivatives clearing organization and its clearing members to commingle customer positions in futures, options, and swaps, and any money, securities, or property received to margin, guarantee or secure such positions, in an account subject to the requirements of section 4d(f) of the Act, the derivatives clearing organization shall file rules for Commission approval pursuant to § 40.5 of this chapter. Such rule submission shall include, at a minimum, the following:

(A) Identification of the futures, options, and swaps that would be commingled, including product specifications or the criteria that would be used to define eligible futures, options, and swaps;

(B) Analysis of the risk characteristics of the eligible products;

(C) Identification of whether the swaps would be executed bilaterally and/or executed on a designated contract market and/or a swap execution facility;

(D) Analysis of the liquidity of the respective markets for the futures, options, and swaps that would be commingled, the ability of clearing members and the derivatives clearing organization to offset or mitigate the risk of such futures, options, and swaps in a timely manner, without compromising the financial integrity of the account, and, as appropriate, proposed means for addressing insufficient liquidity;

(E) Analysis of the availability of reliable prices for each of the eligible products;

(F) A description of the financial, operational, and managerial standards or requirements for clearing members that would be permitted to commingle such futures, options, and swaps;

(G) A description of the systems and procedures that would be used by the derivatives clearing organization to oversee such clearing members' risk management of any such commingled positions;

(H) A description of the financial resources of the derivatives clearing organization, including the composition and availability of a guaranty fund with respect to the futures, options, and swaps that would be commingled;

(I) A description and analysis of the margin methodology that would be applied to the commingled futures, options, and swaps, including any margin reduction applied to correlated positions, and any applicable margin rules with respect to both clearing members and customers;

(J) An analysis of the ability of the derivatives clearing organization to manage a potential default with respect to any of the futures, options, or swaps that would be commingled;

(K) A discussion of the procedures that the derivatives clearing organization would follow if a clearing member defaulted, and the procedures that a clearing member would follow if a customer defaulted, with respect to any of the commingled futures, options, or swaps in the account; and

(L) A description of the arrangements for obtaining daily position data with respect to futures, options, and swaps in the account.

(ii) *Futures account.* In order for a derivatives clearing organization and its clearing members to commingle customer positions in futures, options, and swaps, and any money, securities, or property received to margin, guarantee or secure such positions, in an account subject to the requirements of section 4d(a) of the Act, the derivatives clearing organization shall file with the Commission a petition for an order pursuant to section 4d(a) of the Act. Such petition shall include, at a minimum, the information required under paragraph (b)(2)(i) of this section.

(iii) *Commission action.* (A) The Commission may request additional information in support of a rule submission filed under paragraph (b)(2)(i) of this section, and may grant approval of such rules in accordance with § 40.5 of this chapter.

(B) The Commission may request additional information in support of a

petition filed under paragraph (b)(2)(ii) of this section, and may issue an order under section 4d of the Act in its discretion.

(c) *Holding of funds and assets.* A derivatives clearing organization shall hold funds and assets belonging to clearing members and their customers in a manner which minimizes the risk of loss or of delay in the access by the derivatives clearing organization to such funds and assets.

(d) *Transfer of customer positions.* A derivatives clearing organization shall have rules providing that the derivatives clearing organization will promptly transfer all or a portion of a customer's portfolio of positions and related funds at the same time from the carrying clearing member of the derivatives clearing organization to another clearing member of the derivatives clearing organization, without requiring the close-out and re-booking of the positions prior to the requested transfer, subject to the following conditions:

(1) The customer has instructed the carrying clearing member to make the transfer;

(2) The customer is not currently in default to the carrying clearing member;

(3) The transferred positions will have appropriate margin at the receiving clearing member;

(4) Any remaining positions will have appropriate margin at the carrying clearing member; and

(5) The receiving clearing member has consented to the transfer.

(e) *Permitted investments.* Funds and assets belonging to clearing members and their customers that are invested by a derivatives clearing organization shall be held in instruments with minimal credit, market, and liquidity risks. Any investment of customer funds or assets by a derivatives clearing organization shall comply with § 1.25 of this chapter, as if all such funds and assets comprise customer funds subject to segregation pursuant to section 4d(a) of the Act and Commission regulations thereunder.

§ 39.16 Default rules and procedures.

(a) *General.* A derivatives clearing organization shall adopt rules and procedures designed to allow for the efficient, fair, and safe management of events during which clearing members become insolvent or default on the obligations of such clearing members to the derivatives clearing organization.

(b) *Default management plan.* A derivatives clearing organization shall maintain a current written default management plan that delineates the roles and responsibilities of its board of directors, its risk management committee, any other committee that a derivatives clearing organization may have that has responsibilities for default management, and the derivatives clearing organization's management, in addressing a default, including any necessary coordination with, or notification of, other entities and regulators. Such plan shall address any differences in procedures with respect to highly liquid products and less liquid products. A derivatives clearing organization shall conduct and document a test of its default management plan at least on an annual basis.

(c) *Default procedures.* (1) A derivatives clearing organization shall adopt procedures that would permit the derivatives clearing organization to take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a default on the obligations of a clearing member to the derivatives clearing organization.

(2) A derivatives clearing organization shall adopt rules that set forth its default procedures, including:

(i) The derivatives clearing organization's definition of a default;

(ii) The actions that the derivatives clearing organization may take upon a default, which shall include the prompt transfer, liquidation, or hedging of the customer or house positions of the defaulting clearing member, as applicable, and which may include, in the discretion of the derivatives clearing organization, the auctioning or allocation of such positions to other clearing members;

(iii) Any obligations that the derivatives clearing organization imposes on its clearing members to participate in auctions, or to accept allocations, of the customer or house positions of the defaulting clearing member, *provided that:*

(A) The derivatives clearing organization shall permit a clearing member to outsource to a qualified third party, authority to act in the clearing member's place in any auction, subject to appropriate safeguards imposed by the derivatives clearing organization;

(B) The derivatives clearing organization shall permit a clearing member to outsource to a qualified third party, authority to act in the clearing member's place in any allocations, subject to appropriate safeguards imposed by the derivatives clearing organization; and

(C) Any allocation shall be proportional to the size of the participating or accepting clearing member's positions in the same product class at the derivatives clearing organization;

(iv) The sequence in which the funds and assets of the defaulting clearing member and its customers and the financial resources maintained by the derivatives clearing organization would be applied in the event of a default;

(v) A provision that the funds and assets of a defaulting clearing member's customers shall not be applied to cover losses with respect to a house default;

(vi) A provision that the excess house funds and assets of a defaulting clearing member shall be applied to cover losses with respect to a customer default, if the relevant customer funds and assets are insufficient to cover the shortfall; and

(3) A derivatives clearing organization shall make its default rules publicly available as provided in § 39.21 of this part.

(d) *Insolvency of a clearing member.*

(1) A derivatives clearing organization shall adopt rules that require a clearing member to provide prompt notice to the derivatives clearing organization if it becomes the subject of a bankruptcy petition, receivership proceeding, or the equivalent;

(2) No later than upon receipt of such notice, a derivatives clearing organization shall review the continuing eligibility of the clearing member for clearing membership; and

(3) No later than upon receipt of such notice, a derivatives clearing organization shall take any appropriate action, in its discretion, with respect to such clearing member or its house or customer positions, including but not limited to liquidation or transfer of positions, suspension, or revocation of clearing membership.

§ 39.17 Rule enforcement.

(a) *General.* Each derivatives clearing organization shall:

(1) Maintain adequate arrangements and resources for the effective monitoring and enforcement of compliance with the rules of the derivatives clearing organization and the resolution of disputes;

(2) Have the authority and ability to discipline, limit, suspend, or terminate the activities of a clearing member due to a violation by the clearing member of any rule of the derivatives clearing organization; and

(3) Report to the Commission regarding rule enforcement activities and sanctions imposed against clearing members as provided in paragraph (a)(2) of this section, in accordance with § 39.19(c)(4)(xi) of this part.

(b) *Authority to enforce rules.* The board of directors of the derivatives clearing organization may delegate responsibility for compliance with the requirements of paragraph (a) of this

section to the risk management committee, unless the responsibilities are otherwise required to be carried out by the chief compliance officer pursuant to the Act or this part.

§ 39.18 System safeguards.

(a) *Definitions.* For purposes of this section:

Recovery time objective means the time period within which an entity should be able to achieve recovery and resumption of clearing and settlement of existing and new products, after those capabilities become temporarily inoperable for any reason up to or including a wide-scale disruption.

Relevant area means the metropolitan or other geographic area within which a derivatives clearing organization has physical infrastructure or personnel necessary for it to conduct activities necessary to the clearing and settlement of existing and new products. The term ''relevant area'' also includes communities economically integrated with, adjacent to, or within normal commuting distance of that metropolitan or other geographic area.

Wide-scale disruption means an event that causes a severe disruption or destruction of transportation, telecommunications, power, water, or other critical infrastructure components in a relevant area, or an event that results in an evacuation or unavailability of the population in a relevant area.

(b) *General*—(1) *Program of risk analysis.* Each derivatives clearing organization shall establish and maintain a program of risk analysis and oversight with respect to its operations and automated systems to identify and minimize sources of operational risk through:

(i) The development of appropriate controls and procedures; and

(ii) The development of automated systems that are reliable, secure, and have adequate scalable capacity.

(2) *Resources.* Each derivatives clearing organization shall establish and maintain resources that allow for the fulfillment of each obligation and responsibility of the derivatives clearing organization in light of the risks identified pursuant to paragraph (b)(1) of this section.

(3) *Verification of adequacy.* Each derivatives clearing organization shall periodically verify that resources described in paragraph (b)(2) of this section are adequate to ensure daily processing, clearing, and settlement.

(c) *Elements of program.* A derivatives clearing organization's program of risk analysis and oversight with respect to its operations and automated systems, as described in paragraph (b) of this section, shall address each of the following categories of risk analysis and oversight:

(1) Information security;

(2) Business continuity and disaster recovery planning and resources;

(3) Capacity and performance planning;

(4) Systems operations;

(5) Systems development and quality assurance; and

(6) Physical security and environmental controls.

(d) *Standards for program.* In addressing the categories of risk analysis and oversight required under paragraph (c) of this section, a derivatives clearing organization shall follow generally accepted standards and industry best practices with respect to the development, operation, reliability, security, and capacity of automated systems.

(e) *Business continuity and disaster recovery.* (1) *Plan and resources.* A derivatives clearing organization shall maintain a business continuity and disaster recovery plan, emergency procedures, and physical, technological, and personnel resources sufficient to enable the timely recovery and resumption of operations and the fulfillment of each obligation and responsibility of the derivatives clearing organization following any disruption of its operations.

(2) *Responsibilities and obligations.* The responsibilities and obligations described in paragraph (e)(1) of this section shall include, without limitation, daily processing, clearing, and settlement of transactions cleared.

(3) *Recovery time objective.* The derivatives clearing organization's business continuity and disaster recovery plan described in paragraph (e)(1) of this section, shall have the objective of, and the physical, technological, and personnel resources described therein shall be sufficient to, enable the derivatives clearing organization to resume daily processing, clearing, and settlement no later than the next business day following the disruption.

(f) *Location of resources; outsourcing.* A derivatives clearing organization may maintain the resources required under paragraph (e)(1) of this section either:

(1) Using its own employees as personnel, and property that it owns, licenses, or leases (own resources); or

(2) Through written contractual arrangements with another derivatives clearing organization or other service provider (outsourcing).

(i) *Retention of responsibility.* A derivatives clearing organization that enters into such a contractual arrangement shall retain complete liability for any failure to meet the responsibilities specified in paragraph (e) of this section, although it is free to seek indemnification from the service provider. The outsourcing derivatives clearing organization must employ personnel with the expertise necessary to enable it to supervise the service provider's delivery of the services.

(ii) *Testing.* The testing referred to in paragraph (j) of this section shall include all of the derivatives clearing organization's own and outsourced resources, and shall verify that all such resources will work effectively together.

(g) *Notice of exceptional events.* A derivatives clearing organization shall notify staff of the Division of Clearing and Risk promptly of:

(1) Any hardware or software malfunction, cyber security incident, or targeted threat that materially impairs, or creates a significant likelihood of material impairment, of automated system operation, reliability, security, or capacity; or

(2) Any activation of the derivatives clearing organization's business continuity and disaster recovery plan.

(h) *Notice of planned changes.* A derivatives clearing organization shall give staff of the Division of Clearing and Risk timely advance notice of all:

(1) Planned changes to automated systems that are likely to have a significant impact on the reliability, security, or adequate scalable capacity of such systems; and

(2) Planned changes to the derivatives clearing organization's program of risk analysis and oversight.

(i) *Recordkeeping.* A derivatives clearing organization shall maintain, and provide to Commission staff promptly upon request, pursuant to § 1.31 of this chapter, current copies of its business continuity plan and other emergency procedures, its assessments of its operational risks, and records of testing protocols and results, and shall provide any other documents requested by Commission staff for the purpose of maintaining a current profile of the derivatives clearing organization's automated systems.

(j) *Testing.*—(1) *Purpose of testing.* A derivatives clearing organization shall conduct regular, periodic, and objective testing and review of:

(i) Its automated systems to ensure that they are reliable, secure, and have adequate scalable capacity; and

(ii) Its business continuity and disaster recovery capabilities, using testing protocols adequate to ensure that the derivatives clearing organization's backup resources are sufficient to meet

the requirements of paragraph (e) of this section.

(2) *Conduct of testing.* Testing shall be conducted by qualified, independent professionals. Such qualified, independent professionals may be independent contractors or employees of the derivatives clearing organization, but shall not be persons responsible for development or operation of the systems or capabilities being tested.

(3) *Reporting and review.* Reports setting forth the protocols for, and results of, such tests shall be communicated to, and reviewed by, senior management of the derivatives clearing organization. Protocols of tests which result in few or no exceptions shall be subject to more searching review.

(k) *Coordination of business continuity and disaster recovery plans.* A derivatives clearing organization shall, to the extent practicable:

(1) Coordinate its business continuity and disaster recovery plan with those of its clearing members, in a manner adequate to enable effective resumption of daily processing, clearing, and settlement following a disruption;

(2) Initiate and coordinate periodic, synchronized testing of its business continuity and disaster recovery plan and the plans of its clearing members; and

(3) Ensure that its business continuity and disaster recovery plan takes into account the plans of its providers of essential services, including telecommunications, power, and water.

§ 39.19 Reporting.

(a) *General.* Each derivatives clearing organization shall provide to the Commission the information specified in this section and any other information that the Commission deems necessary to conduct its oversight of a derivatives clearing organization.

(b) *Submission of reports.* (1) Unless otherwise specified by the Commission or its designee, each derivatives clearing organization shall submit the information required by this section to the Commission electronically and in a format and manner specified by the Commission.

(2) *Time zones.* Unless otherwise specified by the Commission or its designee, any stated time in this section is Central time for information concerning derivatives clearing organizations located in that time zone, and Eastern time for information concerning all other derivatives clearing organizations.

(3) Unless otherwise specified by the Commission or its designee, *business day* means the intraday period of time starting at the business hour of 8:15 a.m. and ending at the business hour of 4:45 p.m., on all days except Saturdays, Sundays, and Federal holidays.

(c) *Reporting requirements.* Each registered derivatives clearing organization shall provide to the Commission or other person as may be required or permitted by this paragraph the information specified below:

(1) *Daily reporting.* (i) A report containing the information specified by this paragraph (c)(1), which shall be compiled as of the end of each trading day and shall be submitted to the Commission by 10 a.m. on the following business day:

(A) Initial margin requirements and initial margin on deposit for each clearing member, by house origin and by each customer origin;

(B) Daily variation margin, separately listing the mark-to-market amount collected from or paid to each clearing member, by house origin and by each customer origin;

(C) All other daily cash flows relating to clearing and settlement including, but not limited to, option premiums and payments related to swaps such as coupon amounts, collected from or paid to each clearing member, by house origin and by each customer origin; and

(D) End-of-day positions for each clearing member, by house origin and by each customer origin.

(ii) The report shall contain the information required by paragraph (c)(1)(i) of this section for:

(A) All futures positions, and options positions, as applicable;

(B) All swaps positions; and

(C) All securities positions that are held in a customer account subject to section 4d of the Act or are subject to a cross-margining agreement.

(2) *Quarterly reporting.* A report of the derivatives clearing organization's financial resources as required by § 39.11(f) of this part; provided that, additional reports may be required by paragraph (c)(4)(i) of this section or § 39.11(f) of this part.

