

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 39

RIN 3038-AC98

Enhanced Risk Management Standards for Systemically Important Derivatives Clearing Organizations

AGENCY: Commodity Futures Trading Commission

ACTION: Final rule

SUMMARY: The Commodity Futures Trading Commission (“Commission” or “CFTC”) is adopting final regulations to implement enhanced risk management standards for systemically important derivatives clearing organizations that include (1) increased financial resources requirements for systemically important derivatives clearing organizations that are involved in activities with a more complex risk profile or that are systemically important in multiple jurisdictions, (2) the prohibited use of assessments by systemically important derivatives clearing organizations in calculating their available default resources, and (3) enhanced system safeguards for systemically important derivatives clearing organizations for business continuity and disaster recovery (“BC-DR”). This final rule also implements special enforcement authority over systemically important derivatives clearing organizations granted to the Commission under section 807(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

DATES: The rules will become effective [INSERT DATE THAT IS 60 DAYS AFTER PUBLICATION OF THIS RULE IN THE FEDERAL REGISTER]. Systemically important derivatives clearing organizations must comply with § 39.29 and § 39.30 no later than December 31, 2013.

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- I. Background**
 - A. Core Principles for DCOs

On July 21, 2010, President Obama signed the Dodd-Frank Act.¹ Title VII of the Dodd-Frank Act, entitled the “Wall Street Transparency and Accountability Act of 2010,”² amended the Commodity Exchange Act (“CEA” or the “Act”)³ to establish a comprehensive regulatory framework for over-the-counter (“OTC”) derivatives, including swaps. The legislation was enacted 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 mandatory clearing and trade execution requirements on clearable swap contracts; (3) creating rigorous recordkeeping and real-time reporting regimes; and (4) enhancing the Commission’s rulemaking and enforcement authorities with respect to, among others, 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 that a derivatives clearing organization (“DCO”) must comply with to register and maintain registration with the Commission. The core principles were originally added to the CEA by the Commodity Futures Modernization Act of 2000 (“CFMA”),⁴ and in 2001, the Commission issued guidance on DCO compliance with these core principles.⁵ However, in furtherance of the goals of the Dodd-Frank Act to reduce risk, increase transparency, and promote market integrity, the Commission, pursuant to the Commission’s

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/ucm/groups/public/@swaps/documents/file/hr4173_enrolledbill.pdf.

² Section 701 of the Dodd-Frank Act.

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 A New Regulatory Framework for Clearing Organizations, 66 FR 45604 (Aug. 29, 2001) (final rule) (adopting 17 CFR part 39, app. A).

enhanced rulemaking authority,⁶ withdrew the 2001 guidance and adopted regulations establishing standards for compliance with the DCO core principles.⁷

As noted in the preamble to the adopting release for subparts A and B of part 39 of the Commission’s regulations, the regulations that implement the DCO core principles, the Commission sought to provide legal certainty for market participants, strengthen the risk management practices of DCOs, and increase overall confidence in the financial system by assuring the public that DCOs are meeting minimum risk management standards.⁸ These risk management standards include, in part:

(1) with respect to financial resources, (a) Core Principle B, which requires DCOs to have “adequate financial, operational, and managerial resources, as determined by the Commission, to discharge each responsibility of the [DCO],”⁹ and (b) Commission regulation 39.11, which requires 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,¹⁰ and permits the inclusion of assessment powers to meet a limited portion of the DCO’s default resources requirement;¹¹ and

⁶ See section 725(c) of the Dodd-Frank Act (explicitly giving the Commission authority to promulgate rules regarding the core principles pursuant to its rulemaking authority under section 8a(5) of the CEA, 7 U.S.C. 12a(5)).

⁷ See Derivatives Clearing Organization General Provisions and Core Principles, 76 FR 69334 (Nov. 8, 2011) (final rule).

⁸ Id. at 69335.

⁹ Core Principle B also expressly requires DCOs to “possess financial resources that, at a minimum, exceed the total amount that would (I) enable the organization to meet its financial obligations to its members and participants notwithstanding a default by the member or participant creating the largest financial exposure for that organization in extreme but plausible market conditions; and (II) enable the [DCO] to cover operating costs of the [DCO] for a period of 1 year (as calculated on a rolling basis).” Section 5b(c)(2)(B) of the CEA, 7 U.S.C. 7a-1(c)(2)(B) (emphasis added).

¹⁰ 17 CFR 39.11(a)(1) (implementing Core Principle B pertaining to financial resources).

