

CFTC Proposes Major Amendments to Derivatives Clearing Organization (DCO) Regulations and Core Principles USA (National/Federal) [Related Content](#)

The CFTC issued proposed amendments to certain regulations applicable to registered derivatives clearing organizations (DCOs) under Part 39 of the CFTC's regulations.

On April 29, 2019, the CFTC issued a [proposed rule](#) that would amend certain regulations applicable to registered [derivatives clearing organizations](#) (DCOs) under Part 39 of the CFTC's regulations (Part 39) ([17 C.F.R. § 39.1-39.42](#)).

Adopted in 2011, Part 39 includes Subparts A and B, which implement the core principles, set out in the [Commodity Exchange Act](#) (CEA), that a DCO must comply with in order to gain and maintain registration as a DCO (core principles) (see [Practice Note, The Dodd-Frank Act: Clearing and Exchange Trading Under Title VII: DCO Core Principles](#)). Part C was adopted in 2013, establishing additional compliance standards for DCO core principles for DCOs that have been designated as systemically important (SIDCOs) by the [Financial Stability Oversight Council](#) (FSOC) in accordance with the [Dodd-Frank Act](#) (see [Practice Note, The Dodd-Frank Act: Swap Clearing and Exchange Trading Under Title VII: Types of DCOs](#)).

The CFTC is seeking to amend and clarify certain provisions of Part 39, as well as codify related DCO staff relief and interim guidance.

Amendments to Subpart A of Part 39

Subpart A of Part 39 deals with general provisions applicable to DCOs. Proposed amendments to this section include those relating to:

- Definitions, including the terms:
 - Business day.
 - Customer.
 - Customer account or customer origin.
 - Enterprise risk management.
 - Fully-collateralized position.
 - Key personnel.
- Procedures for registration, which includes changes to:
 - DCO application procedures;
 - stays of DCO application reviews;
 - amendments of DCO orders of registration;

- dormant DCO registrations;
- vacations of DCO registrations; and
- requests for transfers of DCO registrations and open interests.
- Procedures for implementing DCO rules and clearing new products, including changes to:
 - request for DCO rule approvals; and
 - customer portfolio margining.

Amendments to Subpart B of Part 39

Subpart B of Part 39 deals with compliance with core principles. Proposed amendments to this section include those relating to:

- Compliance with core principles, including:
 - revised DCO chief compliance officer (CCO) compliance standards; and
 - the addition of an enterprise risk-management program.
- Financial resources; the proposed changes are designed to enhance consistency with Core Principle B of Section 5b(c)(2) of the CEA ([7 U.S.C. § 7a-1](#)), which it was designed to implement. Core Principle B requires that a DCO maintain sufficient financial resources to:
 - meet its financial obligations to its [clearing members](#), even if the clearing member to which it has the greatest exposure defaults, in extreme but plausible market conditions; and
 - cover its operating costs for at least one year.
- Participant and product eligibility, including:
 - changing language requiring a DCO to "adopt" or "establish" rules to simply "have" rules; and
 - revising Section 39.12(b)(2), which provides that a DCO shall adopt rules providing that all swaps with the same terms and conditions are economically equivalent within the DCO, to explicitly apply only to DCOs that clear swaps.
- Risk management, including:
 - clarifying aspects of the DCO risk-management framework;
 - limiting DCO exposure to potential default losses;
 - margin requirements at the DCO;
 - other DCO risk-control mechanisms; and
 - cross-margining arrangements.
- Treatment of funds, including amending aspects related to:
 - the segregation of customer funds at the DCO;
 - commingling of cleared swaps and futures customer accounts at the DCO;
 - transfers of customer positions;
 - permitted investments of segregated customer funds and cleared swaps collateral; and
 - CFTC actions relating to any of the above.
- Default rules and procedures, including amendments related to:
 - DCO default management plans; and
 - DCO default procedures.

- Rule enforcement, including amendments to:
 - Section 39.17(a)(1) to clarify the CFTC's expectation that a DCO currently does, and will continue to, ensure that both the DCO and its members comply with the DCO's rules; and
 - Section 39.17(b) to replace the words "risk management committee" with "an appropriate committee."
- DCO reporting, including:
 - enhancing consistency between Section 39.39 and Core Principle J of Section 5b(c)(2) of the CEA ([7 U.S.C. § 7a-1](#)), which it was designed to implement. Core Principle J requires a DCO to report information required for CFTC oversight ([7 U.S.C. § 7a-1\(c\)\(2\)](#)); this includes, daily, quarterly, annual, and event-specific reports; and
 - clarifying existing requirements related to the submission of DCO reports to the CFTC, daily reporting of information and securities positions, quarterly reporting, audited year-end financial statements, time of reports, decreases in financial or liquidity resources, requests to clearing members to reduce positions, changes in key personnel, changes to legal name, changes to liquidity funding arrangements, changes to settlement bank arrangements, settlement bank issues, changes in depositories for customer funds, changes to fiscal year, changes to independent accounting firm, major decisions of the board of directors, margin model issues, recovery and wind-down plans, new products accepted for clearing, and requested reporting.
- Public information – the information deemed sufficient to enable market participants to identify and evaluate accurately the risks and costs associated with using the services of a DCO. Minor proposed changes include the clarification of:
 - the method of proper public disclosure by DCOs and DCO publication of information;
 - requirements to publicly update information relating to a DCO's financial resource package size and composition each fiscal quarter or upon CFTC request;
 - daily settlement prices, volume, and open interest, including the reiteration of Section 39.21(c)(5), which requires a DCO to publicly disclose daily settlement prices, volume, and open interest for each contract, agreement, or transaction cleared or settled by the DCO, and Section 39.21(d), which requires posting of this information "unless otherwise permitted by the [CFTC]." The CFTC also notes that though the plain language of Section 39.21(c)(5) indicates that "daily" is intended to apply not only to settlement prices, but also to volume and open interest, the CFTC confirms that DCOs are expected to publicly disclose volume and open interest, as well as settlement prices, on a daily basis in order to be in compliance with the regulation. Relatedly, the CFTC encourages DCOs to make several days' worth of this information available on their websites; and
 - swaps required to be cleared, including adopting a cross-reference to Section 50.3(a), which requires a DCO to make publicly available on its website a list of all swaps that it will accept for clearing and identify which swaps on the list are required to be cleared under Section 2(h)(1) of the CEA and Part 50 of the CFTC's regulations.
- DCO governance and fitness standards, requirements for resolving conflicts of interest, and composition of governing boards, as discussed below.
- Legal risk, including amending Section 39.27(c) by adding a subparagraph (3), which would require a DCO that provides clearing services outside the US to ensure on an ongoing basis that the memorandum required in Exhibit R of Form DCO is accurate and up to date and to submit an updated memorandum to the CFTC promptly following all material changes to the analysis or content contained in the memorandum.
- Fully collateralized positions, including amendments relating to:
 - the definition of a fully-collateralized position;
 - computing the DCO's financial resources requirement;
 - liquidity of the DCO's financial resources;
 - periodic reporting of DCO participant eligibility;
 - DCO-conducted large-trader stress tests; and
 - daily reporting of information on [initial margin](#) (IM), daily [variation margin](#) (VM) payments, other daily cash flows, and end-of-day positions for fully-collateralized positions.