(3) *Annual reporting*—(i) *Annual report of chief compliance officer.* The annual report of the chief compliance officer required by § 39.10 of this part.

(ii) *Audited financial statements.* Audited year-end financial statements of the derivatives clearing organization or, if there are no financial statements available for the derivatives clearing organization itself, the consolidated audited year-end financial statements of the derivatives clearing organization's parent company.

(iii) [Reserved]

(iv) *Time of report.* The reports required by this paragraph (c)(3) shall be submitted concurrently to the Commission not more than 90 days after the end of the derivatives clearing organization's fiscal year; provided that, a derivatives clearing organization may request from the Commission an extension of time to submit a report, provided the derivatives clearing organization's failure to submit the report in a timely manner could not be avoided without unreasonable effort or expense. Extensions of the deadline will be granted at the discretion of the Commission.

(4) *Event-specific reporting*—(i) *Decrease in financial resources.* If there is a decrease of 25 percent in the total value of the financial resources available to satisfy the requirements under § 39.11(a)(1) of this part, either from the last quarterly report submitted under § 39.11(f) of this part or from the value as of the close of the previous business day, the derivatives clearing organization shall report such decrease to the Commission no later than one business day following the day the 25 percent threshold was reached. The report shall include:

(A) The total value of the financial resources:

(*1*) As of the close of business the day the 25 percent threshold was reached, and

(*2*) If reporting a decrease in value from the previous business day, the total value of the financial resources immediately prior to the 25 percent decline;

(B) A breakdown of the value of each financial resource reported in each of paragraphs (c)(4)(i)(A)(*1*) and (*2*) of this section, calculated in accordance with the requirements of § 39.11(d) of this part, including the value of each individual clearing member's guaranty fund deposit if the derivatives clearing organization reports guaranty fund deposits as a financial resource; and

(C) A detailed explanation for the decrease.

(ii) *Decrease in ownership equity.* No later than two business days prior to an event which the derivatives clearing organization knows or reasonably should know will cause a decrease of 20 percent or more in ownership equity from the last reported ownership equity balance as reported on a quarterly or audited financial statement required to be submitted by paragraph (c)(2) or (c)(3)(ii), respectively, of this section; but in any event no later than two business days after such decrease in ownership equity for events that caused the decrease about which the derivatives clearing organization did not know and reasonably could not have

known prior to the event. The report shall include:

(A) Pro forma financial statements reflecting the derivatives clearing organization's estimated future financial condition following the anticipated decrease for reports submitted prior to the anticipated decrease and current financial statements for reports submitted after such a decrease; and

(B) Details describing the reason for the anticipated decrease or decrease in the balance.

(iii) *Six-month liquid asset requirement.* Immediate notice when a derivatives clearing organization knows or reasonably should know of a deficit in the six-month liquid asset requirement of § 39.11(e)(2).

(iv) *Change in current assets.* No later than two business days after current liabilities exceed current assets; the notice shall include a balance sheet that reflects the derivatives clearing organization's current assets and current liabilities and an explanation as to the reason for the negative balance.

(v) *Request to clearing member to reduce its positions.* Immediate notice, of a derivatives clearing organization's request to a clearing member to reduce its positions because the derivatives clearing organization has determined that the clearing member has exceeded its exposure limit, has failed to meet an initial or variation margin call, or has failed to fulfill any other financial obligation to the derivatives clearing organization. The notice shall include:

(A) The name of the clearing member;

(B) The time the clearing member was contacted;

(C) The number of positions by which the derivatives clearing organization requested the reduction;

(D) All products that are the subject of the request; and

(E) The reason for the request.

(vi) *Determination to transfer or liquidate positions.* Immediate notice, of a determination that any position a derivatives clearing organization carries for one of its clearing members must be liquidated immediately or transferred immediately, or that the trading of any account of a clearing member shall be only for the purpose of liquidation because that clearing member has failed to meet an initial or variation margin call or has failed to fulfill any other financial obligation to the derivatives clearing organization. The notice shall include:

(A) The name of the clearing member;

(B) The time the clearing member was contacted;

(C) The products that are subject to the determination;

(D) The number of positions that are subject to the determination; and

(E) The reason for the determination.

(vii) *Default of a clearing member.* Immediate notice, upon the default of a clearing member. An event of default shall be determined in accordance with the rules of the derivatives clearing organization. The notice of default shall include:

(A) The name of the clearing member;

(B) The products the clearing member defaulted upon;

(C) The number of positions the clearing member defaulted upon; and

(D) The amount of the financial obligation.

(viii) *Change in ownership or corporate or organizational structure.*

(A) *Reporting requirement.* Any anticipated change in the ownership or corporate or organizational structure of the derivatives clearing organization or its parent(s) that would:

(*1*) Result in at least a 10 percent change of ownership of the derivatives clearing organization,

(*2*) Create a new subsidiary or eliminate a current subsidiary of the derivatives clearing organization, or

(*3*) Result in the transfer of all or substantially all of the assets of the derivatives clearing organization, including its registration as a derivatives clearing organization to another legal entity.

(B) *Required information.* The report shall include: a chart outlining the new ownership or corporate or organizational structure; a brief description of the purpose and impact of the change; and any relevant agreements effecting the change and corporate documents such as articles of incorporation and bylaws. With respect to a corporate change for which a derivatives clearing organization submits a request for approval to transfer its derivatives clearing organization registration and open interest under § 39.3(f) of this part, the informational requirements of this paragraph (c)(4)(viii)(B) shall be satisfied by the derivatives clearing organization's compliance with § 39.3(f)(3).

(C) *Time of report.* The report shall be submitted to the Commission no later than three months prior to the anticipated change; provided that the derivatives clearing organization may report the anticipated change to the Commission later than three months prior to the anticipated change if the derivatives clearing organization does not know and reasonably could not have known of the anticipated change three months prior to the anticipated change. In such event, the derivatives clearing organization shall immediately report such change to the Commission as soon as it knows of such change.

(D) *Confirmation of change report.* The derivatives clearing organization shall report to the Commission the consummation of the change no later than two business days following the effective date of the change.

(ix) *Change in key personnel.* No later than two business days following the departure, or addition of persons who are key personnel as defined in § 39.1(b), a report that includes, as applicable, the name of the person who will assume the duties of the position on a temporary basis until a permanent replacement fills the position.

(x) *Change in credit facility funding arrangement.* No later than one business day after a derivatives clearing organization changes an existing credit facility funding arrangement it may have in place, or is notified that such arrangement has changed, including but not limited to a change in lender, change in the size of the facility, change in expiration date, or any other material changes or conditions.

(xi) *Sanctions.* Notice of action taken, no later than two business days after the derivatives clearing organization imposes sanctions against a clearing member.

(xii) *Financial condition and events.* Immediate notice after the derivatives clearing organization knows or reasonably should have known of:

(A) The institution of any legal proceedings which may have a material adverse financial impact on the derivatives clearing organization;

(B) Any event, circumstance or situation that materially impedes the derivatives clearing organization's ability to comply with this part and is not otherwise required to be reported under this section; or

(C) A material adverse change in the financial condition of any clearing member that is not otherwise required to be reported under this section.

(xiii) *Financial statements material inadequacies.* If a derivatives clearing organization discovers or is notified by an independent public accountant of the existence of any material inadequacy in a financial statement, such derivatives clearing organization shall give notice of such material inadequacy within 24 hours, and within 48 hours after giving such notice file a written report stating what steps have been and are being taken to correct the material inadequacy.

(xiv) [Reserved]

(xv) [Reserved]

(xvi) *System safeguards.* A report of:

(A) Exceptional events as required by § 39.18(g) of this part; or

(B) Planned changes as required by § 39.18(h) of this part.

(5) *Requested reporting.* (i) Upon request by the Commission, a derivatives clearing organization shall file with the Commission such information related to its business as a clearing organization, including information relating to trade and clearing details, in the format and manner specified, and within the time provided, by the Commission in the request.

(ii) Upon request by the Commission, a derivatives clearing organization shall file with the Commission a written demonstration, containing such supporting data, information and documents, that the derivatives clearing organization is in compliance with one or more core principles and relevant provisions of this part, in the format and manner specified, and within the time provided, by the Commission in the request.

(iii) Upon request by the Commission, a derivatives clearing organization shall file with the Commission, for each customer origin of each clearing member, the end-of-day gross positions of each beneficial owner, in the format and manner specified, and within the time provided, by the Commission in the request. Nothing in this paragraph shall affect the obligation of a derivatives clearing organization to comply with the daily reporting requirements of paragraph (c)(1) of this section.

§ 39.20 Recordkeeping.

(a) *Requirement to maintain information.* Each derivatives clearing organization shall maintain records of all activities related to its business as a derivatives clearing organization. Such records shall include, but are not limited to, records of:

(1) All cleared transactions, including swaps;

(2) All information necessary to record allocation of bunched orders for cleared swaps;

(3) All information required to be created, generated, or reported under this part 39, including but not limited to the results of and methodology used for all tests, reviews, and calculations in connection with setting and evaluating margin levels, determining the value and adequacy of financial resources, and establishing settlement prices;

(4) All rules and procedures required to be submitted pursuant to this part 39 and part 40 of this chapter, including all proposed changes in rules, procedures or operations subject to § 40.10 of this chapter; and

(5) Any data or documentation required by the Commission or by the derivatives clearing organization to be submitted to the derivatives clearing organization by its clearing members, or by any other person in connection with the derivatives clearing organization's clearing and settlement activities.

(b) *Form and manner of maintaining information.* (1) *General.* The records required to be maintained by this chapter shall be maintained in accordance with the provisions of § 1.31 of this chapter, for a period of not less than 5 years, except as provided in paragraph (b)(2) of this section.

(2) *Exception for swap data.* Each derivatives clearing organization that clears swaps must maintain swap data in accordance with the requirements of part 45 of this chapter.

§ 39.21 Public information.

(a) *General.* Each derivatives clearing organization shall provide to market participants sufficient information to enable the market participants to identify and evaluate accurately the risks and costs associated with using the services of the derivatives clearing organization. In furtherance of this objective, each derivatives clearing organization shall have clear and comprehensive rules and procedures.

(b) *Availability of information.* Each derivatives clearing organization shall make information concerning the rules and the operating and default procedures governing the clearing and settlement systems of the derivatives clearing organization available to market participants.

(c) *Public disclosure.* Each derivatives clearing organization shall disclose publicly and to the Commission information concerning:

(1) The terms and conditions of each contract, agreement, and transaction cleared and settled by the derivatives clearing organization;

(2) Each clearing and other fee that the derivatives clearing organization charges its clearing members;

(3) The margin-setting methodology;

(4) The size and composition of the financial resource package available in the event of a clearing member default;

(5) Daily settlement prices, volume, and open interest for each contract, agreement, or transaction cleared or settled by the derivatives clearing organization;

(6) The derivatives clearing organization's rules and procedures for defaults in accordance with § 39.16 of this part; and

(7) Any other matter that is relevant to participation in the clearing and settlement activities of the derivatives clearing organization.

(d) *Publication of information.* The derivatives clearing organization shall make its rulebook, a list of all current clearing members, and the information listed in paragraph (c) of this section readily available to the general public, in a timely manner, by posting such information on the derivatives clearing organization's Web site, unless otherwise permitted by the Commission. The information required in paragraph (c)(5) of this section shall be made available to the public no later than the business day following the day to which the information pertains.

§ 39.22 Information sharing.

Each derivatives clearing organization shall enter into, and abide by the terms of, each appropriate and applicable domestic and international information-sharing agreement, and shall use relevant information obtained from each such agreement in carrying out the risk management program of the derivatives clearing organization.

§ 39.23 Antitrust considerations.

Unless necessary or appropriate to achieve the purposes of the Act, a derivatives clearing organization shall not adopt any rule or take any action that results in any unreasonable restraint of trade, or impose any material anticompetitive burden.

§ 39.24 [Reserved]

§ 39.25 [Reserved]

§ 39.26 [Reserved]

§ 39.27 Legal risk considerations.

(a) *Legal authorization.* A derivatives clearing organization shall be duly organized, legally authorized to conduct business, and remain in good standing at all times in the relevant jurisdictions. If the derivatives clearing organization provides clearing services outside the United States, it shall be duly organized to conduct business and remain in good standing at all times in the relevant jurisdictions, and be authorized by the appropriate foreign licensing authority.

(b) *Legal framework.* A derivatives clearing organization shall operate pursuant to a well-founded, transparent, and enforceable legal framework that addresses each aspect of the activities of the derivatives clearing organization. As applicable, the framework shall provide for:

(1) The derivatives clearing organization to act as a counterparty, including novation;

(2) Netting arrangements;

(3) The derivatives clearing organization's interest in collateral;

(4) The steps that a derivatives clearing organization would take to address a default of a clearing member, including but not limited to, the unimpeded ability to liquidate collateral and close out or transfer positions in a timely manner;

(5) Finality of settlement and funds transfers that are irrevocable and unconditional when effected (no later than when a derivatives clearing organization's accounts are debited and credited); and

(6) Other significant aspects of the derivatives clearing organization's operations, risk management procedures, and related requirements.

(c) *Conflict of laws.* If a derivatives clearing organization provides clearing services outside the United States:

(1) The derivatives clearing organization shall identify and address any material conflict of law issues. The derivatives clearing organization's contractual agreements shall specify a choice of law.

(2) The derivatives clearing organization shall be able to demonstrate the enforceability of its choice of law in relevant jurisdictions and that its rules, procedures, and contracts are enforceable in all relevant jurisdictions.

Appendix to Part 39—Form DCO Derivatives Clearing Organization Application for Registrations

BILLING CODE 6351–01–P

OMB No. 3038-0076

COMMODITY FUTURES TRADING COMMISSION

FORM DCO

DERIVATIVES CLEARING ORGANIZATION
APPLICATION FOR REGISTRATION

GENERAL INSTRUCTIONS

Intentional misstatements or omissions of fact may constitute federal criminal violations (7 U.S.C. § 13 and 18 U.S.C. § 1001) or grounds for disqualification from registration.

DEFINITIONS

Unless the context requires otherwise, all terms used in this Form DCO have the same meaning as in the Commodity Exchange Act ("Act"), and in the General Rules and Regulations of the Commodity Futures Trading Commission ("Commission") thereunder. All references to Commission regulations are found at 17 CFR Ch. 1.

For the purposes of this Form DCO, the term "Applicant" shall include any applicant for registration as a derivatives clearing organization or any registered derivatives clearing organization that is applying for an amendment to its derivatives clearing organization registration.

GENERAL INSTRUCTIONS

1. This Form DCO, which includes a Cover Sheet and required Exhibits (together, "Form DCO" or "application"), is to be filed with the Commission by all applicants for registration as a derivatives clearing organization, including applicants when amending a pending application, and by any registered derivatives clearing organization applying for an amendment to its registration, pursuant to Section 5b of the Act and the Commission's regulations thereunder. Upon the filing of an application for registration, an amendment to an application, or a registration amendment in accordance with the instruction provided herein, the Commission will publish notice of the filing and afford interested persons an opportunity to submit written data, views and comments concerning such application. No application for registration or registration amendment will be effective unless the Commission, by order, grants such registration or amended registration.

2. Individuals' names, except the executing signature, shall be given in full (Last Name, First Name, Middle Name).

3. With respect to the executing signature, it must be manually signed by a duly authorized representative of the Applicant as follows: If the Form DCO is filed by a corporation, it must be signed in the name of the corporation by a principal officer duly authorized; if filed by a limited liability company, it must be signed in the name of the limited liability company by a manager or member duly authorized to sign on the limited liability company's behalf; if filed by a partnership, it must be signed in the name of the partnership by a general partner duly authorized; if filed by an unincorporated organization or association which is not a partnership, it must be signed in the name of such organization or association by the managing agent, i.e., a duly authorized person who directs or manages or who participates in the directing or managing of its affairs.

4. If this Form DCO is being filed as an application for registration, all applicable items must be answered in full. If any item or Exhibit is inapplicable, this response must be affirmatively indicated by the designation "none," "not applicable," or "N/A," as appropriate.

5. Under Section 5b of the Act and the Commission's regulations thereunder, the Commission is authorized to solicit the information required to be supplied by this Form DCO from any Applicant seeking registration as a derivatives clearing organization and from any registered derivatives clearing organization. Disclosure by the

Applicant of the information specified in this Form DCO is mandatory prior to the start of the processing of an application for, or amendment to, registration as a derivatives clearing organization. The information provided in this Form DCO will be used for the principal purpose of determining whether the Commission should grant or deny registration to an Applicant.