¹¹ See 17 CFR 39.11(d)(2)(iii) (requiring a DCO to apply a 30 percent haircut to the value of potential assessments); see also 17 CFR 39.11(d)(2)(iv) (permitting a DCO to count the value of assessments, after the 30 percent haircut, to meet up to 20 percent of its default obligations).

(2) with respect to business continuity, (a) Core Principle I, which requires DCOs to “establish and maintain emergency procedures, backup facilities, and a plan for disaster recovery that allows for (I) the timely recovery and resumption of operations of the [DCO], and (II) the fulfillment of each obligation and responsibility of the [DCO],”¹² and (b) Commission regulation 39.18, which requires a DCO to maintain a BC-DR plan, emergency procedures, and physical, technological, and personnel resources sufficient to enable the DCO to resume daily processing, clearing, and settlement no later than the next business day following the disruption of its operations.¹³

B. Designation of Systemically Important Derivatives Clearing Organizations Under Title VIII of the Dodd-Frank Act

Title VIII of the Dodd-Frank Act, entitled “Payment, Clearing, and Settlement Supervision Act of 2010,”¹⁴ was enacted to mitigate systemic risk in the financial system and promote financial stability.¹⁵ Section 804 of the Dodd-Frank Act requires the Financial Stability Oversight Council (“Council”)¹⁶ to designate those financial market utilities (“FMUs”) that the

¹² Core Principle I also requires DCOs to “establish and maintain a program of risk analysis and oversight to identify and minimize sources of operational risk through the development of appropriate controls and procedures, and automated systems, that are reliable, secure, and have adequate scalable capacity,” and “periodically conduct tests to verify that the backup resources of the [DCO] are sufficient to ensure daily processing, clearing, and settlement.” Section 5b(c)(2)(I) of the CEA, 7 U.S.C. 7a-1(c)(2)(I).

¹³ 17 CFR 39.18(e)(3) (implementing Core Principle I pertaining to system safeguards).

¹⁴ Section 801 of the Dodd-Frank Act.

¹⁵ Section 802(b) of the Dodd-Frank Act.

¹⁶ The Council was established by section 111 of the Dodd-Frank Act. In general, the Council is tasked with identifying “risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace,” promoting “market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure,” and responding “to emerging threats to the stability of the United States financial system.” Section 112(a)(1) of the Dodd-Frank Act.

Council determines are, or are likely to become, systemically important.¹⁷ An FMU includes “any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person.”¹⁸ As noted by the Council,

FMUs form a critical part of the nation’s financial infrastructure. They exist in many markets to support and facilitate the transfer, clearing or settlement of financial transactions, and their smooth operation is integral to the soundness of the financial system and the overall economy. However, their function and interconnectedness also concentrate a considerable amount of risk in the financial system due, in large part, to the interdependencies, either directly through operational, contractual or affiliation linkages, or indirectly through payment, clearing, and settlement processes. In other words, problems at one FMU could trigger significant liquidity and credit disruptions at other FMUs or financial institutions.¹⁹

In determining whether an FMU is systemically important, the Council uses a two-stage designation process, applying certain statutory considerations²⁰ and other metrics to assess,

¹⁷ Section 804(a)(1) of the Dodd-Frank Act. The term “systemically important” means “a situation where the failure of or a disruption to the functioning of a financial market utility... could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States.” Section 803(9) of the Dodd-Frank Act; see also Authority to Designate Financial Market Utilities as Systemically Important, 76 FR 44763, 44774 (July 27, 2011) (final rule).

¹⁸ Section 803(6)(A) of the Dodd-Frank Act. The term expressly excludes the following:

“(i) designated contract markets, registered futures associations, swap data repositories, and swap execution facilities registered under the Commodity Exchange Act (7 U.S.C. 1 et seq.), or national securities exchanges, national securities associations, alternative trading systems, security-based swap data repositories, and swap execution facilities registered under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), solely by reason of their providing facilities for comparison of data respecting the terms of settlement of securities or futures transactions effected on such exchange or by means of any electronic system operated or controlled by such entities, provided that the exclusions in this clause apply only with respect to the activities that require the entity to be so registered; and

(ii) any broker, dealer, transfer agent, or investment company, or any futures commission merchant, introducing broker, commodity trading advisor, or commodity pool operator, solely by reason of functions performed by such institution as part of brokerage, dealing, transfer agency, or investment company activities, or solely by reason of acting on behalf of a financial market utility or a participant therein in connection with the furnishing by the financial market utility of services to its participants or the use of services of the financial market utility by its participants, provided that services performed by such institution do not constitute critical risk management or processing functions of the financial market utility.” Section 803(6)(B) of the Dodd-Frank Act.

