Client Update
CFTC Staff Interpretations Regarding Derivatives Clearing Organizations

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On September 18, 2015, the Division of Clearing and Risk ("DCR") of the Commodity Futures Trading Commission (the "CFTC") issued a memorandum (the "PFMI Memorandum")[1] in which the DCR interprets Part 39 of the CFTC's regulations (the "CFTC Regulations") applicable to derivatives clearing organizations ("DCOs") to be consistent with the Principles of Financial Market Infrastructures ("PFMI") of the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions ("CPSS-IOSCO") of the Bank for International Settlements.[2]

On the same day, the DCR and the CFTC's Division of Market Oversight (together, the "Divisions") issued an interpretive letter (the "Forced Trade Letter")[3] regarding the applicability of certain regulatory requirements to the "firm or forced trades" process used by some DCOs to determine the price of swaps for which public market prices are not available.

PFMI MEMORANDUM

Background

On December 2, 2013, the CFTC published final rules establishing additional standards for compliance with the DCO core principles in the Commodity Exchange Act (the "CEA") for systemically important DCOs ("SIDCOs") and DCOs that opt in to the SIDCO regulatory requirements ("Subpart C DCOs").

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1 CFTC Memorandum No. 15-50 (Sep. 18, 2015), available at: http://www.cftc.gov/PressRoom/PressReleases/pr7236-15.

2 The PFMI, published in April 2012, are available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD377.pdf.

3 CFTC Letter No. 15-51 (Sep. 18, 2015), available at: http://www.cftc.gov/PressRoom/PressReleases/pr7237-15.

These additional standards, set forth in subpart C of Part 39 of the CFTC Regulations (the "Subpart C Rules"), are intended to harmonize CFTC regulations with the PFMI.

On February 26, 2015, CPSS-ISCO published the Level 2 assessment reports on the implementation of the PFMI for central counterparties ("CCPs") and trade repositories located in the United States (among other jurisdictions). The Level 2 report interpreted the CFTC SIDCO regime as completely and consistently implementing the majority of the Principles in the PFMI and recommended that the CFTC clarify its interpretation of certain Part 39 regulations in regards to their consistency with the PFMI.

It is crucial that the CFTC's risk-management standards for SIDCOs and Subpart C DCOs fully implement the PFMI as this allows these U.S. DCOs[4] to be treated as "qualifying central counterparties" ("QCCPs") under the Basel III capital rules.[5] Under the Basel III capital rules, a banking organization's exposures to QCCPs are assigned a lower risk weight than its exposures to CCPs that are not QCCPs. A CCP is a QCCP under the Basel III capital rules if it meets certain conditions, including that it is based and prudentially supervised in a jurisdiction where the relevant regulator has established domestic rules and regulations that are consistent with the PFMI, and publicly indicated that they apply to the CCP on an ongoing basis. As the CFTC noted in the release accompanying the Subpart C Rules, ensuring that the CFTC's risk-management standards for SIDCOs and Subpart C DCOs are consistent with the PFMI affords such DCOs the opportunity to achieve QCCP status and thus avoid an important competitive disadvantage relative to similarly situated foreign CCPs that are QCCPs.

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[4] By providing a process for U.S. DCOs that are not SIDCOs to opt in to the SIDCO regime (*i.e.*, to become Subpart C DCOs), the CFTC's Subpart C Rules allow any U.S. DCO an opportunity to become a QCCP.

[5] In July 2012, the Basel Committee on Banking Supervision ("BCBS") published *Capital Requirements for Bank Exposures to Central Counterparties* (the "interim requirements") as part of Basel III, which requires banks to hold capital due to exposure to CCPs. In April 2014, BCBS published a final standard for CCP capital requirements, which will supersede the interim requirements, effective January 1, 2017. The interim requirements and final standards are available at http://www.bis.org/publ/bcbs282.htm. In July 2013, the U.S. banking agencies adopted bank capital rules that incorporate the Basel III CCP capital requirements. See 78 Fed. Reg. 62018, at 62166 (Oct. 11, 2013), available at http://www.federalreserve.gov/newsevents/press/bcreg/20130702a.htm.

DCR Interpretations

The DCR clarifies in the PFMI Memorandum that it interprets Part 39 (subparts A, B and C) to incorporate all of the standards set forth in, and to be fully consistent with, the PFMI, noting that this position is supported by CFTC Regulation 39.40, which states that "subpart C is intended to establish standards which, together with subparts A and B of [Part 39], are consistent with Section 5b(c) of the [CEA] and the [PFMI] . . . and should be interpreted in that context."

The PFMI Memorandum addresses several specific Part 39 regulations, clarifying that each such regulation, through the application of CFTC Regulation 39.40, encompasses the standards in the PFMI (such that SIDCOs and Subpart C DCOs must comply with such standards).

Risk Management

CFTC Regulation 39.13 requires all DCOs to establish and implement a risk management framework that provides for a comprehensive examination of all risks the DCO faces in its day-to-day operations. Specifically, a DCO must ensure it has the ability to manage the risks associated with discharging its responsibilities, to clearly identify and document the range of risks to which it is exposed, to address the monitoring and management of those risks and to use risk control mechanisms to limit its exposure to potential losses from clearing member defaults.