The Commission may determine that additional information is required from the Applicant in order to process its application. An Applicant is therefore encouraged to supplement this Form DCO with any additional information that may be significant to its operation as a derivatives clearing organization and to the Commission's review of its application. A Form DCO which is not prepared and executed in compliance with applicable requirements and instructions may be returned as not acceptable for filing. Acceptance of this Form DCO, however, shall not constitute a finding that the Form DCO has been filed as required or that the information submitted is true, current or complete.

6. Except as provided in 17 CFR 39.3(a)(5), in cases where the Applicant submits a request for confidential treatment with the Secretary of the Commission pursuant to the Freedom of Information Act and 17 CFR 145.9, information supplied in this application will be included routinely in the public files of the Commission and will be available for inspection by any interested person.

APPLICATION AMENDMENTS

1. 17 CFR 39.3(a)(4) requires an Applicant to promptly amend its application if it discovers a material omission or error in the application, or if there is a material change in the information contained in the application, including any supplement or amendment thereto.

2. Applicants, when filing this Form DCO for purposes of amending an application, must re-file a Cover Sheet, amended if necessary and including an executing signature, and attach thereto revised Exhibits or other materials marked to show changes, as applicable.

REGISTRATION AMENDMENTS

1. Applicants, when filing this Form DCO for purposes of requesting an amendment to an existing registration, are only required to submit Exhibits and updated information that are relevant to the requested amendment and are necessary to demonstrate compliance with the core principles affected by the requested amendment.

2. Applicants must file a Cover Sheet, including an executing signature, and attach thereto Exhibits or other materials, as applicable.

WHERE TO FILE

This Form DCO must be filed electronically with the Secretary of the Commission in a format specified by the Secretary of the Commission.

COMMODITY FUTURES TRADING COMMISSION

FORM DCO
DERIVATIVES CLEARING ORGANIZATION
APPLICATION FOR REGISTRATION

COVER SHEET

_____

Exact name of Applicant as specified in charter

_____

Address of principal executive offices

☐ If this is an **APPLICATION** for registration, complete in full and check here.

☐ If this is an **AMENDMENT** to an application, list below all items that are being amended and check here.

☐ If this is an **APPLICATION FOR AN AMENDMENT** to an existing registration, list below all items to be amended and check here.

_____

_____

_____

_____

GENERAL INFORMATION

- Name under which business is or will be conducted, if different than name specified above (include acronyms, if any):

_____

- If name of derivatives clearing organization is being amended, state previous derivatives clearing organization name:

_____

- Additional contact information:

_____

Website URL Main Phone Number

- List of principal office(s) and address(es) where derivatives clearing organization activities are/will be conducted:

Office Address

_____ _____

_____ _____

_____ _____

BUSINESS ORGANIZATION

- If Applicant is a successor to a previously registered derivatives clearing organization, please complete the following:

a. Date of succession _____

b. Full name and address of predecessor registrant

_____
Name

_____
Street Address

_____
City State Country Zip Code

- Applicant is a:

☐ Corporation

☐ Partnership (specify whether general or limited)

☐ Limited Liability Company

☐ Other form of organization (specify) _____

- Date of formation: _____
- Jurisdiction of organization: _____

List all other jurisdictions in which Applicant is qualified to do business (including non-US jurisdictions):

_____

_____

List all other regulatory licenses or registrations of Applicant (or exemptions from any licensing requirement) including with non-US regulators:

_____

_____

- FEIN or other Tax ID#: _____
- Fiscal Year End: _____

ADDITIONAL CONTACT INFORMATION

- Provide contact information specifying name, title, phone numbers, mailing address and e-mail address for the following individuals:

a. The primary contact for questions and correspondence regarding the application

_____

Name and Title

_____

Office Phone Number Mobile Phone Number

_____

Mailing address E-mail Address

b. The individual responsible for handling questions regarding the Applicant's financial statements

_____

Name and Title

_____

Office Phone Number Mobile Phone Number

_____

Mailing address E-mail Address

c. The individual responsible for serving as the Chief Risk Officer of the Applicant pursuant to § 39.13 of the Commission's regulations

_____

Name and Title

_____

Office Phone Number Mobile Phone Number

_____

Mailing address E-mail Address

d. The individual responsible for serving as the Chief Compliance Officer of the Applicant pursuant to § 39.10 of the Commission's regulations

_____

Name and Title

_____

Office Phone Number Mobile Phone Number

_____

Mailing address E-mail Address

e. The individual responsible for serving as the chief legal officer of the Applicant

_____

Name and Title

_____

Office Phone Number Mobile Phone Number

_____

Mailing address E-mail Address

• Outside Service Providers: Provide contact information specifying name, title, phone number, mailing address and e-mail address for any outside service provider retained by the Applicant as follows:

a. Certified Public Accountant

_____

Name and Title

_____

Office Phone Number Mobile Phone Number

_____

Mailing address E-mail Address

b. Legal Counsel

_____

Name and Title

_____

Office Phone Number Mobile Phone Number

_____

Mailing address E-mail Address

c. Records Storage or Management

_____

Name and Title

_____

Office Phone Number Mobile Phone Number

_____

Mailing address E-mail Address

d. Business Continuity/Disaster Recovery

_____

Name and Title

_____

Office Phone Number Mobile Phone Number

_____

Mailing address E-mail Address

e. Professional consultants providing services related to this application.

_____

Name and Title

_____

Office Phone Number Mobile Phone Number

_____

Mailing address E-mail Address

- Applicant agrees and consents that the notice of any proceeding before the Commission in connection with this application may be given by sending such notice by certified mail to the person named below at the address given.

_____

Print Name and Title

_____

Number and Street

_____

City State Zip Code

SIGNATURE/REPRESENTATION

- Applicant has duly caused this application to be signed on its behalf by its duly authorized representative as of the _____ day of _____, 20_____. Applicant and the undersigned each represent hereby that, to the best of their knowledge, all information contained herein is true, current and complete in all material respects. It is understood that all required items and Exhibits are considered integral parts of this Form DCO. Applicant and the undersigned each further represent that, if this submission is an application for an amendment to an existing registration, Applicant has submitted those items and Exhibits that are relevant to the requested amendment and as necessary to demonstrate Applicant's compliance with the core principles affected by the requested amendment and that such items and Exhibits are, to the best of their knowledge, true, current, and complete in all material respects.

_____

Name of Applicant

By:_____

Manual Signature of Duly Authorized Person

_____

Print Name and Title of Signatory

COMMODITY FUTURES TRADING COMMISSION

FORM DCO

DERIVATIVES CLEARING ORGANIZATION
APPLICATION FOR REGISTRATION

EXHIBIT INSTRUCTIONS

1. The following Exhibits must be filed with the Commission by each Applicant seeking registration as a derivatives clearing organization or applying for an amendment to an existing derivatives clearing organization registration, pursuant to Section 5b of the Act and the Commission's regulations thereunder.

2. The application must include a Table of Contents listing each Exhibit required by this Form DCO and indicating which, if any, Exhibits are inapplicable. For any Exhibit that is inapplicable, next to the Exhibit letter specify "none," "not applicable," or "N/A," as appropriate.

3. The Exhibits must be labeled as specified in this Form DCO. If any Exhibit requires information that is related to, or may be duplicative of, information required to be included in another Exhibit, Applicant may summarize such information and provide a cross-reference to the Exhibit that contains the required information.

4. If the information required in an Exhibit involves computerized programs or systems, Applicant must submit descriptions of system test procedures, tests conducted, or test results in sufficient detail to demonstrate the Applicant's ability to comply with the core principles specified in Section 5b of the Act and the Commission's regulations thereunder (the "Core Principles"). With respect to each system test, Applicant must identify the methodology used and provide the computer software, programs, and data necessary to enable the Commission to duplicate each system test as it relates to the applicable Core Principle.

5. If Applicant seeks confidential treatment of any Exhibit or a portion of any Exhibit, Applicant must mark such Exhibit with a prominent stamp, typed legend, or other suitable form of notice on each page or segregable portion of each page stating "Confidential Treatment Requested by [Applicant]." If such marking is impractical under the circumstances, a cover sheet prominently marked "Confidential Treatment Requested by [Applicant]" should be provided for each group of records submitted for which confidential treatment is requested. Each of the records transmitted in this matter shall be individually marked with an identifying number and code so that they are separately identifiable. Applicant must also file a confidentiality request with the Secretary of the Commission in accordance with 17 CFR 145.9.

DESCRIPTION OF EXHIBITS

EXHIBIT A – GENERAL INFORMATION/COMPLIANCE

- Attach as **Exhibit A-1**, a regulatory compliance chart setting forth each Core Principle and providing citations to the Applicant's relevant rules, policies, and procedures that address each Core Principle, and a brief summary of the manner in which Applicant will comply with each Core Principle.

- Attach as **Exhibit A-2**, a current copy of Applicant's rulebook. The rulebook must consist of all the rules necessary to carry out Applicant's role as a derivatives clearing organization. Applicant must certify that its rules constitute a binding agreement between Applicant and its clearing members and, in addition to the separate clearing member agreements, establish rights and obligations between Applicant and its clearing members.

- Attach as **Exhibit A-3**, a narrative summary of Applicant's proposed clearing activities including (i) the anticipated start date of clearing products (or, if Applicant is already clearing products, the anticipated start date of activities for which Applicant is seeking an amendment to its registration) and (ii) a description of the scope of Applicant's proposed clearing activities (e.g., clearing for a designated contract market; clearing for a swap execution facility; clearing bilaterally executed products).

- Attach as **Exhibit A-4**, a detailed business plan setting forth, at a minimum, the nature of and rationale for Applicant's activities as a derivatives clearing organization, the context in which it is beginning or expanding its activities, and the nature, terms, and conditions of the products it will clear.

- Attach as **Exhibit A-5**, a list of the names of any person (i) who owns 5% or more of Applicant's stock or other ownership or equity interests; or (ii) who, either directly or indirectly, through agreement or otherwise, may control or direct the management or policies of Applicant. Provide as part of **Exhibit A-5** the full name and address of each such person, indicate the person's ownership percentage, and attach a copy of the agreement or, if there is no agreement, an explanation of the basis upon which such person exercises or may exercise such control or direction.

- Attach as **Exhibit A-6**, a list of Applicant's current officers, directors, governors, general partners, LLC managers, and members of all standing committees (including any committee referenced in Section (a)(2) of **Exhibit P** herein), as applicable, or persons performing functions similar to any of the foregoing, indicating for each:

a. Name and Title (with respect to a director, such title must include participation on any committee of Applicant);

b. Phone number (both work and mobile) and e-mail contact information;

c. Dates of commencement and, if appropriate, termination of present term of office or position;

d. Length of time each such person has held the same office or position;

e. Brief description of the business experience of each person over the last ten years;

f. Any other current business affiliations in the financial services industry;

g. If such person is not an employee of Applicant, list any compensation paid to the person as a result of his or her position at Applicant. For a director, describe any performance-based compensation;

h. A certification for each such person that the individual would not be disqualified under Section 8a(2) of the Act or §1.63; and

i. With respect to a director, whether such director is a public director or a clearing member customer, and the basis for such a determination as to the director's status.

If another entity will operate or control the day-to-day business operations of the Applicant, attach for such entity all of the items indicated in **Exhibit A-6**.

- Attach as **Exhibit A-7**, a diagram of the entire corporate organizational structure of Applicant including the legal name of all entities within the organizational structure and the applicable percentage ownership among affiliated entities. Additionally, provide (i) a list of all jurisdictions in which Applicant or its affiliated entities are doing business; (ii) the registration status of Applicant and its affiliated entities, including pending applications or exemption requests and whether any applications or exemptions have been denied (e.g., country, regulator, registration category, date of registration or request for exemption, date of denial, if applicable); and (ii) the address for legal service of process for Applicant (which cannot be a post office box) for each applicable jurisdiction.

- Attach as **Exhibit A-8**, a copy of the constituent documents, articles of incorporation or association with all amendments thereto, partnership or limited liability agreements, and existing bylaws, operating agreement, and rules or instruments corresponding thereto, of Applicant. Provide a certificate of good standing or its equivalent for Applicant for each jurisdiction in which Applicant is doing business, including any foreign jurisdiction, dated within one month of the date of the Form DCO.

- Attach as **Exhibit A-9**, a brief description of any material pending legal proceeding(s) or governmental investigation(s) to which Applicant or any of its affiliates is a party or is subject, or to which any of its or their property is at issue. Include the name of the court or agency where the proceeding(s) is pending, the date(s) instituted, the principal parties involved, a description of the factual allegations in the complaint(s), the laws that were allegedly violated, and the relief sought. Include similar information as to any such proceeding(s) or any investigation known to be contemplated by any governmental agency.

- If Applicant intends to use the services of an outside service provider (including services of its clearing members or market participants), to enable Applicant to comply with any of the Core Principles, Applicant must submit as **Exhibit A-10** all agreements entered into or to be entered into between Applicant and the outside service provider, and identify (1) the services that will be provided; (2) the staff who will provide the services; and (3) the Core Principles addressed by such arrangement. If a submitted agreement is not final and executed, the Applicant must submit evidence that constitutes reasonable assurance that such services will be provided as soon as operations require.

- Attach as Exhibit **A-11**, documentation that demonstrates compliance with the Chief Compliance Officer ("CCO") requirements set forth in § 39.10(c), including but not limited to:

a. Evidence of the designation of an individual to serve as Applicant's CCO with full responsibility and authority to develop and enforce appropriate compliance policies and procedures;

b. A description of the background and skills of the person designated as the CCO and a certification that the individual would not be disqualified under Section 8a(2) or 8a(3) of the Act or §1.63;

c. Identification of to whom the CCO reports (i.e., the senior officer or the Board of Directors);

d. Any plan of communication or regular or special meetings between the CCO and the Board of Directors or senior officer as appropriate;

e. A job description setting forth the CCO's duties;

f. Procedures for the remediation of noncompliance issues; and

g. A copy of Applicant's written compliance policies and procedures (including a code of ethics and conflict of interest policy).

EXHIBIT B — FINANCIAL RESOURCES

- Attach as **Exhibit B**, documents that demonstrate compliance with the financial resources requirements set forth in § 39.11, including but not limited to:

a. General – Provide as **Exhibit B-1**:

(1) The most recent set of audited financial statements of Applicant or of its parent company, including the balance sheet, income statement, statement of cash flows, notes to the financial statements, and accountant's opinion;

(2) If the audited financial statements are not dated within 1 month of the date of filing of the Form DCO, Applicant must provide a set of unaudited financial statements current within 1 month of the date of filing of the Form DCO;

(3) If Applicant does not have audited financial statements, Applicant must provide a balance sheet as of a date within 1 month of the date of filing of the Form DCO and an income statement and statement of cash flows reflecting the period since Applicant's formation and a date that is within 1 month of the date of filing of the Form DCO. These statements must be accompanied by an independent certified public accountant's review report.; and

(4) Evidence of ability to satisfy the requirements of **Exhibits B-2** and **B-3** below which may include (i) pro forma financial statements setting forth all projections and assumptions used therein, and (ii) a narrative description of how Applicant will fund its financial resources obligations on the first day of its operation as a derivatives clearing organization.

b. Default Resources – Provide as **Exhibit B-2**:

(1) A calculation of the financial resources needed to enable Applicant to meet its requirements under § 39.11(a)(1). Applicant must provide hypothetical default scenarios designed to reflect a variety of market conditions, and the assumptions and variables underlying the scenarios must be explained. All results of the analysis must be included. This calculation requires a start-up enterprise to estimate its largest anticipated financial exposure. A start-up must be able to explain the basis for its estimate;

(2) Evidence of unencumbered assets sufficient to satisfy § 39.11(a)(1). This may be demonstrated by a copy of a bank balance statement(s) in the name of Applicant. If relying on § 39.11(b)(1)(vi), such other resources must be thoroughly explained. If relying on § 39.11(b)(1)(ii) and/or (vi), Applicant cannot also count these assets when demonstrating its compliance with its operating resources requirement under § 39.11(a)(2) and Applicant must detail the amounts or percentages of such assets that apply to each financial resource requirement;

(3) A demonstration that Applicant can perform the monthly calculations required by § 39.11(c)(1);

(4) A demonstration that Applicant's financial resources are sufficiently liquid as required by § 39.11(e)(1);

(5) A demonstration of how Applicant will be able to maintain, at all times, the level of resources required by § 39.11(a)(1); and

(6) A demonstration of how default resources financial information will be updated and reported to clearing members and the public under § 39.21, and to the Commission as required by § 39.11(f)(1) and § 39.19.

c. Operating Resources – Provide as **Exhibit B-3**:

(1) A calculation of the financial resources needed to enable Applicant to meet its requirements under § 39.11(a)(2);

(2) Evidence of assets sufficient to satisfy the amount required under § 39.11(a)(2). This may be demonstrated by a copy of a bank balance statement(s) in the name of Applicant. If relying on § 39.11(b)(2)(ii), such other resources must be thoroughly explained. If relying on § 39.11(b)(2)(i) or (ii), Applicant cannot also count these assets when demonstrating its compliance with meeting its default resources requirement under § 39.11(a)(1) and Applicant must detail the amounts or percentages of such assets that apply to each financial resource requirement;

(3) A narrative statement demonstrating the adequacy of Applicant's physical infrastructure to carry out business operations, which includes a principal executive office (separate from any personal dwelling) with a U.S. street address (not merely a post office box number). For its principal executive office and other facilities Applicant

plans to occupy in carrying out its DCO functions, a description of the space (e.g., location and square footage), use of the space (e.g., executive office, data center), and the basis for Applicant's right to occupy the space (e.g., lease, agreement with parent company to share leased space);

(4) A narrative statement demonstrating the adequacy of the technological systems necessary to carry out Applicant's business operations, including a description of Applicant's information technology and telecommunications systems and a timetable for full operability;

(5) A calculation pursuant to § 39.11(c)(2), including the total projected operating costs for Applicant's first year of operation, calculated on a monthly basis with an explanation of the basis for calculating each cost and a discussion of the type, nature, and number of the various costs included;

(6) A demonstration that Applicant's financial resources are sufficiently liquid and unencumbered, as required by § 39.11(e)(2);

(7) A demonstration of how Applicant will maintain, at all times, the level of resources required by § 39.11(a)(2) with an explanation of asset valuation methodology and calculation of projected revenue, if applicable; and

(8) A demonstration of how operating resources financial information will be updated and reported to clearing members and the public under § 39.21, and to the Commission as required by § 39.11(f)(1) and § 39.19.

d. Human Resources – Provide as **Exhibit B-4**:

(1) An organizational chart showing Applicant's current and planned staff by position and title, including key personnel (as such term is defined in § 39.2) and, if applicable, managerial staff reporting to key personnel.