Amendments to Subpart C of Part 39

Subpart C of Part 39 deals with provisions applicable to SIDCOs and DCOs that elect to be subject to the provisions. Proposed amendments to this section include those relating to:

- Financial resources for SIDCOs and Subpart C DCOs, including amending:
 - Section 39.33(a)(1), which states that SIDCOs and Subpart C DCOs that are systemically important in multiple jurisdictions or are involved in activities with a more complex risk profile shall maintain financial resources sufficient to enable them to meet their financial obligations to their clearing members notwithstanding a default by two clearing members creating the largest combined loss to the DCO in extreme but plausible market conditions. The amended version would replace the phrase "largest combined loss" with "largest combined financial exposure" in order to achieve consistency with relevant CFTC provisions and the CEA;
 - Section 39.33(c)(1) by adding the phrase "in all relevant currencies" to clarify that the "largest aggregate liquidity obligation" means the total amount of cash, in each relevant currency, that the defaulted clearing member would be required to pay the DCO during the time it would take to liquidate or auction the defaulted clearing member's positions, as reasonably modeled by the DCO; and
 - Section 39.22(d) to additionally require a SIDCO with access to deposit accounts and related services at the Federal Reserve to use such services where practical.
- Risk management for SIDCOs and Subpart C DCOs, including amending:
 - Section 39.36(a)(6) to clarify that a SIDCO or Subpart C DCO that is subject to the minimum financial resources requirement set forth in Section 39.11(a)(1), rather than Section 39.33(a), should use the results of its stress tests to support compliance with that requirement;
 - Section 39.36(b)(2)(ii) to replace the words "produce accurate results" with "react appropriately" to more accurately reflect that the purpose of sensitivity analysis is to assess whether the margin model will react appropriately to changes of inputs, parameters, and assumptions;
 - Section 39.36(d) to clarify that an assessment by a DCO of the theoretical and empirical properties of its margin model for all products it clears should be conducted "on at least an annual basis (or more frequently if there are material relevant market developments)"; and
 - Section 39.36(e) by adding the heading "[i]ndependent validation" to the provision – though it remains unclear whether the annual DCO validation would be required to be conducted by an independent third party, as is implied by the amendment.
- Additional disclosure for SIDCOs and Subpart C DCOs, including amendments to:
 - Section 39.37(b) to additionally require that a SIDCO or Subpart C DCO provide notice to the CFTC of any updates to its responses to the Committee on Payments and Market Infrastructures (CPMI) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) Disclosure Framework following material changes to its system or environment no later than ten business days after the updates are made; and
 - Section 39.37(c) to explicitly state that a SIDCO or a Subpart C DCO must disclose relevant basic data on transaction volume and values that are consistent with the standards set forth in the CPMI-IOSCO Public Quantitative Disclosure Standards for Central Counterparties.

Though many of the aforementioned provisions are only general principles, of particular importance are the new governance standards set forth in the amendments to Part 39 Subpart B of the proposed rule. These new regulations propose to remove Section 39.32 from the current Subpart C and adopt new Sections 39.24, 39.25, and 39.26 into Subpart B.

New Sections 39.24, 39.25, and 39.26 will incorporate the same requirements as Section 39.32, namely, Core Principles O, P, and Q as set forth in the Dodd-Frank Act, respectively. However, by incorporating these sections into Subpart B, they will apply to all DCOs as opposed to just SIDCOs and Subpart C DCOs. The sections are generally designed to enhance risk management and controls by promoting transparency and making sure that the interest of a DCO's clearing members and customers are considered.

The proposed rule is part of the CFTC's Project KISS initiative, which seeks to simplify CFTC rules and regulations to reduce costs and regulatory burden (see [Legal Update, CFTC Requests Public Input as Part of Project KISS Initiative to Simplify Rules](#)).

The CFTC is accepting public comment on the proposed rule until July 15, 2019.

Update: The CFTC extended the public comment period until September 13, 2019.

PRODUCTS

PLC US Finance, PLC US Law Department

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