- Principle 12 of the PFMI requires that if a financial market infrastructure ("FMI")[6] settles transactions involving the settlement of two linked obligations (*e.g.*, securities or foreign exchange transactions), it should eliminate the principal risk by conditioning final settlement of one obligation on final settlement of the other. The PFMI Memorandum clarifies that the DCR interprets CFTC Regulation 39.13 to require that any SIDCO or Subpart C DCO performing exchange-of-value settlement services must manage the risks arising from such services (*i.e.*, its exposure to potential losses from defaults) consistent with Principle 12 by ensuring that settlement of one obligation occurs if and only if final settlement of the linked obligation also occurs.

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[6] The term "financial market infrastructure" refers to any multilateral system used to facilitate the clearing, settlement or recording of securities, derivatives and other financial transactions (including a DCO, clearing agency and swap data repository).

- Principle 20 of the PFMI provides that an FMI that establishes a link with one or more FMIs[7] should identify, monitor and manage link-related risks. The PFMI Memorandum clarifies that the DCR interprets CFTC Regulation 39.13 to require a SIDCO or Subpart C DCO that engages in link arrangements with other FMIs (including CCPs, central securities depositories or trade repositories) to manage the risks arising from these link arrangements consistent with this Principle by:
  - identifying, monitoring and managing all potential sources of risks arising from the link both before entering into the arrangement and on an ongoing basis thereafter;
  - ensuring the link has a well-founded legal basis in all relevant jurisdictions that supports its design and protects all FMIs involved in the link;
  - ensuring that prior to entering any link arrangement with another CCP, it identifies and manages the potential spill-over effects from the default of the other CCP; and
  - ensuring that, for any link arrangement with another CCP, it is able to cover, on at least a daily basis, its current and potential future exposures to the linked CCP and its participants, if any, fully with a high degree of confidence without reducing its ability to fulfil its obligations to its own participants at any time.

Protection of Customer and Clearing Member Assets and Funds

CFTC Regulation 39.15 requires all DCOs to protect the assets and funds of clearing members and their customers by establishing standards and procedures to protect and ensure the safety of such funds and assets and by holding such funds and assets in a manner which minimizes the risk of loss or of delay in the access by the DCO to such funds and assets.

In addition, CFTC Regulation 39.21(a) requires all DCOs to provide to market participants sufficient information to enable them to identify and evaluate accurately the risks and costs associated with using the DCO's services.

- Principle 7 of the PFMI provides, in relevant part, that an FMI should effectively measure, monitor and manage its liquidity risk. The PFMI

[7] As noted in paragraph 2.3 of the PFMI, FMIs may be linked to or dependent upon one another, may have common participants and may serve interconnected institutions and markets. These interdependencies may introduce systemic risk (for instance, by allowing disruptions to spread quickly and widely across markets).

Memorandum clarifies that since one of the most effective ways for a DCO to manage liquidity risk is to use central bank services, the DCR interprets CFTC Regulation 39.15, consistent with Principle 7, to require that to the extent a SIDCO or Subpart C DCO has the opportunity to access central bank accounts or payment or custodial services, it must do so when practicable.[8]

- Principle 16 of the PFMI provides that an FMI should safeguard its own and its participants' assets to minimize the risk of loss on and delay in access to such assets, and that an FMI's investments should be in instruments with minimal credit, market and liquidity risks. The PFMI Memorandum clarifies that the DCR interprets CFTC Regulations 39.15 and 39.21 to require a SIDCO or Subpart C DCO to: (1) to evaluate and understand its exposures to, and to consider the full scope of its relationship with, each custodian bank when conducting due diligence on such custodians; (2) ensure that its investment strategy is consistent with its overall risk management framework; and (3) disclose its strategy to market participants, all in a manner consistent with Principle 16 of the PFMI.

FORCED TRADE LETTER

Background

In addition to the interpretations in the PFMI Memorandum, the CFTC issued the Forced Trade Letter to clarify the application of certain regulatory requirements to the "firm or forced trades" process used by some DCOs to determine the price of swaps for which public market prices are unavailable.

The Forced Trade Letter explains that although the details of firm or forced trade processes used by DCOs vary, a DCO using such a process will generally require its clearing members to submit both bid and ask prices for the relevant swaps, and will then match the bid and ask prices submitted by the various clearing members and, under certain conditions, require a clearing member to buy or sell a swap at a price based on the clearing member's submitted bid or ask price.[9] The process is intended to ensure the integrity of end-of-day pricing in the absence of

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[8] In the United States, only SIDCOs may be authorized to establish accounts at the Federal Reserve Banks. In other jurisdictions, CCPs may be permitted or required to hold accounts at the jurisdictions' central bank.