(2) A discussion and description of the staffing requirements needed to fulfill all operations and associated functions, tasks, services, and areas of supervision necessary to operate Applicant on a day-to-day basis; and

(3) The names and qualifications of individuals who are key personnel or other managerial staff who will carry out the operations and associated functions, tasks, services, and supervision needed to run the Applicant on day-to-day basis. In particular, Applicant must identify such individuals who are responsible for risk management, treasury, clearing operations and compliance (and specify whether each such person is an employee or consultant/agent).

EXHIBIT C —PARTICIPANT AND PRODUCT ELIGIBILITY

- Attach as **Exhibit C**, documents that demonstrate compliance with the participant and product eligibility requirements set forth in § 39.12 of the Commission's regulations, including but not limited to:

a. Participant Eligibility – Provide as **Exhibit C-1**, an explanation of the requirements for becoming a clearing member and how those requirements satisfy § 39.12 and, where applicable, support Applicant's compliance with other Core Principles. Applicant must address how its participant eligibility requirements comply with the core principles and regulations thereunder for financial resources, risk management and operational capacity. The explanation also must include:

(1) A final version of the membership agreement between Applicant and its clearing members that sets forth the full scope of respective rights and obligations;

(2) A discussion of how Applicant will monitor for and enforce compliance with its eligibility criteria, especially minimum financial requirements;

(3) An explanation of how the eligibility criteria are objective and allow for fair and open access to Applicant. Applicant must include an explanation of the differences between various classes of membership or participation that might be based on different levels of capital and/or creditworthiness. Applicant must also include information about whether any differences exist in how Applicant will monitor and enforce the obligations of its various clearing members including any differences in access, privilege, margin levels, position limits, or other controls;

(4) If Applicant allows intermediation, Applicant must describe the requirements applicable to those who may act as intermediaries on behalf of customers or other market participants;

(5) A description of the program for monitoring the financial status of the clearing members on an ongoing basis;

(6) The procedures that Applicant will follow in the event of the bankruptcy or insolvency of a clearing member, which did not result in a default to Applicant;

(7) A description of whether and how Applicant would adjust clearing member participation under continuing eligibility criteria based on the financial, risk, or operational status of a clearing member;

(8) A discussion of whether Applicant's clearing members will be required to be registered with the Commission; and

(9) A list of current or prospective clearing members. If a current or prospective clearing member is a Commission registrant, Applicant must identify the member's designated self-regulatory organization.

b. Product Eligibility – Provide as **Exhibit C-2**, an explanation of the criteria for instruments acceptable for clearing including:

(1) The regulatory status of each market on which a contract to be cleared by Applicant is traded (e.g., DCM, SEF, not a registered market), and whether the market for which Applicant clears intends to join the Joint Audit Committee. For bilaterally executed agreements, contracts, or transactions not traded on a registered market, Applicant must describe the nature of the related market and its interest in having the particular bilaterally executed agreement, contract, or transaction cleared;

(2) The criteria, and the factors considered in establishing the criteria, for determining the types of products that will be cleared;

(3) An explanation of how the criteria for deciding what products to clear take into account the different risks inherent in clearing different agreements, contracts, or transactions and how those criteria affect maintenance of assets to support the guarantee function in varying risk environments;

(4) A precise list of all the agreements, contracts, or transactions to be covered by Applicant's registration order, including the terms and conditions of all agreements, contracts, or transactions;

(5) A forecast of expected volume and open interest at the outset of clearing operations, after six months, and after one year of operation; and

(6) The mechanics of clearing the contract, such as reliance on exchange for physical, exchange for swap, or other substitution activity; whether the contracts are matched prior to submission for clearing or after submission; and other aspects of clearing mechanics that are relevant to understanding the products that would be eligible for clearing.

EXHIBIT D —RISK MANAGEMENT

- Attach as **Exhibit D**, documents that demonstrate compliance with the risk management requirements set forth in § 39.13 of the Commission's regulations, including but not limited to:

a. Risk Management Framework - Provide as **Exhibit D-1**, a copy of Applicant's written policies, procedures, and controls, as approved by Applicant's Board of Directors, that establish Applicant's risk management framework as required by § 39.13(b). Applicant must also provide a description of the composition and responsibilities of Applicant's Risk Management Committee.

b. Measuring Risk - Provide as **Exhibit D-2**, a narrative explanation of how Applicant has projected and will continue to measure its counterparty risk exposure, including:

(1) A description of the risk-based margin calculation methodology;

(2) The assumptions upon which the methodology was designed, including the risk analysis tools and procedures employed in the design process;

(3) An explanation as to whether other margining methodologies were considered and, if so, why they were not chosen;

(4) A demonstration of the margin methodology as applied to real or hypothetical clearing scenarios;

(5) A description of the data sources for inputs used in the methodology, e.g. historical price data reflecting market volatility over various periods of time;

(6) A description of the sources of price data for the measurement of current exposures and the valuation models for addressing circumstances where pricing data is not readily available or reliable;

(7) The frequency and circumstances under which the margin methodology will be reviewed and the criteria for deciding how often to review and whether to modify a margin methodology;

(8) An independent validation of Applicant's systems for generating initial margin requirements, including its theoretical models;

(9) The frequency of measuring counterparty risk exposures (mark to market), whether counterparty risk exposures are routinely measured on an intraday basis, whether Applicant has the operational capacity to measure counterparty risk exposures on an intraday basis, and the circumstances under which Applicant would conduct a non-routine intraday measurement of counterparty risk exposures;

(10) Preliminary forecasts regarding future counterparty risk exposure and assumptions upon which such forecasts of exposure are based;

(11) A description of any systems or software that Applicant will require clearing members to use in order to margin their positions in their internal bookkeeping systems, and whether and under what terms and conditions Applicant will provide such systems or software to clearing members; and

(12) A description of the extent to which counterparty risk can be offset through the clearing process (i.e., the limitations, if any, on Applicant's duty to fulfill its obligations as the buyer to every seller and the seller to every buyer).

c. Limiting Risk - Provide as **Exhibit D-3**, a narrative discussion addressing the specifics of Applicant's clearing activities, including:

(1) How Applicant will collect financial information about its clearing members and other traders or market participants, monitor price movements, and mark to market, on a daily basis, the products and/or portfolios it clears;

(2) How Applicant will monitor accounts carried by clearing members, the accumulation of positions by clearing members and other market participants, and compliance with position limits; and how it will use large trader information;

(3) How Applicant will determine variation margin levels and outstanding initial margin due;

(4) How Applicant will identify unusually large pays on a proactive basis before they occur;

(5) Whether and how Applicant will compare price moves and position information to historical patterns and to the financial information collected from its clearing members; how it will identify unusually large pays on a daily basis;

(6) How Applicant will use various risk tools and procedures such as: (i) value-at-risk calculations; (ii) stress testing; (iii) back testing; and/or (iv) other risk management tools and procedures;

(7) How Applicant will communicate with clearing members, settlement banks, other derivatives clearing organizations, designated contract markets, swap execution facilities, major swap participants, swap data repositories, and other entities in emergency situations or circumstance that might require immediate action by the Applicant;

(8) How Applicant will monitor risk outside business hours;

(9) How Applicant will review its clearing members' risk management practices;

(10) Whether Applicant will impose credit limits and/or employ other risk filters (such as automatic system denial of entry of trades under certain conditions);

(11) Plans for handling "extreme market volatility" and how Applicant defines that term;

(12) An explanation of how Applicant will be able to offset positions in order to manage risk including: (i) ensuring both Applicant and clearing members have the operational capacity to do so; and (ii) liquidity of the relevant market, especially with regard to bilaterally executed products;

(13) Plans for managing accounts that are "too big" to liquidate and for conducting "what if" analyses on these accounts;

(14) If options are involved, how Applicant will manage the different and more complex risk presented by these products;

(15) If Applicant intends to clear swaps, whether and how often Applicant will offer multilateral portfolio compression exercises for its clearing members; and

(16) If Applicant intends to clear credit default swaps, how Applicant will manage the unique risks associated with clearing these products, such as jump-to-default risk.

d. Existence of collateral (funds and assets) to apply to losses resulting from realized risk – Provide as **Exhibit D-4**:

(1) An explanation of the factors, process, and methodology used for calculating and setting required collateral levels, the required inputs, the appropriateness of those inputs, and an illustrative example;

(2) An analysis supporting the sufficiency of Applicant's collateral levels for capturing all or most price moves that may take place in one settlement cycle;

(3) A description of how Applicant will value open positions and collateral assets;

(4) A description and explanation of the forms of assets allowed as collateral, why they are acceptable, and whether there are any haircuts or concentration limits on certain kinds of assets, including how often any such haircuts and concentration limits are reviewed;

(5) An explanation of how and when Applicant will collect collateral, whether and under what circumstances it will collect collateral on an intraday basis, and what will happen if collateral is not received in a timely manner. Include a proposed collateral collection schedule based on changes in market positions and collateral values; and

(6) If options are involved, a full explanation of how it will manage the associated risk through the use of collateral including, if applicable, a discussion of its option pricing model, how it establishes its implied volatility scan range, and other matters related to the complex matter of managing the risk associated with the clearing of option contracts.

EXHIBIT E — SETTLEMENT PROCEDURES

- Attach as **Exhibit E**, documents that demonstrate compliance with the settlement procedures requirements set forth in § 39.14 of the Commission's regulations, including but not limited to:

a. Settlement – Provide as **Exhibit E-1**, a full description of the daily process of settling financial obligations on all open positions being cleared. This must include:

(1) Procedures for completing settlements on a timely basis during normal market conditions (and no less frequently than once each business day);

(2) Procedures for completing settlements on a timely basis in varying market circumstances including in the event of a default by the clearing member creating the largest financial exposure for Applicant in extreme but plausible market conditions;

(3) A description of how contracts will be marked to market on at least a daily basis;

(4) Identification of the settlement banks used by Applicant (including identification of the lead settlement bank, if applicable) and a copy of Applicant's settlement bank agreement(s). Such settlement bank agreements must (i) outline daily cash settlement procedures, (ii) state clearly when settlement fund transfers will occur, (iii) provide procedures for settlements on bank holidays when the markets are open, and (iv) ensure that settlements are final when effected;

(5) Identification of settlement banks that Applicant will allow its clearing members to use for margin calls and variation settlements;

(6) A description of the criteria and review process used by Applicant when selecting settlement banks; procedures for monitoring the continued appropriateness of all settlement banks including a description of how Applicant monitors its concentration risk or exposure to each settlement bank;

(7) The specific means by which settlement instructions are communicated from Applicant to the settlement bank(s);

(8) A timetable showing the flow of funds associated with the settlement of products for a 24-hour period or such other settlement timeframe specified by a particular product; this may be presented in the form of a chart, as in the following example:

FORM DCO - SAMPLE SETTLEMENT CYCLE CHART **[Specify U.S. Dollar or other currency as applicable]**	
TRADE DATE = T [INSERT TIME ZONE] [INSERT EXACT TIMES BELOW]	**EXAMPLE OF SETTLEMENT ACTIVITY FOR WHICH TIMES SHOULD BE PROVIDED**
T: _____ pm	Last market closes (end of regular trading hours).
T: Approx. ____ pm	DCO/DCM/SEF establishes daily settlement price for each product based on information generated by its [INSERT NAME OF APPLICABLE CLEARING SYSTEM].
T: By _____ pm	Clearing members' position information for intraday settlement is obtained from DCO's clearing system.
T+1: Approx. ____ am	DCO provides daily initial margin (IM) and settlement variation/option premium (SVOP) amounts to clearing members and banks.
T+1: By ____ am	Banks commit to pay daily IM and SVOP amounts.
T+1: Approx. ____ am	Banks pay daily IM and SVOP amounts from clearing members to DCO.
T+1: Approx. __ am	Banks pay daily IM and SVOP amounts from DCO to clearing members.
T: Approx. ____ pm	DCO/DCM/SEF determines prices for intraday settlement.
T: Approx. ____ pm	Clearing members' position information for intraday settlement is obtained from DCO's clearing system.
T: By approx. ____ pm	DCO provides intraday IM and SVOP amounts to banks and clearing members.
T: By ____ pm	Banks commit to pay intraday IM and SVOP amounts.
T: Approx. ____ pm	Banks pay intraday IM and SVOP amounts from clearing members to DCO.
T: Approx. ____ pm	Banks pay intraday IM and SVOP amounts from DCO to clearing members.

(9) A description of what happens in the event that there are insufficient funds in a clearing member's settlement account;

(10) An explanation of how and when Applicant will collect variation margin, whether and under what circumstances it will collect variation margin on an intraday basis, what will happen if variation margin is not received in a timely manner, and a proposed variation margin collection schedule based on changes in market prices;

(11) All the information above, to the extent relevant, for any products cleared that may be denominated in a foreign currency; and

(12) With respect to physical settlements, identify Applicant's rules that clearly state each obligation of Applicant with respect to physical deliveries, and explain how Applicant intends to identify and manage risks arising from physical settlement.

b. Recordkeeping – Provide as **Exhibit E-2**, a full description of the following:

(1) The nature and quality of the information collected concerning the flow of funds involved in clearing and settlement; and

(2) How such information will be recorded, maintained, and accessed.

c. Interfaces with other clearing organizations – Provide as **Exhibit E-3**, a description of Applicant's relationships with other derivatives clearing organizations, clearing agencies, financial market utilities or foreign entities that perform similar functions including how compliance with the terms and conditions of agreements or arrangements with such other entities will be satisfied, e.g., any netting or offset arrangements, cross-margining, portfolio margining, linkage, common banking, common clearing programs or limited guaranty agreements or arrangements.

