

Rule 17Ad-22(e)(19): Tiered Participation Arrangements a. Proposed Rule

As proposed, Rule 17Ad-22(e)(19) would require a covered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify, monitor, and manage the material risks to the covered clearing agency arising from arrangements in which firms that are indirect participants in the covered clearing agency rely on the services provided by direct participants in the covered clearing agency to access the covered clearing agency's payment, clearing, or settlement facilities (hereinafter "tiered participation arrangements"). In addition, proposed Rule 17Ad-22(e)(19) would require that a covered clearing agency establish, implement, maintain and enforce written policies and procedures reasonably designed to regularly review the material risks to the covered clearing agency arising from such tiered participation arrangements.

b. Comments Received and Commission Response

The Commission received several comments regarding tiered participation arrangements under Rule 17Ad-22(e)(19). One commenter believed that regular reviews of tiered participation arrangements are an important part of a covered clearing agency's ability to perform prompt and accurate clearance and settlement, to protect investors, and to safeguard securities and funds. However, some commenters focused on particular aspects of the proposal in seeking to have the Commission consider a specific approach or issue. Comments directed to these particular substantive aspects of Rule 17Ad-22(e)(19) are discussed below.

Need for Due Diligence of Indirect Participants

One commenter believed that the Commission did not provide sufficient guidance regarding who would be indirect participants of a covered clearing agency and, as a result, cannot ascertain whether it is correctly reading the proposed rule. The commenter further expressed the view that it is not appropriate for a covered clearing agency to perform due diligence on the clients of its clearing members for the following reasons:

- The covered clearing agency has no direct, contractual relationship to these clients;
- Performing due diligence on what may be a very large number of clients could be very burdensome for the covered clearing agency; and clients may object to due diligence inquiries from a covered clearing agency and choose to move their business to another CCP that is not required to perform such due diligence.

Instead, the commenter expressed a view that a covered clearing agency can reasonably rely on the due diligence that its clearing members perform on their clients and should not have to perform its own due diligence on these indirect participants.

In response, the Commission first notes that the scope of Rule 17Ad-22(e)(19) does not only contemplate clients of clearing members. Instead, the rule also contemplates situations where other parties may enter into a contractual arrangement with a clearing member, particularly arrangements that create credit exposures to the clearing member, such as where a third party acts as guarantor to an obligation on behalf of the clearing member, may be indirect participants in the covered clearing agency. The Commission therefore believes that the alternative approach suggested by the commenter above does not entirely contemplate the scope of indirect participants addressed by the Rule 17Ad-22(e)(19).

The Commission acknowledges that there are limits on the extent to which a covered clearing agency can, in practice, observe or influence a direct participant's commercial or contractual relationships, and that these limits will, in turn, affect the appropriateness of a covered clearing agency performing due diligence on its indirect participants. However, a clearing agency will often have access to information, including through the due diligence that a member performs on its clients as well as information on transactions undertaken on behalf of

indirect participants. A clearing agency can also set direct participation requirements that may include criteria relating to how direct participants manage relationships with their customers in- so-far as these criteria are relevant for the safe, efficient, and effective operation of the clearing agency. Accordingly, a covered clearing agency generally should have the ability to identify the types of risk that could arise from tiered participation and should monitor concentrations of such risk. Further, the Commission notes that some direct and indirect participants of the covered clearing agency will be registered with the Commission as, for example, a broker-dealer, and therefore be subject to their own requirements for reporting and financial responsibility, which a covered clearing agency could use in developing policies and procedures for tiered participation arrangements. In light of the availability of the tools described above, the Commission does not believe that the commenter's suggestion for a covered clearing agency to rely on due diligence performed by its clearing members is an appropriate alternative for the purposes of addressing the requirements a covered clearing agency must satisfy under Rule 17Ad-22(e)(19).

Need to Obtain Information from Clearing Members

One commenter expressed concern that proposed Rule 17Ad-22(e)(19) could be interpreted as requiring a covered clearing agency to obtain information from its clearing

members identifying with specificity each of the customers attached to each cleared transaction and to routinely monitor customer-level risk with respect to each such customer. The commenter acknowledged that covered clearing agencies should have the ability to gather certain information from its direct participants and that some circumstances may require clearing agencies to monitor the systemic risk created by one or more significant indirect participants, but the commenter believed it is inappropriate for a covered clearing agency to routinely police the systemic risks created by each indirect participant. In response, the Commission notes that Rule 17Ad-22(e)(19) requires a covered clearing agency to have policies and procedures governing risk management that considers a clearing member's customer relationships, but it does not require a covered clearing agency to actively risk manage those customer relationships on behalf of each clearing member. Instead, Rule 17Ad-22(e)(19) requires policies and procedures that identify, monitor, and manage the material risks to the covered clearing agency arising from tiered participation arrangements. Such policies and procedures would require a covered clearing agency to account for the range of risks stemming from each clearing member, which necessarily includes risks resulting from the clearing member's relationships with its customers, as previously described above. To engage in effective risk management of a clearing member, the covered clearing agency would need a complete picture of cleared transactions attributed to each clearing member, but it may require less specific information from the clearing member with respect to customers so long as the information it does receive provides the covered clearing agency with a comprehensive understanding of the material risks posed to the covered clearing agency by each clearing member.