[9] The Divisions note that this process may include a random component, such as only effecting such firm or forced trades on certain trading days, some of which are determined randomly and are only identified to members after the DCO has effected the trades.

a continuous liquid market for a given product by incentivizing clearing members to submit fair and accurate bid and ask prices, satisfying the DCO's obligations under CFTC Regulation 39.13(g)(5), in the context of variation margin payments and collections, to have "a reliable source of timely price data" and to implement "written procedures and sound valuation models for addressing circumstances where pricing data is not readily available or reliable."

The Forced Trade Letter was issued in response to a request by ICE Clear Credit ("ICE") for an interpretation regarding CFTC Regulation 37.3(a)(1), which implements section 5h(a)(1) of the CEA[10] by requiring a person operating a facility that offers a multilateral trading platform to register as a swap execution facility ("SEF") or designated contract market ("DCM"). Specifically, ICE requested clarification as to (1) whether a DCO's use of a firm or forced trade process to help determine end-of-day swap pricing information would require the DCO to register as a SEF, (2) whether the swaps resulting from such a process would be subject to the trade execution requirement of section 2(h)(8) of the CEA[11] and (3) whether the DCO would be the counterparty required to report such swaps under Part 45 of the CFTC Regulations.

Divisions' Interpretations

The Forced Trade Letter grants ICE's requested interpretation on each of its queries.

SEF Registration

First, the Divisions state that a DCO's use of a firm or forced trade process would not, by itself, require it to register as a SEF under CFTC Regulation 37.3(a)(1). The Divisions note that in proposing and adopting the SEF regime under Part 37, the CFTC stated that section 1a(50) of the CEA defines a SEF as, in part, "a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system." This language, in the Divisions' view, "implies a functionality that market participants may exercise in their discretion to submit

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[10] Section 5h(a)(1) of the CEA prohibits any person from operating a facility for the trading or processing of swaps unless the facility is registered as a SEF or DCM.

[11] For additional information on the trade execution requirement, see our client memorandum, "Mandatory Exchange-Trading for Swaps," (Dec. 12, 2013), available at: http://www.debevoise.com/insights/publications/2013/12/mandatory-exchangetrading-for-swaps. See also our subsequent client update on developments relating to the trade execution requirement, available at: [DOC PROD: INSERT CLICKABLE LINK: http://www.debevoise.com/insights/publications/2014/02/recent-cftc-actions-relating-to-mandatory-exchan__.

orders for execution and enter into desired trades," whereas the firm or forced trade process requires clearing members to enter into swap transactions they have not sought out and may not wish to enter. In addition, the Divisions note that the firm or forced trade process does not provide its participants the ability to accept bids and offers made by multiple participants; rather, the DCO requires clearing members to submit prices and, based on those submissions, selects clearing members to enter into swaps.

The Divisions also note that SEFs are required under CFTC Regulation 37.3(a)(2) to ensure that their systems or platforms provide at least a minimum functionality to allow their participants the ability to make executable bids and offers, and to display them to all other SEF participants.[12] In the Divisions' view, this requirement indicates that the CFTC did not contemplate DCOs registering as SEFs in connection with an activity such as the firm or forced trade process, since providing for transparent bids and offers would expose the process to manipulation.

Finally, the Divisions note that because DCOs are already regulated by the CFTC, their end-of-day pricing practices are already subject to CFTC examination and supervision.

Clearing and Trade Execution

The Divisions clarify in the Forced Trade Letter that the swap generated as a result of the firm or forced trade process is not subject to the clearing or trade execution requirements. The Divisions note that swaps created by this process cannot logically be subject to the clearing requirement, as the DCO is a party to the swap (such that it cannot be submitted to a DCO for clearing), and since the trade execution requirement only applies to swaps required to be cleared, such swaps are not subject to the trade execution requirement.

DCO as Reporting Party

The Divisions clarify that swaps created by the firm or forced trade process would qualify as "clearing swaps" under the CFTC's recently proposed amendments to the swap data reporting requirements in Part 45, which define "clearing swaps" as swaps created pursuant to the rules of a DCO that have a DCO as a counterparty. The Divisions conclude that since the proposed

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[12] See the adopting release accompanying the CFTC's final rules on core principles for SEFs, 78 Fed. Reg. 33,476 at 33,484, available at: https://www.federalregister.gov/articles/2013/06/04/2013-12242/core-principles-and-other-requirements-for-swap-execution-facilities.

amendments to Part 45 would establish the DCO as the reporting party for clearing swaps, the DCO would be the reporting party for swaps created by the firm or forced trade process.

Expiring No-Action Relief

The Divisions' issuance of the Forced Trade Letter results in the expiration of the existing no-action relief available to DCOs and their clearing members from the SEF registration requirement, the trade execution requirement and various Part 45 reporting requirements in connection with certain cleared credit default swaps ("CDS") entered into pursuant to a DCO's firm or forced trade process.[13]

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Please do not hesitate to contact us with any questions.

[13] See CFTC Letter No. 14-119, dated Sep. 29, 2014, available at: http://www.cftc.gov/PressRoom/PressReleases/pr7016-14 (providing that this no-action relief would expire on the earlier of September 30, 2015 or the effective date of any Division or CFTC action to facilitate a longer-term approach to establishing settlement prices for CDS).