EXHIBIT F — TREATMENT OF FUNDS

- Attach as **Exhibit F**, documents that demonstrate compliance with the treatment of funds requirements set forth in § 39.15 of the Commission's regulations, including but not limited to:

a. Safe custody – Provide as **Exhibit F-1**, documents that demonstrate:

(1) How Applicant will ensure the safekeeping of funds and collateral in depositories and how Applicant will minimize the risk of loss or of delay in accessing such funds and collateral;

(2) The depositories that will hold the funds and collateral and any written agreements between or among such depositories, Applicant or its clearing members regarding the legal status of the funds and collateral and the specific conditions or prerequisites for movement of the funds and collateral; and

(3) How Applicant will limit the concentration of risk in depositories where funds and collateral are deposited.

b. Segregation of customer and proprietary funds – Provide as **Exhibit F-2**, documents that demonstrate:

(1) The appropriate segregation of customer funds and associated acknowledgement documentation; and

(2) Requirements or restrictions regarding commingling customer funds with proprietary funds, obligating customer funds for any purpose other than to purchase, clear, and settle the products Applicant is clearing, procedures regarding customer funds which are subject to cross-margin or similar agreements, and any other aspects of customer fund segregation.

c. Investment standards – Provide as **Exhibit F-3**, documents that demonstrate:

(1) How customer funds would be invested in instruments with minimal credit, market, and liquidity risks, and in compliance with the requirements of § 1.25; and

(2) How Applicant will obtain and keep associated records and data regarding the details of such investments.

EXHIBIT G — DEFAULT RULES AND PROCEDURES

- Attach as **Exhibit G**, documents that demonstrate compliance with the default rules and procedures requirements set forth in § 39.16 of the Commission's regulations, including but not limited to:

a. Default Management Plan – Applicant must provide a copy of its written default management plan which must contain all of the information required by § 39.16(b), along with Applicant's most recently documented results of a test of its default management plan.

b. Definition of default – Applicant must describe or otherwise document:

(1) The events (activities, lapses, or situations) that will constitute a clearing member default;

(2) What action Applicant can take upon a default and how Applicant will otherwise enforce the rules applicable in the event of default, including the steps and the sequence of the steps that will be followed. Identify whether a Default Management Committee exists and, if so, its role in the default process; and

(3) An example of a hypothetical default scenario and the results of the default management process used in the scenario.

c. Remedial action – Applicant must describe or otherwise document:

(1) The authority and methods by which Applicant may take appropriate action in the event of the default of a clearing member which may include, among other things, liquidating positions, hedging, auctioning, allocating (including any obligations of clearing members to participate in auctions or to accept allocations), and transferring of customer accounts to another clearing member (including an explanation of the movement of positions and collateral on deposit); and

(2) Actions taken by a clearing member or other events that would put a clearing member on Applicant's "watch list" or similar device.

d. Process to address shortfalls – Applicant must describe or otherwise document:

(1) Procedures for the prompt application of Applicant and/or clearing member financial resources to address monetary shortfalls resulting from a default;

(2) How Applicant will make publicly available its default rules including a description of the priority of application of financial resources in the event of default (i.e., the "waterfall"); and

(3) How Applicant will take timely action to contain losses and liquidity pressures and to continue to meet each obligation of Applicant.

e. Use of cross-margin programs – Describe or otherwise document, as applicable, how cross-margining programs will provide for fair and efficient means of covering losses in the event of a default of any clearing member participating in the program.

f. Customer priority rule – Describe or otherwise document rules and procedures regarding priority of customer accounts over proprietary accounts of defaulting clearing members and, where applicable, specifically in the context of specialized margin reduction programs such as cross-margining or common banking arrangements with other derivatives clearing organizations, clearing agencies, financial market utilities or foreign entities that perform similar functions.

EXHIBIT H — RULE ENFORCEMENT

- Attach as **Exhibit H**, documents that demonstrate compliance with the rule enforcement requirements set forth in § 39.17 of the Commission's regulations, including but not limited to:

a. Surveillance – Describe or otherwise document arrangements and resources for the effective monitoring and enforcement of compliance with Applicant's rules and the resolution of disputes.

b. Enforcement – Applicant must describe or otherwise document:

(1) Arrangements and resources for the effective enforcement of rules and authority and ability to discipline and limit or suspend a member's activities pursuant to clear and fair standards;

(2) Arrangements for enforcing compliance with its rules and addressing instances of non-compliance, including: disciplinary tools such as limiting, suspending, or terminating a clearing member's access or member privileges;

(3) How Applicant will address situations related to, but which may not constitute an event of default, such as a clearing member's failure to comply with certain rules or to maintain eligibility standards, or actions taken by other regulatory bodies;

(4) The standards and any procedural protections Applicant will follow in imposing any such enforcement measure; and

(5) Processes for reporting to the Commission Applicant's rule enforcement activities and possible sanctions that could be imposed against clearing members.

c. Dispute resolution – Describe or otherwise document arrangements and resources for resolution of disputes between customers and clearing members, and between clearing members.

EXHIBIT I — SYSTEM SAFEGUARDS

- Attach as **Exhibit I**, documents that demonstrate compliance with the system safeguards requirements set forth in § 39.18 of the Commission's regulations, including but not limited to:

a. A description of Applicant's program of risk analysis and oversight with respect to its operations and automated systems. This program must be designed to ensure daily processing, clearing, and settlement of transactions and address each of the following categories of risk:

(1) Information security;

(2) Business continuity-disaster recovery planning and resources;

(3) Capacity and performance planning;

(4) Systems operations;

(5) Systems development and quality assurance; and

(6) Physical security and environmental controls.

b. An explanation of how Applicant will establish and maintain resources that allow for the fulfillment of its program of risk analysis and oversight with respect to its operations and automated systems, and a description of such resources, including:

(1) A description of how Applicant will periodically verify that its resources are adequate to ensure daily processing, clearing, and settlement;

(2) A demonstration that Applicant's automated systems are reliable, secure, and have (and will continue to have) adequate scalable capacity;

(3) A description of the physical, technological and personnel resources and procedures used by Applicant as part of its business continuity and disaster recovery plan, and support for the conclusion that these resources are sufficient to enable the Applicant to resume daily processing, clearing and settlement no later than the next business day following a disruption; and

(4) A statement identifying which such resources are Applicant's own resources and which are provided by a service provider (outsourced). For resources that are outsourced, provide (i) all contracts governing the outsourcing arrangements, including all schedules and other supplemental materials, and (ii) a demonstration that Applicant employs personnel with the expertise necessary to enable them to supervise the service provider's delivery of the services.

c. An explanation of how Applicant will ensure the proper functioning of its systems, including its program for the periodic objective testing and review of its systems and back-up facilities (including all of its own and outsourced resources), and verification that all such resources will work effectively together;

d. Identification of the persons conducting the testing, including information as to their qualifications and independence;

e. A description of Applicant's emergency procedures, including a copy of its written plan for business continuity and disaster recovery and a description of how Applicant will coordinate its business continuity and disaster recovery plan (including testing) with those of its clearing members and providers of essential services such as telecommunications, power and water; and

f. A description of how Applicant will report exceptional events and planned changes to the Commission as required by §§ 39.18(g) and 39.18(h).

EXHIBIT J — REPORTING

- Attach as **Exhibit J**, documents that demonstrate compliance with the reporting requirements set forth in § 39.19 of the Commission's regulations including but not limited to:

a. How Applicant will make available to Commission staff all the information Commission staff need in order to carry out effective oversight. This must include a discussion of what will be made available on a routine basis, how often it will be made available, and the method of its transmission. The same items must be addressed for information it will make available on a non-routine basis and what events would precipitate the generation of such data or information. Applicant must also address the manner in which any information will be made available to clearing members, customers, market participants and/or the general public. If not part of an initial application, Applicant must provide a representation that it will provide the following when initially generated or when content changes occur:

(1) A list of current members/market participants;

(2) A list of all products currently eligible for clearing;

(3) The initial margin collection schedule;

(4) Information on any disciplinary actions (such as suspensions, etc.);

(5) Information concerning any physical or other emergencies;

(6) All information concerning any default by a member and the impact of the default on Applicant's financial resources;

(7) A copy of any examination/evaluation/compliance report of any regulatory body other than the Commission that oversees Applicant;

(8) A copy of any internal examination/evaluation/compliance reports such as, but not limited to, those related to stress testing and systems testing;

(9) Key personnel that have particular knowledge of the market(s) for which Applicant clears and any changes in those personnel, especially those to be contacted in case of market volatility or to respond to inquiries and emergencies;

(10) Copies of audited financial statements of Applicant; and

(11) Information regarding counterparties and their positions, stress test results, internal governance, legal proceedings, and other clearing activities.

b. Forms or templates to be used to satisfy the daily, quarterly, annual, and event-specific reporting requirements specified in § 39.19(c) of the Commission's regulations.

EXHIBIT K — RECORDKEEPING

- Attach as **Exhibit K**, documents that demonstrate compliance with the recordkeeping requirements set forth in § 39.20 of the Commission's regulations including but not limited to:

a. Applicant's recordkeeping and record retention policies and procedures;

b. The different activities related to the entity as a derivatives clearing organization for which it must maintain records;

c. The manner in which records relating to swaps and swap data are gathered and maintained; and

d. How Applicant will satisfy the performance standards of § 1.31 as applicable to derivatives clearing organizations, including:

(1) What "full" or "complete" will encompass with respect to each type of book or record that will be maintained;

(2) The form and manner in which books or records will be compiled and maintained with respect to each type of activity for which such books or records will be kept;

(3) Confirmation that books and records will be open to inspection by any representative of the Commission or of the U.S. Department of Justice;

(4) How long books and records will be readily available and how they will be made readily available during the first two years; and

(5) How long books and records will be maintained (and confirmation that, in any event, they will be maintained as required in § 1.31).

EXHIBIT L — PUBLIC INFORMATION

- Attach as **Exhibit L**, documents that demonstrate compliance with the public information requirements set forth in § 39.21 of the Commission's regulations including but not limited to:

a. Applicant's procedures for making its rulebook, a list of all current clearing members, and the information listed in § 39.21(c) readily available to the general public, in a timely manner, by posting such information on Applicant's website in accordance with § 39.21(d);

b. Any other information routinely made available to the public by Applicant;

c. How Applicant will make information available to clearing members and market participants in order to allow such persons to become familiar with Applicant's procedures before participating in clearing operations; and

d. How clearing members will be informed of their specific rights and obligations preceding a default and upon a default, and of the specific rights, options and obligations of Applicant preceding and upon a clearing member's default.

EXHIBIT M — INFORMATION SHARING

- Attach as **Exhibit M**, documents that demonstrate compliance with the information sharing requirements set forth in § 39.22 of the Commission's regulations, including but not limited to:

a. The appropriate and applicable information sharing agreements to which Applicant is, or intends to be, a party including any domestic or international information-sharing agreements or arrangements, whether formal or informal, which involve or relate to Applicant's operations, especially as it relates to measuring and addressing counterparty risk;

b. A description of the types of information expected to be shared and how that information will be shared;

c. An explanation as to how information obtained pursuant to any information-sharing agreements or arrangements would be used to further the objectives of Applicant's risk management program and any of its surveillance programs including financial surveillance and continuing eligibility of its clearing members; and

d. An explanation as to how Applicant expects to obtain accurate information pursuant to the information-sharing agreement or arrangement and the mechanisms or procedures which would allow for timely use and application of all information.

EXHIBIT N — ANTITRUST CONSIDERATIONS

- Attach as **Exhibit N**, documents that demonstrate compliance with the antitrust considerations requirements set forth in § 39.23 of the Commission's regulations, including but not limited to policies or procedures to ensure compliance with the antitrust considerations requirements.

EXHIBIT O — GOVERNANCE FITNESS STANDARDS

- Attach as **Exhibit O**, documents that demonstrate compliance with the governance fitness standards requirements set forth in § 39.24 of the Commission's regulations, including but not limited to:

a. The manner in which its governance arrangements permit consideration of the views of Applicant's owners, whether voting or non-voting, and its participants (clearing members and customers) including (i) the general method by which Applicant will learn of the views of Applicant's owners, other than through their exercise of voting power, or the views of participants, other than through representation on the Board of Directors or any committee of Applicant, and (ii) the manner in which Applicant will consider such views;

b. The fitness standards applicable to members of the Board of Directors, members of any disciplinary panels or disciplinary committees, clearing members, any individual or entity with direct access to settlement or clearing activities, and any party affiliated with any of the above individuals or entities, as well as natural persons who, directly or indirectly, own greater than 10 % of any one class of equity interest in Applicant; including a description or other documentation explaining how Applicant will collect and verify information that supports compliance with the fitness standards; and

c. The manner in which Applicant will condition clearing member access and other direct access to its settlement and clearing activities on agreement to be subject to the jurisdiction of Applicant.

EXHIBIT P — CONFLICTS OF INTEREST

- Attach as **Exhibit P**, documents that demonstrate compliance with the conflicts of interest requirements set forth in §§ 39.13(d), 39.25, and 40.9 of the Commission's regulations, including but not limited to:

a. A copy of:

(1) The charter (or mission statement) of Applicant (if not attached as **Exhibit A-8**).

(2) The charter (or mission statement) of Applicant's Board of Directors, each committee with a composition requirement (including any Executive Committee), as well as each other committee that has the authority to amend or constrain actions of Applicant's Board of Directors (if not attached as **Exhibit A-8**).

(3) If another entity "operates" the Applicant, the charter (or mission statement) of such entity's Board of Directors (if not attached as **Exhibit A-8**); and a description of the manner in which the Applicant will ensure that such entity's officers, directors, employees and agents and such entity's books and records shall be subject to the authority of the Commission pursuant to the Act and the Commission's regulations thereunder.

(4) An internal organizational chart showing the lines of responsibility and accountability for each operational unit.

b. Describe or otherwise document:

(1) Applicant's rules and procedures for ensuring compliance with the Commission's regulations with respect to limitations on voting equity ownership and the exercise of voting power by owners of the Applicant (and the parent company of the Applicant, if applicable) including the manner in which Applicant would remediate any breach of such limits;

(2) Applicant's nominations process for the Board of Directors and the process for assigning members of the Board of Directors or other persons to any committee referenced in item a.(2) above;

1. The manner in which the Board of Directors reviews its performance and the performance of its members on an annual basis; and

2. The procedures for removing a member of the Board of Directors, including where the conduct of such member is likely to be prejudicial to the sound and prudent management of Applicant;

(3) The composition of its nominating committee, including the number or percentage of public directors, and the identity of the Chairman of the Committee;

(4) The composition of any Executive Committee, including the number or percentage of public directors;

(5) The composition of the Risk Management Committee, including the number or percentage of public directors, the number or percentage of customer representatives, and the identity of the Chairman of the committee;

1. Whether the Risk Management Committee is an executive committee or an advisory committee; and

2. Whether the Risk Management Committee has delegated certain functions to any risk management subcommittee, including a description or other documentation of the functions so delegated;

(6) The form of report to be used in reporting to the Commission those instances in which the Board of Directors rejects a recommendation or supersedes an action of the Risk Management Committee, or the Risk Management Committee rejects a recommendation or supersedes an action of its subcommittee;

(7) The manner in which Applicant will (i) ensure decisions by the Risk Management Committee (or a subcommittee thereof) will not be restricted or limited by a body other than the Board of Directors (or the Risk Management Committee in the case of decisions by its subcommittee) with respect to decisions regarding clearing member eligibility or applications or product eligibility; (ii) prevent any undue influence on disciplinary panels or committees (including recusals by any member of a disciplinary panel or committee where such member has a financial interest in a matter before the panel); and (iii) provide that decisions by a disciplinary panel or committee may be appealed;

(8) Whether the Board of Directors has delegated the functions of the disciplinary panel to any other committee;

(9) The manner in which Applicant will record and summarize significant decisions, including decisions relating to open access, membership, and the finding of products acceptable or not acceptable for clearing;

(10) The manner in which Applicant will ensure that all information relating to transparency of governance arrangements at the Applicant is current, accurate, clear, and readily accessible to both the Commission and the public;

(11) Any written procedures that Applicant intends to adopt to identify, on an ongoing basis, existing and potential conflicts of interest;

(12) Applicant's process for making fair and non-biased decisions in the event of a conflict of interest; and

(13) Applicant's written policies or procedures on safeguarding non-public information.

EXHIBIT Q — COMPOSITION OF GOVERNING BOARDS

• Attach as **Exhibit Q**, documents that demonstrate compliance with the composition of governing boards requirements set forth in § 39.26, including but not limited to documentation describing the composition of Applicant's Board of Directors, including the number or percentage of public directors and market participants.