Recommendation for a Risk-Based Approach

One commenter expressed the belief that covered clearing agencies should use a risk-based approach when developing policies and procedures to implement the requirement that a covered clearing agency have policies and procedures reasonably designed to identify, monitor, and manage the risks to the clearing agency arising from indirect participants. The commenter expressed the belief that a covered clearing agency should provide direct participants with information relevant to their activities (both direct and indirect) that is available to the clearing agency, thus enabling direct participants to use such information to evaluate and manage its correspondent customer relationships. The commenter also expressed a view that a covered clearing agency should evaluate the risks presented to it by indirect relationships in the context of a direct participant's overall risk management policies and procedures. The commenter expressed the belief that such policies will need to take into account the level of information available to the covered clearing agency and that there needs to be

a distinction between the supervisory oversight of the direct participant by its primary supervisor and the type of oversight that a clearing agency can be expected to provide.

The Commission agrees that such a risk-based approach could be one approach to achieving compliance with Rule 17Ad-22(e)(19), but believes that each covered clearing agency should determine the appropriate approach for determining compliance with Rule 17Ad- 22(e)(19) in light of the composition of its members and the products they clear, as well as its risk management framework. Policies and procedures at a covered clearing agency for managing risks from indirect participants will necessarily be constrained to some degree by the lack of a direct contractual agreement between the covered clearing agency itself and the indirect participant. The Commission notes, however, that evaluating and managing the risk from direct participants, pursuant to Rule 17Ad-22(e)(19), would require policies and procedures consistent with the Commission's statements in Parts.C.19.b and above. As noted there, the Commission acknowledges that direct and indirect participants in a covered clearing agency may be regulated entities themselves subject to reporting and other requirements that may help facilitate the covered clearing agency's management of risk from tiered participation arrangements.

Final Rule

The Commission is adopting Rule 17Ad-22(e)(19) as proposed. Because the Commission recognizes that there may be a number of ways to address compliance with Rule 17Ad-22(e)(19), the Commission is providing the following guidance that a covered clearing agency generally should consider in establishing and maintaining policies and procedures that address tiered participation arrangements:

- whether a covered clearing agency ensures that its rules, procedures, and agreements allow it to gather sufficient information about indirect participation to identify, monitor, and manage any material risks to the covered clearing agency arising from such tiered

participation arrangements;

- whether it identifies material dependencies between direct and indirect participants that might affect the covered clearing agency;
- whether it identifies indirect participants responsible for a significant proportion of transactions processed by the covered clearing agency and indirect participants whose transaction volumes or values are large relative to the capacity of the direct participants through which they access the covered clearing agency to manage the risks arising from these transactions; and

- whether it regularly reviews risks arising from tiered participation arrangements and takes mitigation action when appropriate.

In addition to the guidance above, the Commission notes that, when addressing its compliance with Rule 17Ad-22(e)(19), a covered clearing agency could consider whether its rules, policies, procedures, and agreements with direct participants allow it to gather basic information about indirect participants to identify, monitor, and manage any material risks to the covered clearing agency arising from such tiered participation arrangements. This information should help enable the covered clearing agency to identify the proportion of activity that direct participants conduct on behalf of indirect participants, direct participants that act on behalf of a material number of indirect participants, indirect participants with significant volumes or values of transactions in the system, and indirect participants whose transaction volumes or values are large relative to those of the direct participants through which they access the covered clearing agency. In this vein, a covered clearing agency could consider an indirect participant's status as a designated market maker or supplemental liquidity provider in identifying material risks to the covered clearing agency. A covered clearing agency could also consider different trading strategies or changes in trading strategies used by indirect participants in identifying, monitoring, and managing material risks to the covered clearing agency.

- The Commission also notes that Rule 17Ad-22(e)(19) is intended to promote the ongoing management of risks associated with tiered participation arrangements stemming from the dependencies and risk exposures that such arrangements can create. However, because proposed Rule 17Ad-22(e)(19) only addresses the situation where indirect participants in the covered clearing agency rely on direct participants, the Commission notes that Rule 17Ad-22(e)(19) would not apply in the circumstance where a covered clearing agency providing CSD services has members that are broker-dealers maintaining accounts for retail customers.