EXHIBIT R — LEGAL RISK CONSIDERATIONS

• Attach as **Exhibit R**, documents that demonstrate compliance with the legal risk considerations requirements set forth in § 39.27 of the Commission's regulations, including but not limited to

a. A discussion of how Applicant operates pursuant to a well-founded, transparent, and enforceable legal framework that addresses each aspect of the activities of Applicant. The framework must provide for Applicant to act as a counterparty, including, as applicable:

(1) Novation;

(2) Netting arrangements;

(3) Applicant's interest in collateral (including margin);

(4) The steps that Applicant can take to address a default of a clearing member, including but not limited to, the unimpeded ability to liquidate collateral and close out or transfer positions in a timely manner;

(5) Finality of settlement and funds transfers that are irrevocable and unconditional when effected (when Applicant's accounts are debited and credited); and

(6) Other significant aspects of Applicant's operations, risk management procedures, and related requirements.

b. If Applicant provides, or will provide, clearing services outside the United States, Applicant must (i) provide a memorandum from local counsel analyzing insolvency issues in the foreign jurisdiction where Applicant is based and (ii) describe or otherwise document:

(1) How Applicant has identified and addressed any conflict of law issues;

(2) Which jurisdiction's law is intended to apply to each aspect of Applicant's operations;

(3) The enforceability of Applicant's choice of law in relevant jurisdictions; and

(4) That its rules, procedures, and products are enforceable in all relevant jurisdictions.

BILLING CODE 6351–01–C

PART 140—ORGANIZATION, FUNCTIONS, AND PROCEDURES OF THE COMMISSION

■ 9. The authority citation for part 140 continues to read as follows:

Authority: 7 U.S.C. 2 and 12a.

■ 10. Amend § 140.94 by revising the section heading and paragraph (a)(5), redesignating paragraph (a)(6) as paragraph (a)(7), revise newly redesignated paragraph (a)(7), and add new paragraphs (a)(6) and (a)(8) through (a)(14) to read as follows:

§ 140.94 Delegation of authority to the Director of the Division of Clearing and Risk.

(a) * * *

(5) All functions reserved to the Commission in § 5.14 of this chapter;

(6) All functions reserved to the Commission in §§ 39.3(a)(2) and (a)(3) of this chapter;

(7) All functions reserved to the Commission in §§ 39.5(b)(2), (b)(3)(ix), and (d)(3) of this chapter;

(8) All functions reserved to the Commission in § 39.10(c)(4)(iv) of this chapter;

(9) All functions reserved to the Commission in §§ 39.11(b)(1)(vi), (b)(2)(ii), (c)(1), (c)(2), (f)(1) and (f)(4) of this chapter;

(10) All functions reserved to the Commission in § 39.12(a)(5)(i)(B) of this chapter;

(11) All functions reserved to the Commission in §§ 39.13(g)(8)(ii), (h)(1)(i)(C), (h)(1)(ii), (h)(3)(i), (h)(3)(ii), and (h)(5)(i)(A) of this chapter;

(12) The authority to request additional information in support of a rule submission under § 39.15(b)(2)(iii)(A) of this chapter and in support of a petition pursuant to section 4d of the Act under § 39.15(b)(2)(iii)(B) of this chapter;

(13) All functions reserved to the Commission in §§ 39.19(c)(3)(iv), (c)(5)(i), (c)(5)(ii), and (c)(5)(iii) of this chapter; and

(14) All functions reserved to the Commission in § 39.21(d) of this chapter.

Issued in Washington, DC, on October 18, 2011, by the Commission.

David A. Stawick,

Secretary of the Commission.

Appendices to Derivatives Clearing Organization General Provisions and Core Principles—Commission Voting Summary and Statements of Commissioners

Note: The following appendices will not appear in the Code of Federal Regulations

Appendix 1—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Dunn and Chilton voted in the affirmative; Commissioners Sommers and O'Malia voted in the negative.

Appendix 2—Statement of Chairman Gary Gensler

I support the final rulemaking on core principles for derivatives clearing organizations (DCOs). Centralized clearing has been a feature of the U.S. futures markets since the late-19th century. Clearinghouses have functioned both in clear skies and during stormy times—through the Great Depression, numerous bank failures, two world wars, and the 2008 financial crisis—to lower risk to the economy. Importantly, centralized clearing protects banks and their customers from the risk of either party failing.

When customers don't clear their transactions, they take on their dealer's credit risk. We have seen over many decades, however, that banks do fail. Centralized clearing protects all market participants by requiring daily mark to market valuations and requiring collateral to be posted by both parties so that both the swap dealer and its customers are protected if either fails. It lowers the interconnectedness between financial entities that helped spread risk throughout the economy when banks began to fail in 2008.

Today's rulemaking will establish certain regulatory requirements for DCOs to implement important core principles that were revised by the Dodd-Frank Act. We recognize the need for very robust risk management standards, particularly as more swaps are moved into central clearinghouses. We have incorporated the newest draft Committee on Payment and Settlement Systems (CPSS)-International Organization of Securities Commissions (IOSCO) standards for central counterparties into our final rules.

First, the financial resources and risk management requirements will strengthen financial integrity and enhance legal certainty for clearinghouses. We're adopting a requirement that DCOs collect initial margin on a gross basis for its clearing member's customer accounts For interest rates and financial index swaps, such as credit default swaps, we are maintaining, as proposed, a minimum margin for a five-day liquidation period. This is consistent with current market practice, and many commenters recommended this as a minimum. For the clearing of physical commodity swaps, such as on energy, metals and agricultural products, we are requiring margin that is risk-based but consistent with current market practice—a minimum of one day. Maintaining a minimum five day liquidation period for interest rates and credit default swaps is appropriate not only as it is consistent with current market practice, but also as these markets are the most systemically relevant for the interconnected financial system. History shows that, in 2008, it took five days after the failure of Lehman Brothers for the clearinghouse to transfer Lehman's interest rate swaps positions to other clearing members. These financial resource requirements, and particularly the margin requirements, are critical for safety and soundness as more swaps are moved into central clearing.

Second, the rulemaking implements the Dodd-Frank Act's requirement for open access to DCOs. The participant eligibility requirements promote fair and open access to clearing. Importantly, the rule addresses how a futures commission merchant can become a member of a DCO. The rule promotes more inclusiveness while allowing DCO to scale a member's participation and risk based upon its capital. This improves competition that will benefit end-users of swaps, while protecting DCOs' ability manage risk.

Third, the reporting requirements will ensure that the Commission has the information it needs to monitor DCO compliance with the Commodity Exchange Act and Commission regulations.

Fourth, the rules formalize the DCO application procedures to bring about greater uniformity and transparency in the application process and facilitate greater efficiency and consistency in processing applications.

These reforms will both lower risk in the financial system and strengthen the market by making many of the processes more efficient and consistent.

Appendix 3—Statement of Commissioner Jill Sommers

The final rules adopted by the Commission today for derivatives clearing organizations (DCOs) will implement a key component of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) to facilitate centralized clearing of both exchange-traded and over-the-counter swaps. While I fully support the centralized clearing of swaps, I reluctantly cannot support the final DCO rules.

In my opinion, the rules are needlessly prescriptive, internally inconsistent, and depart from the Commission's time-tested principles-based oversight regime, with little to no explanation of the costs and benefits of doing so, or even a rationale other than an overarching belief that prescriptive rules will increase legal certainty and prevent a race to the bottom by competing clearinghouses. A few examples will illustrate my point.

Rule 39.11(a)(1) requires a DCO to maintain sufficient financial resources to cover a default by its largest clearing member. Rule 39.11(a)(2) requires a DCO to maintain sufficient financial resources to cover its operating costs for a period of at least one year. Rules 39.11(b)(1) and (b)(2) list the types of financial resources deemed sufficiently liquid to meet the requirements of Rules 39.11(a)(1) and (a)(2). The preamble to the rules states that letters of credit are not an acceptable financial resource for purposes of Rules 39.11(a)(1) or (a)(2), but may be allowed on a case-by-case basis. Letters of credit are also banned for purposes of Rule 39.11(e)(1) (cash obligations), and Rule 39.11(e)(3) (guaranty fund obligations), neither of which allow for a case-by-case determination. When it comes to initial margin, letters of credit are allowed for futures and options without qualification, but banned for swaps.

These distinctions, in my opinion, are not legally or factually justifiable. The ability to draw on safe, liquid assets is critical in all of the situations described above. We should treat letters of credit the same way unless there is a compelling reason not to. This is especially true given the fact that banning their use as initial margin for swaps will have the perverse, unintended consequence of disincentivizing voluntary clearing by commercial end-users who support their swaps positions using letters of credit—a result that is directly at odds with the goals of Dodd-Frank.

Another example can be found in Rule 39.13(g)(2)(ii), which establishes a one-day minimum liquidation time for calculating initial margin for futures and options, a one-day minimum liquidation time for swaps on agricultural, metal, and energy commodities, and a five-day minimum liquidation time for all other swaps. In the cost-benefit analysis, the Commission states that ''using only one criterion—i.e., the characteristic of the commodity underlying a swap—to determine liquidation time could result in less-than-optimal margin calculations.'' The Commission goes on to describe the complex nature of calculating appropriate margin levels, which includes the ability to assess quantitative factors such as the risk characteristics of the instrument traded,

its historical price volatility and liquidity in the relevant market, as well as ''expert judgment as to the extent to which such characteristics and data may be an accurate predictor of future market behavior with respect to such instruments, and [the application of] such judgment to the quantitative results.'' We then explain that the Commission is not capable of determining the risk characteristics, price volatility and market liquidity of even a sample of swaps for purposes of determining an appropriate liquidation time for specific swaps.

In the face of our admitted inability to determine appropriate liquidation times for particular swaps, we are picking a one-day time for some, based on the underlying commodity, and a five-day time for all others, even though this ''could result in less-than-optimal margin calculations.'' This defies common sense.

The only reason we give for eliminating the long-standing discretion of the acknowledged experts, i.e., the DCOs, to determine the appropriate liquidation times for the transactions they clear is to prevent a feared race to the bottom by DCOs who will compete to clear swaps in the future. We acknowledge, however, that DCOs have used reasonable and prudent judgment in establishing liquidation times in the past, including DCOs that currently compete in the swaps clearing space. The Commission gives no reason for its belief that there may be a race to the bottom if we do not establish this less than ideal methodology. Nor does the Commission acknowledge the existence of other safeguards in the rules that give us strong tools for policing a potential race to the bottom.

With the passage of Dodd-Frank, Congress gave the Commission broad authority to regulate swap transactions, swap markets and swap market participants. I do not believe, however, that Congress intended for the Commission to strip DCOs of the flexibility to determine the manner in which they comply with core principles, as we have done with these rules. Our registered DCOs have a strong track record of prudent risk management, including during the financial crisis, and there is no reason to believe they will not continue to use their expert judgment in a responsible fashion. Moreover, unnecessary and inflexible rules, such as these, will prevent DCOs from quickly adapting to changing market conditions for no apparent benefit. I therefore dissent.

Appendix 4—Statement of Commissioner Scott O'Malia

Today, the Commission approved a final rulemaking on the operation of derivatives clearing organizations (each, a ''DCO'').[289] Of the Dodd-Frank rulemakings that the Commission has so far undertaken, this rulemaking is among the most important. I have been a strong proponent of clearing. In the aftermath of the Enron crisis, I witnessed first-hand how the creation of ClearPort ameliorated counterparty credit fears in the energy merchant markets and restored liquidity to those markets. I am certain that clearing will similarly benefit the swaps market,[290] particularly by significantly expanding execution on electronic platforms, thereby increasing price transparency and discovery. Moreover, as we have seen in the 2008 financial crisis, clearing has the potential to mitigate systemic risk, by ensuring that swap counterparties—not hardworking American taxpayers—post collateral to support their exposures.

The main goal of this final rulemaking is to ensure that clearing contributes to the integrity of the United States financial system by, among other things, allowing entities other than the largest dealer banks to offer clearing services to commercial and financial end-users. I fully support this goal. However, in an attempt to achieve this goal, this rulemaking abandons the principles-based regulatory regime which permitted DCOs to perform so admirably in the 2008 financial crisis. Instead, the final rulemaking sets forth a series of prescriptive requirements. I disagree with this approach. DCO risk management poses complex and multidimensional challenges. One DCO may have a significantly different risk profile than another. Consequently, each DCO must have sufficient discretion to match requirements to risks. The role of the Commission is to oversee the exercise of such discretion, not to prevent such exercise.[291]

Additionally, I am mindful of the cost of clearing and want to ensure that such cost does not constitute a barrier to entry. Certain provisions in this final rulemaking may impose substantial costs without corresponding benefits. Such provisions may discourage market participants from executing transactions subject to mandatory clearing, even if they need such transactions to prudently hedge risks, or from clearing on a voluntary basis. By creating perverse incentives to keep risk outside of the regulatory framework, and to leave it within our commercial and financial enterprises, the DCO rules undermine a fundamental purpose of the Dodd-Frank Act—namely, the expansion of clearing.

I will elaborate on each concern in turn.

Participant Eligibility: One-Size Does Not Fit All

This final rulemaking prohibits a DCO from requiring more than $50 million in capital from any entity seeking to become a swaps clearing member. This number makes a great headline, mainly because it is so low. It also sends an unequivocal message to DCOs that have clearing members that are primarily dealer banks. However, in adopting and interpreting this requirement, the Commission may unwisely limit the range of legitimate actions that DCOs can take to manage their counterparty risks. By imposing such limitations, the Commission is introducing costs to clearing that it fails to detail and explore.

Let me be plain. I oppose anticompetitive behavior. However, an entity with $50 million in capitalization may not be an appropriate clearing member for every DCO. The $50 million threshold prevents DCOs from engaging in anticompetitive behavior but also prohibits DCOs from taking legitimate, risk-reducing actions. Instead of adopting this prescriptive requirement, the Commission should have provided principles-based guidance to DCOs on the other components of fair and open access, such as the standard for less restrictive participation requirements.[292] By taking a more principles-based approach, the Commission could have been in greater accord with international regulators, one of which explicitly cautioned against the $50 million threshold.[293]

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[289] Derivatives Clearing Organizations (to be codified at 17 CFR pts. 1, 21, 39, and 140), available at: *http://www.cftc.gov/PressRoom/Events/opaevent_cftcdoddfrank101811* (the ''DCO Final Rule'').

[290] *See* Kathryn Chen et al., An Analysis of CDS Transactions: Implications for Public Reporting, Federal Reserve Bank of New York Staff Report no. 517 (September 2011), available at: *http://www.newyorkfed.org/research/staff_reports/sr517.pdf* (stating that ''[c]learing-eligible products within our sample traded on more days and had more intraday transactions than non-clearing eligible products'').

[291] *See* section 3(b) of the Commodity Exchange Act (CEA), 7 U.S.C. 5(b) (stating that ''[i]t is the purpose of this Act to serve the public interests * * * through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission.'').

[292] The DCO Final Rule, *supra* note 289, at 387–388 (to be codified at 17 CFR 39.12(a)(1)).

[293] *See* letter, dated March 21, 2011, from the United Kingdom Financial Services Authority (''FSA''), available at *http://comments.cftc.gov/*

Basis for the $50 Million?

How did the Commission determine that the $50 million threshold is appropriate? It is not really evident from the notice of proposed rulemaking.[294] In the final rulemaking, the Commission states that the $50 million threshold was derived from the fact that most registered futures commission merchants (''FCMs'') that are currently DCO clearing members have at least $50 million in capital.[295]

The final rulemaking, however, does not answer a number of questions that are crucial to determining whether the $50 million threshold is appropriate for all swap transactions. These questions include, without limitation: What types of products do the referenced FCMs currently clear? Are there differences between the capital distributions of FCMs that clear different products? If so, what are such differences?

The answers to these questions are important because FCMs may need different amounts of capital to support their exposures to different products. Assume, for example, that the average capitalization of FCMs clearing agricultural futures is $50 million. Further assume that an FCM has $50 million in capital, and is seeking to become a clearing member. The Commission may reasonably conclude that such FCM would have the resources to clear agricultural futures. It may also reasonably conclude that such FCM would have the resources to clear agricultural swaps that have the same terms and conditions as agricultural futures. The Commission cannot reasonably conclude, however, that such FCM would have the resources to clear credit default swaps.

By not setting forth the answers to questions such as these, the final rulemaking creates the impression that the $50 million threshold is arbitrary, and renders vulnerable its conclusion that the threshold ''captures firms that the Commission believes have the financial, operational, and staffing resources to participate in clearing swaps without posing an unacceptable level of risk to a DCO.'' [296]

Anticompetitive behavior? Or legitimate, risk-reducing action?

The final rulemaking recognizes that DCOs may increase capital requirements for legitimate, risk-reducing reasons. In fact, the final rulemaking requires a DCO to ''set forth capital requirements that * * * appropriately match capital to risk.'' [297] Further, the final rulemaking mandates DCOs to ''require clearing members to have access to sufficient financial resources to meet obligations arising from participation in the [DCO] in extreme but plausible market conditions.'' [298] The final rulemaking states that a DCO ''may permit such financial resources to include, without limitation, a clearing member's capital.'' [299]

The final rulemaking, however, provides little insight on how the Commission intends to differentiate between (i) a required risk-based increase in capital requirements and (ii) an illegitimate attempt to circumvent the $50 million threshold to squash competition. To use an example grounded in reality—ICE Clear Credit recently lowered its minimum capital requirement for clearing members to $100 million. However, it added a requirement that clearing members hold excess net capital equal to 5 percent of their segregated customer funds. Upon learning about the additional requirement, at least two existing FCMs complained that it violates fair and open access.[300] The final rulemaking gives very little guidance on the criteria that the Commission will apply in adjudicating a dispute such as this. The preamble to the final rulemaking simply states: ''A DCO may not * * * [enact] some additional financial requirement that effectively renders the $50 million threshold meaningless for some potential clearing members.'' It further states that such a requirement *would* violate the other components of fair and open access, such as ''§ 39.12(a)(1)(i) (less restrictive alternatives), or § 39.12(a)(1)(iii) (exclusion of certain types of firms).'' [301] This vague statement provides no legal certainty or bright lines for DCOs and potential clearing members to follow.

If I were running a DCO, I would be extremely confused. On the one hand, the final rulemaking requires me to match capital requirements to risk. On the other hand, the preamble suggests that I cannot increase capital requirements (or any other financial requirement), if that would prohibit some entities with $50 million in capitalization from becoming clearing members. How should I resolve this conundrum?

Hidden Costs

If a DCO took a narrow interpretation of the reference to *financial requirements* in the preamble, then it has only one alternative: (i) Admit any entity with $50 million in capital as a clearing member and (ii) impose strict risk limits.[302] How strict could such limits be? To lend some context to this $50 million threshold, a recent report from the staff of the Federal Reserve Bank of New York observed that $50 million tended to be the notional value of one single transaction in a credit default swap index with relatively high liquidity.[303]

Assuming that the Commission does not require the DCO to increase its risk limits,[304] where does this situation leave the DCO? The DCO would need to incur the cost of (i) evaluating applications from all entities with $50 million in capital, (ii) operationally connecting to such entities, and (iii) potentially defending itself against claims from such entities that the risk limits or financial requirements are too stringent. The DCO may pass on such costs to clearing members, which may pass on such costs to commercial and financial end-users. In the meantime, such entities, when admitted, may be unable to clear any significant volume

PublicComments/CommentList.aspx?id=957 (stating that ''whilst capital thresholds or other participation eligibility threshold limitations may be a potential tool to help ensure fair and open access to [central counterparties (''CCPs'')], to impose them on clearing arrangements for products that have complex or unique characteristics could lead to increased risk to the system in the short to medium term.'')

[294] *See* Risk Management Requirements for Derivatives Clearing Organizations, 76 FR 3698, 3791 (Jan. 20, 2011).

[295] *See* the DCO Final Rule, *supra* note 289, at 83 to 84 (further stating that ''of 126 FCMs, 63 currently have capital above $50 million and most FCMs with capital below that amount are not clearing members.'').

[296] *Id.* at 83.

[297] *Id.* at 388 (to be codified at 17 CFR 39.12(a)(2)(ii)) (further stating that ''[c]apital requirements shall be scalable to risks posed by clearing members''.).

[298] *Id.* (to be codified at 17 CFR 39.12(a)(2)(i)).

[299] *Id.* Additionally, the notice of proposed rulemaking states: ''Proposed §§ 39.12(a)(2)(ii) and 39.12(a)(2)(iii), considered together, would require a DCO to admit any person to clearing membership for the purpose of clearing swaps, if the person had $50 million in capital, but would permit a DCO to require each clearing member to hold capital proportional to its risk exposure. Thus, if a clearing member's risk exposure were to increase in a non-linear manner, the DCO could increase the clearing member's corresponding scalable capital requirement in a non-linear manner.'' 76 FR at 3701.

[300] *See* Matthew Leising, ''ICE Clear Credit's Member Rules Too Exclusive, Small Firms Say,'' Bloomberg, Aug. 9, 2011, available at: *http://www.bloomberg.com/news/2011-08-09/ice-clear-credit-s-member-rules-too-exclusive-small-firms-say.html.*

[301] The DCO Final Rule, supra note 289, at 85–86.

[302] The final rulemaking requires DCOs to impose risk limits on clearing members. *See id.* at 399 to 400 (to be codified at 17 CFR 39.13(h)(1)).

[303] *See supra* note.

[304] *See* the DCO Final Rule, supra note 289, at 399 to 400 (to be codified at 17 CFR 39.13(h)(1)(i)(C)) (stating that ''[t]he Commission may review such methods, thresholds, and financial resources and require the application of different methods, thresholds, or financial resources, as appropriate.'').

of transactions, for themselves or for customers, especially in asset classes such as credit default swaps. Under this scenario, rather than leading to fair and open access, the $50 million threshold may actually impede access to clearing by commercial and financial end-users, because the threshold would increase their costs without introducing meaningful competition among FCMs offering clearing services.

If, on the other hand, a DCO took a more aggressive interpretation of the reference to *financial requirements* in the preamble, then it may have other alternatives to mitigate risks that admitting an entity with $50 million in capital may introduce. For example, it may increase margin requirements. It may also increase guaranty fund contributions for all clearing members, in proportion to their clearing activity. In other words, a DCO may increase the overall cost of clearing in order to compensate for the risks of having lesser capitalized new clearing members.

What are the potential effects of such increases? It is difficult to determine from our cost-benefit analysis. The analysis does not identify increases in margin or guaranty fund contributions as potential costs, much less attempt to quantify such costs.[305] However, if the increases in costs are significant, and if such increases apply to a wide range of clearing members (because the DCO fears being accused of unjustified discrimination),[306] then such increases would most definitely influence whether commercial and financial entities voluntarily clear or even enter into hedges in the first place.

Principles-Based Regulation Is a Better Solution

I propose a simple solution that would have addressed the confusion and hidden costs resulting from the $50 million threshold. The Commission should have eliminated the threshold. The threshold adds no value to the other components of fair and open access.[307] Given that the final rulemaking rightfully requires a DCO to properly manage its risks, one or more DCOs would inevitably impose some sort of financial requirement that would prevent entities with $50 million (or more) in capital from directly participating in clearing. At that point, the Commission would not be able to opine on such a requirement without looking to the other components of fair and open access. As a result, it would have served the Commission well to have focused in the first instance on setting forth principles-based guidance on such components.[308] Moreover, principles-based guidance would have brought the Commission into greater accord with certain international regulators,[309] current international standards on CCP regulation,[310] as well as the proposed revisions to such standards.[311]

Costs Without Benefits: Minimum Liquidation Time Requirements

I have consistently highlighted that our rulemakings are interconnected and that the Commission has an obligation to analyze the cost impact across rulemakings. In this instance, I am concerned about the relationship between this final rulemaking and our proposal interpreting core principle 9 for designated contract markets (DCMs), which may be finalized in the future.[312] Although this relationship may result in significant costs for the market, this final rulemaking fails to disclose such costs.

Specifically, this final rulemaking requires a DCO to calculate margin using different minimum liquidation times for different products. A DCO must calculate margin for (i) futures based on a one-day minimum liquidation time, (ii) agricultural, energy, and metals swaps based on a one-day minimum liquidation time, and (iii) all other swaps based on a five-day minimum liquidation time.[313]

No Policy Basis for Minimum Liquidation Times

As a preliminary matter, this final rulemaking creates the impression that these requirements are arbitrary, like the $50 million threshold. Although the final rulemaking characterizes these requirements as ''prudent,'' it sets forth

[305] Interestingly, the preamble notes that at least two commenters agreed that a DCO may legitimately use such increases to moderate the risk of a member with only $50 million in capital. Specifically, the preamble states: ''Newedge commented that the proposed rule should not increase risk to a DCO because a DCO can mitigate risk by, among other things, imposing position limits, stricter margin requirements, or stricter default deposit requirements on lesser capitalized clearing members.'' The preamble also states: ''J.P. Morgan, however, commented that a cap on a member's minimum capital requirement would not impact the systemic stability of a DCO as long as * * * DCOs hold a sufficient amount of margin and funded default guarantee funds.'' *Id.* at 80 to 82. It is therefore unclear why the cost-benefit analysis did not address the potential for such increases.

[306] *See id.* at 387 (to be codified at 17 CFR 39.12(a)(1)(iii)) (stating that ''[a] derivatives clearing organization shall not exclude or limit clearing membership of certain types of market participants unless the derivatives clearing organization can demonstrate that the restriction is necessary to address credit risk or deficiencies in the participants' operational capabilities that would prevent them from fulfilling their obligations as clearing members.'' The regulation contains no further detail regarding what type of demonstration would be sufficient.).

[307] In legal parlance, the $50 million threshold is neither necessary nor sufficient to determining whether a DCO has violated fair and open access. The threshold is not necessary because a DCO can set an even lower minimum capital requirement and still violate fair and open access if another requirement ''excludes or limits clearing membership of certain types of market participants.'' *Id.* (to be codified at 17 CFR 39.12(a)(1)(iii)). The threshold is not sufficient because, even if the DCO accepts all entities with $50 million in capital as clearing members, the Commission may still hold that DCO violated fair and open access if it imposes ''some additional financial requirement that effectively renders the $50 million threshold meaningless.'' *Id.* at 85–86.

[308] In such guidance, the Commission could have detailed the information that a DCO would need to provide in order to demonstrate that it could not adopt a less restrictive participation requirement without materially increasing its own risk. The Commission could have also discussed the weight that DCOs should accord to a particular level of capitalization, depending on whether the relevant clearing member (i) engages in businesses other than the intermediation of futures or swaps, or (ii) participates at multiple DCOs rather than one DCO.

[309] *See supra* note. I note that the Commission and FSA share jurisdiction over three DCOs clearing swaps—namely, LCH.Clearnet Limited, ICE Clear Europe Limited, and CME Clearing Europe. How the Commission and FSA will resolve conflicting regulation remains to be seen.

[310] *See* Bank for International Settlements' Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions (''CPSS–IOSCO''), ''Recommendations for Central Counterparties,'' CPSS Publ'n No. 64 (November 2004), available at: *http://www.bis.org/publ/cpss64.pdf* (the ''CPSS–IOSCO Recommendations''). Section 4.2.2 of the CPSS–IOSCO Recommendations state: ''To reduce the likelihood of a participant's default and to ensure timely performance by the participant, a CCP should establish rigorous financial requirements for participation. Participants are typically required to meet minimum capital standards. Some CCPs impose more stringent capital requirements if exposures of or carried by a participant are large or if the participant is a clearing participant. Capital requirements for participation may also take account of the types of products cleared by a CCP. In addition to capital requirements, some CCPs impose standards such as a minimum credit rating or parental guarantees.''

[311] *See* CPSS–IOSCO, ''Principles for financial market infrastructures: Consultative report,'' CPSS Publ'n No. 94 (March 2011), available at: *http://www.bis.org/publ/cpss94.pdf* (the ''CPSS–IOSCO Consultation''). The CPSS–IOSCO Consultation, which CPSS–IOSCO has not adopted as final, does not set forth any requirement or suggestion that resembles the $50 million threshold. Instead, the Consultation, like the Recommendations, emphasizes the importance of ''risk-based'' CCP participation criteria that are not unduly discriminatory. Specifically, Section 3.16.6 of the CPSS–IOSCO Consultation states: ''Participation requirements based solely on a participant's size are typically insufficiently related to risk and deserve careful scrutiny.'' Whereas the Consultation may have intended to comment on restrictively high CCP participation requirements, the same logic applies to restrictively low CCP participation requirements. Neither are risk-based.

[312] *See* Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (Dec. 22, 2010).

[313] *See* the DCO Core Principles, *supra* note 289, at 393–394 (to be codified at 17 CFR 39.13(g)(2)(ii)).

no justification for this characterization.[314] According to the final rulemaking, DCOs should consider at least five factors in establishing minimum liquidation times for its products, including trading volume, open interest, and predictable relationships with highly liquid products.[315] In setting forth such factors, the Commission is holding DCOs to a higher standard than it holds itself. The final rulemaking presents no evidence that the Commission considered any of the five factors in determining minimum liquidation times.[316]

Negative Implications for Competition

More importantly, when these requirements are juxtaposed against our proposal interpreting DCM core principle 9, the potential of these requirements to disrupt already established futures markets becomes apparent. In the proposal, which is entitled *Core Principles and Other Requirements for Designated Contract Markets,* the Commission proposed, in a departure from previous interpretations of DCM core principle 9, to prohibit a DCM from listing any contract for trading unless an average of 85 percent or greater of the total volume of such contract is traded on the centralized market, as calculated over a twelve (12) month period.[317] If the Commission finalizes such proposal, then DCMs may need to delist hundreds of futures contracts.[318] Financial contracts may be affected, along with contracts in agricultural commodities, energy commodities, and metals.

According to the proposal, DCMs may convert delisted futures contracts to swap contracts.[319] However, if the futures contracts reference financial commodities, then this final rulemaking would require that a DCO margin such swap contracts using a minimum liquidation time of five days instead of one day for futures. If nothing substantive about the contracts change other than their characterization (*i.e.,* futures to swaps), then how can the Commission justify such a substantial increase in minimum liquidation time and margin? An increase of this magnitude may well result in a chilling of activity in the affected contracts. Such chilling would be an example of the type of market disruption that the CEA was intended to avoid.

I believe this has severe implications for competition. As commenters to the DCM proposal noted, market participants generally execute new futures contracts outside the DCM centralized market until the contracts attract sufficient liquidity. Attracting such liquidity may take years.[320] Let us assume that an established DCM already lists a commercially viable futures contract on a financial commodity that meets the 85 percent threshold. Even without the DCM proposal and this final rulemaking, a DCM seeking to compete by listing a futures contract with the same terms and conditions already faces an uphill battle. Now with the DCM proposal, the competitor DCM would have to also face the constant threat of being required to convert the futures contract into a swap contract.

With this final rulemaking, the competitor DCM (or a competitor swap execution facility (SEF)) faces the additional threat that, by virtue of such conversion, the contract would be margined using a five-day minimum liquidation time. In contrast, the incumbent futures contract—which may have the same terms and conditions as the new ''swap'' contract—would still be margined using a one-day minimum liquidation time. It is difficult to imagine a DCM (or a competitor SEF) willing to compete given the twin Swords of Damocles that it would need to confront. By dissuading such competition, this final rulemaking and the DCM proposal undermine the ''responsible innovation and fair competition among boards of trade'' that the CEA was intended to promote.[321]

Some may argue that this final rulemaking would not have the negative effects that I articulated because it explicitly permits the Commission to establish, either sua sponte or upon DCO petition, longer or shorter liquidation times for particular products or portfolios.[322] I would argue that requiring market participants, during the pendency of such a petition, to pay margin calculated using a five-day minimum liquidation time would likely cause a substantial number of market participants to withdraw from the market, thereby chilling activity—perhaps irrevocably—in the contract. I would further argue that the additional cost that (i) a DCM would incur to persuade a DCO to file a petition with the Commission and (ii) a DCM or DCO would incur to prepare such a petition, when coupled with the possibility that the Commission may deny such petition, would likely deter a DCM from seeking to compete with an incumbent futures contract. After all, the Commission may take a long time to consider any DCO petition. For example, the Commission took approximately two years to approve a petition to reduce the minimum liquidation time for certain contracts on the Dubai Mercantile Exchange from two days to one day.[323] Thus, this power to petition the Commission for relief may be of little value to offset the likely stifling of competition.

Return to Principles-Based Regulation

What should the Commission have done to avoid market disruption and a curtailment in competition? Again, the Commission should have retained a principles-based regime, and should have permitted each DCO to determine the appropriate minimum liquidation time for its products, using the five factors articulated above. Determining

[314] *See id.* at 126–127.

[315] According to the final rulemaking, such factors are: ''(i) Average daily trading volume in a product; (ii) average daily open interest in a product; (iii) concentration of open interest; (iv) availability of a predictable basis relationship with a highly liquid product; and (v) availability of multiple market participants in related markets to take on positions in the market in question.'' *Id.* at 129.

[316] Instead of considering the five factors, the Commission appears to have simply codified the minimum liquidations times that certain DCOs currently use for swaps. For example, the Commission justifies setting a minimum liquidation time of five days for swaps referencing non-physical commodities as follows: ''The longer liquidation time, currently five days for credit default swaps at ICE Clear Credit LLC and CME, and for interest rate swaps at LCH and CME, is based on their assessment of the higher risk associated with these products.'' *Id.* at 127–128. Given that this justification appears to focus on credit default swaps and interest rate swaps, it is unclear how the Commission concluded that a five-day minimum liquidation time is appropriate for swaps that reference financial commodities but are neither credit default swaps nor interest rate swaps.

[317] 75 FR at 80616.

[318] According to information that I have received from one DCM, the proposal would force conversion of 628 futures and options contracts to swap contracts. Moreover, according to the Off-Market Volume Study (May-2010 through July-2010) prepared by Commission staff, the proposal would force conversion of approximately 493 futures and options contracts. *See* Off-Market Volume Study, available at: *http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_12_DCMRules/index.htm.*

[319] *See* 75 FR at 80589–90.

[320] *See* letter, dated February 22, 2011, from NYSE Liffe U.S., available at: *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27910&SearchText=. See also* letter, dated February 22, 2011, from ELX Futures, L.P., available at: *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27873&SearchText=. See further* letter, dated February 22, 2011, from Eris Exchange, LLC, available at: *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27853&SearchText=.*

[321] *See* section 3(b) of the CEA, 7 U.S.C. 5(b).

[322] *See* the DCO Final Rule, *supra* note 289, at 394 (to be codified at 17 CFR 39.13(g)(2)(ii)(D)).

[323] The petition is available at: *http://www.cftc.gov/PressRoom/PressReleases/pr5724-09.* The petition was filed on July 28, 2009. The Commission issued an order granting the petition on September 16, 2011. The order does not appear on the Commission Web site.

appropriate margin requirements involves quantitative and qualitative expertise. Such expertise resides in the DCOs and not in the Commission. In its cost-benefit analysis, the final rulemaking admits as much.[324] Returning to a principles-based regime would have also better aligned with current international standards on CCP regulation,[325] as well as the revisions to such standards.[326]

The ''Race to the Bottom'' Argument Simply Cannot Withstand Scrutiny

Some may argue that, by not imposing minimum liquidation times, the Commission may enable a ''race to the bottom,'' where DCOs would compete by offering the lowest margin. As a conceptual matter, given that the Commission has not demonstrated that the minimum liquidation times that it has decided to mandate are ''prudent,'' it cannot demonstrate that the one-day or five-day period would prevent a ''race to the bottom.'' [327] As an empirical matter, the Commission must have decided that DCOs currently competing to clear interest rate swaps and credit default swaps have not entered into a ''race to the bottom,'' because the final rulemaking codifies the existing five-day minimum liquidation time that such competing DCOs voluntarily adopted.[328]

Finally, the Commission has more effective tools to prevent any ''race to the bottom.'' First, this final rulemaking requires a DCO to determine the adequacy of its initial margin requirements on a daily basis.[329] Second, this final rulemaking requires a DCO to conduct back testing of its initial margin requirements on a daily or monthly basis.[330] Third, this final rulemaking requires a DCO to stress test its default resources at least once a month, and to report to the Commission the results of such stress testing at least once every fiscal quarter.[331] Fourth, the Commission has the ability to independently back test and stress test DCO initial margin requirements.[332] Consequently, the Commission would be able to detect any ''race to the bottom'' that would cause any DCO to have insufficient initial margin to cover its risks.

Cost-Benefit Analysis: We Can Do Better

I have always emphasized that the Commission must engage in more rigorous cost-benefit analyses of its rulemakings. At various points in my speeches and writings, I have urged the Commission to (i) focus on the economic effects of its rulemakings, both cumulative and incremental, (ii) quantify the costs and benefits of its rulemakings, both cumulative and incremental, and (iii) better justify the choice of a prescriptive requirement when a less-costly and equally effective principles-based alternative is available. Only by engaging in more rigorous cost-benefit analyses would the Commission fulfill the mandates of two Executive Orders [333] and render our rulemakings less vulnerable to legal challenge.[334]

I have read the cost-benefit analysis in this final rulemaking with great interest. I can confirm that such analysis is longer than previous analyses. Unfortunately, increased length does not ensure an improvement in analysis and content.

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[324] *See* the DCO Final Rule, supra note 289, at 315–316 (stating that ''[i]n addition to the liquidation time frame, the margin requirements for a particular instrument depend upon a variety of characteristics of the instrument and the markets in which it is traded, including the risk characteristics of the instrument, its historical price volatility, and liquidity in the relevant market. Determining such margin requirements does not solely depend upon such quantitative factors, but also requires expert judgment as to the extent to which such characteristics and data may be an accurate predictor of future market behavior with respect to such instruments, and applying such judgment to the quantitative results * * * Determining the risk characteristics, price volatility, and market liquidity of even a sample for purposes of determining a liquidation time specifically for such instrument would be a formidable task for the Commission to undertake and any results would be subject to a range of uncertainty.'').

[325] *See supra* note 310. With respect to minimum liquidation times, Section 4.4.3 of the CPSS–IOSCO Recommendations simply state: ''Margin requirements impose opportunity costs on CCP participants. So, a CCP needs to strike a balance between greater protection for itself and higher opportunity costs for its participants. For this reason, margin requirements are not designed to cover price risk in all market conditions. Nonetheless, a CCP should estimate the interval between the last margin collection before default and the liquidation of positions in a particular product, and hold sufficient margin to cover potential losses over that interval in normal market conditions.''

[326] *See also supra note 311.* Like the CPSS–IOSCO Recommendations, the CPSS–IOSCO Consultation also advocates a principles-based model for estimating minimum liquidation times. Section 3.6.7 of the CPSS–IOSCO Consultation states: ''A CCP should select an appropriate close-out period for each product cleared by the CCP, and document the close-out periods and related analysis for each product type. A CCP should base its close-out period upon historical price and liquidity data when developing its initial margin methodology. Historical data should include the worst events that occurred in the selected time period for the product cleared as well as simulated data projections that would capture potential events outside of the historical data. In certain instances, a CCP may need to determine margin levels using a shorter historical period to reflect better new or current volatility in the market. Conversely, a CCP may need to determine margin levels based on a longer period in order to reflect past volatility. The close-out period should be set based on anticipated close-out times in stressed market conditions. Close-out periods should be set on a product-specific basis, as less-liquid products might require significantly longer close-out periods. A CCP should also consider and address position concentrations, which can lengthen close-out timeframes and add to price volatility during close outs.''

[327] The Commission acknowledged as much in its cost-benefit analysis. The analysis states: ''The Commission anticipates that using only one criterion—*i.e.,* the characteristic of the commodity underlying a swap—to determine liquidation time could result in less-than-optimal margin calculations. For some products, a five-day minimum may prove to be excessive and tie up more funds than are strictly necessary for risk management purposes. For other products, a one-day or even a five-day period may be insufficient and expose a DCO and market participants to additional risk.'' The DCO Final Rule, *supra* note 289, at 315.

[328] *Id.* at 127 to 128 (stating '' * * * the final rule provides that the minimum liquidation time for swaps based on certain physical commodities, *i.e.,* agricultural commodities, energy, and metals, is one day. For all other swaps, the minimum liquidation time is five days. This distinction is based on the differing risk characteristics of these product groups and is consistent with existing requirements that reflect the risk assessments DCOs have made over the course of their experience clearing these types of swaps. The longer liquidation time, currently five days for credit default swaps at ICE Clear Credit, LLC, and CME, and for interest rate swaps at LCH and CME, is based on their assessment of the higher risk associated with these products.'').

[329] *Id.* at 396 (to be codified at 17 CFR 39.13(g)(6)).

[330] *Id.* at 396–397 (to be codified at 17 CFR 39.13(g)(7)).

[331] *Id.* at 383–387 (to be codified at 17 CFR 39.11(c)(1) and (f)).

[332] *See* United States Commodity Futures Trading Commission, International Monetary Fund—Financial Sector Assessment Program: Self-Assessment of IOSCO Objectives and Principles of Securities Regulation, August 2009, available at: *http://www.treasury.gov/resource-center/international/standards-codes/Documents/Securities%20CFTC%20Self%20Assessment%208–28–09.pdf* (the ''FSAP Assessment'') (describing the capabilities of the Risk Surveillance Group within the Division of Clearing and Risk (formerly known as the Division of Clearing and Intermediary Oversight): ''After identifying traders or FCMs at risk, the RSG estimates the magnitude of the risk. The SRM system enables RSG staff to calculate the current performance bond requirement for any trader or FCM. This amount is generally designed to cover approximately 99% of potential one-day moves * * * SRM also enables RSG staff to conduct stress tests. RSG staff can determine how much a position would lose in a variety of circumstances such as extreme market moves. This is a particularly important tool with respect to option positions. As noted, the non-linear nature of options means that the loss resulting from a given price change may be many multiples greater for an option position than for a futures position in the same market. Moreover, the complexity of option positions can result in situations where the greatest loss does not correspond to the most extreme price move.'').

The FSAP Assessment also describes the ability of the RSG to check DCO stress testing of its default resources: ''The RSG compares the risk posed by the largest clearing member to a DCO's financial resource package. The RSG analyzes not only the size of the DCO package but also its composition. In the event of a default, a DCO must have access to sufficient liquidity to meet its obligations as a central counterparty on very short notice.''

[333] *See* Exec. Order No. 13,563, 76 Fed. Reg. 3821 (Jan. 21, 2011); Exec. Order No. 13,579, 76 Fed. Reg. 41,587 (July 14, 2011).

[334] *See, e.g., Business Roundtable and the United States Chamber of Commerce vs. SEC,* No. 10–1305, 2011 U.S. App. LEXIS 14988 (July 22, 2011).

Although I have numerous concerns with the cost-benefit analysis, my primary concern relates to its failure to attempt meaningful quantification. In multiple places in the cost-benefit analysis, the Commission concludes that the costs of a particular requirement are difficult or impossible to estimate. In certain instances, the statement may be accurate. If the Commission truly cannot quantify the costs in those instances, then that fact alone should cause the Commission to proceed with caution if it is going to abandon the existing principles-based regime. In other instances, however, I find the statement to be puzzling, given the capabilities and expertise of the Risk Surveillance Group (''RSG'') and the DCO Review Group (''DRG'') in our Division of Clearing and Risk (formerly known as the Division of Clearing and Intermediary Oversight).

I would like to highlight two such instances where the Commission has not utilized its own data to quantify the costs associated with its policy decisions. First, with respect to the minimum liquidation time requirements, the Commission states that ''it is not feasible to estimate or quantify these costs reliably.'' The Commission justifies such conclusion by stating that (i) ''reliable data is not available for many swaps that prior to the Dodd-Frank Act were executed in unregulated markets,'' and (ii) it would be too difficult for the Commission to estimate margin using either a one-day or five-day minimum liquidation time for any particular product.[335] Whereas these statements may be accurate for certain swaps, they are not accurate for futures contracts currently listed on a DCM that will be converted to swap contracts under the pending DCM proposal. However potentially incomplete, the Off-Market Volume Study (May 2010 through July 2010) accompanying the DCM proposal entitled *Core Principles and Other Requirements for Designated Contract Markets*[336] demonstrates that the Commission has the ability to identify at least a sample of the futures contracts that may be potentially converted to swap contracts. It is true that the DCO usually impounds the minimum liquidation time in the risk arrays that it uses to calculate margin, and the RSG cannot change such risk arrays easily. However, the RSG can ask the DCO to provide the assumptions underlying the risk arrays, including the minimum liquidation time (usually one day). Then the RSG can modify such assumptions to estimate margin calculations using a five-day minimum liquidation time.[337] Would these calculations be imperfect? Yes. However, any attempt, even an imperfect one, undertaken by the Commission to understand the cost of our rulemakings or to justify our policy decisions is better than no attempt at all.

Another instance that I would like to highlight pertains to letters of credit. This final rulemaking prohibits DCOs from accepting letters of credit as (i) initial margin for swaps contracts (but not futures contracts) or (ii) as guarantee fund contributions. In the cost-benefit analysis, the Commission states that, ''it is not possible to estimate or quantify [the] cost'' of the prohibition.[338] In response to questions from me and certain of my colleagues, however, the DRG prepared a memorandum on the use of letters of credit as initial margin. Although this memorandum is non-public, it is part of the administrative record for this final rulemaking. This memorandum details, among other things: (i) the number and identity of certain DCOs accepting and/or holding letters of credit as initial margin; (ii) the percentage of total initial margin on deposit across all DCOs that letters of credit constitute; and (iii) the potential disproportionate impact on energy and agricultural end-users of disallowing letters of credit. Whereas the memorandum may focus on the use of letters of credit as initial margin for futures contracts, the Commission proposal for DCM core principle 9 may force conversion of numerous energy and agricultural futures contracts into swaps contracts. Yet, the cost-benefit analysis contains none of the information in the memorandum, even in aggregate and anonymous form. In the interests of transparency, the Commission should have found a way to share this information with the public.

The Commission (or its predecessor) has regulated the futures markets since the 1930s. The Commission has overseen DCOs clearing swaps since at least 2001. We can do better than this. If the Commission needs to re-propose a rulemaking to provide quantitative estimates of its costs and benefits, so be it. Given the foundational nature of this rulemaking, as well as other rulemakings that are forthcoming, it is more important for the Commission to achieve the most reasonable balance between costs and benefits, rather than to finish the rulemaking fast.

International Coordination: We Must Do Better.

In closing, I would mention my strong desire for the Commission to ensure that its policies do not create disadvantages for United States businesses and that our rules comport with international standards. It is becoming increasingly clear that the schedule for financial reform is converging among the G–20 nations. It is less clear that the substantive policies underlying financial reform are experiencing the same convergence. We must be more cognizant of the effects of such lack of convergence on dually-registered entities, and the incentives created by such divergence for regulatory arbitrage.

This final rulemaking illustrates the inconsistent approach that the Commission has taken towards international coordination to date. First, although the final rulemaking notes that the CPSS–IOSCO Recommendations embody the current international standards on CCP regulation, the final rulemaking does not attempt to comport with the CPSS–IOSCO Recommendations.[339] Instead, the final rulemaking attempts to comport with the CPSS–IOSCO Consultation, which has not been finalized.[340] In general, both the CPSS–IOSCO Recommendations and the CPSS–IOSCO Consultation are less prescriptive than the final rulemaking.

Second, while the final rulemaking does note the rare instance where its prescriptive requirements comport with the CPSS–IOSCO Consultation,[341] it does not reveal where its prescriptive requirements depart from the CPSS–IOSCO Consultation. For example, as I stated above, the CPSS–IOSCO Consultation actually sets forth principles-based considerations for participant eligibility and margin calculation.

Finally, the final rulemaking states that the Commission will review a number of its provisions after CPSS and IOSCO finish their work, which is likely to occur in 2012. Whereas I support such a review, the statement begs the following questions: What legal certainty are these regulations offering

[335] *See* the DCO Final Rule, *supra* note 289, at 315–316.

[336] *See supra* note 318. The Off-Market Volume Survey does not include contracts listed on new DCMs, such as NYSE Liffe U.S., ELX Futures, L.P., or Eris Exchange, LLC. However, the existence of such survey is proof that the Commission has the ability to identify contracts that DCM core principle 9 may affect.

[337] *See supra* note 332. *See* pages 252 to 268 of the FSAP Assessment for a full description of the capabilities of the RSG.

[338] The DCO Final Rule, *supra* note 289, at 344.

[339] *See supra* note 310.

[340] *See supra* note 311.

[341] *See, e.g., id.* at 132 (stating that requiring DCOs to calibrate margin to cover price movements at a 99 percent confidence interval accords with Principle 6 of the CPSS–IOSCO Consultation).

DCOs, clearing members, and market participants if the Commission changes such regulations in 2012? Also, what are the implications of requiring DCOs to incur costs to comport with prescriptive requirements now when the Commission might change such requirements next year? If changes are foreseeable, shouldn't the Commission adopt a phasing or delayed implementation plan to allow the international coordination process to reach completion before our rules and their costs become effective? If, in the alternative, the Commission will not be influenced by international standards, what are the costs of such non-convergence?

As we are finalizing foundational rulemakings, we can no longer rely on an inconsistent approach. We need to produce a more coherent plan for international coordination.

Conclusion

Due to the above concerns, I respectfully dissent from the decision of the Commission to approve this final rulemaking for publication in the **Federal Register.**

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