¹⁹ 76 FR at 44763.

among other things, “whether possible disruptions [to the functioning of an FMU] are potentially severe, not necessarily in the sense that they themselves might trigger damage to the U.S. economy, but because such disruptions might reduce the ability of financial institutions or markets to perform their normal intermediation functions.”²¹ On July 18, 2012, the Council designated eight FMUs as systemically important under Title VIII.²² Two of these designated FMUs are CFTC-registered DCOs²³ for which the Commission is the Supervisory Agency.²⁴ Such designated CFTC-registered DCOs are also known as systemically important derivatives clearing organizations (“SIDCOs”).²⁵

C. Standards for SIDCOs under Title VIII of the Dodd-Frank Act

Section 805 of the Dodd-Frank Act directs the Commission to consider relevant international standards and existing prudential requirements when prescribing risk management standards governing the operations related to payment, clearing, and settlement activities for FMUs that are (1) designated as systemically important by the Council, and (2) engaged in

²⁰ Under section 804(a)(2) of the Dodd-Frank Act, in determining whether an FMU is or is likely to become systemically important, the Council must take into consideration the following: (A) the aggregate monetary value of transactions processed by the FMU; (B) the aggregate exposure of an FMU to its counterparties; (C) the relationship, interdependencies, or other interactions of the FMU with other FMUs or payment, clearing, or settlement activities; (D) the effect that the failure of or a disruption to the FMU would have on critical markets, financial institutions, or the broader financial system; and (E) any other factors the Council deems appropriate.

²¹ 76 FR at 44766.

²² See Press Release, Financial Stability Oversight Council, Financial Stability Oversight Council Makes First Designations in Effort to Protect Against Future Financial Crises (July 18, 2012), available at <http://www.treasury.gov/press-center/press-releases/Pages/tg1645.aspx>.

²³ Chicago Mercantile Exchange, Inc. (“CME”) and ICE Clear Credit LLC (“ICE Clear Credit”) are the CFTC-registered DCOs that were designated systemically important by the Council, for which CFTC is the Supervisory Agency. While The Options Clearing Corporation (“OCC”), a CFTC-registered DCO, was designated systemically important by the Council, the Securities and Exchange Commission (“SEC”) serves as OCC’s Supervisory Agency.

²⁴ See section 803(8)(A) of the Dodd-Frank Act (defining “Supervisory Agency” as “the Federal agency that has primary jurisdiction over a designated [FMU] under Federal banking, securities, or commodity futures laws”).

²⁵ Specifically, under Commission regulations, a systemically important derivatives clearing organization is 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 Act].” See 17 CFR 39.2.

activities for which the Commission is the Supervisory Agency.²⁶ Under Title VIII, the objectives and principles for these risk management standards are to: (1) promote risk management; (2) promote safety and soundness; (3) reduce systemic risks; and (4) support the stability of the broader financial system.²⁷ As outlined in section 805(c), these standards may address such areas as: “(1) risk management policies and procedures; (2) margin and collateral requirements; (3) participant or counterparty default policies and procedures; (4) the ability to complete timely clearing and settlement of financial transactions; (5) capital and financial resources requirements for designated [FMUs]; and (6) other areas that are necessary to achieve the objectives and principles in [section 805(b) of the Dodd-Frank Act].”

The Commission has reviewed the risk management standards set forth in part 39 of the Commission’s regulations in light of recently promulgated relevant international standards and existing prudential requirements to identify those areas in which additional risk management standards for SIDCOs would be necessary and appropriate.

D. Principles for Financial Market Infrastructures

1. Overview

The Commission has determined that the international standards most relevant to the risk management of SIDCOs, for purposes of meeting the Commission’s obligation pursuant to section 805(a)(2)(A) of the Dodd-Frank Act, are the Principles for Financial Market Infrastructures (“PFMIs”), which were developed by the Bank for International Settlements’

²⁶ See section 805(a)(2) of the Dodd-Frank Act. The Commission notes that it also has the authority to prescribe risk management standards governing the operations related to payment, clearing, and settlement activities for FMUs that are designated as systemically important by the Council and that are engaged in activities for which the Commission is the appropriate financial regulator. Furthermore, section 805 establishes a review mechanism by which the Council may intervene if the Board of Governors of the Federal Reserve System (the “Board”) determines that the existing risk management standards set by the Commission “are insufficient to prevent or mitigate significant liquidity, credit, operational, or other risks to the financial markets or to the financial stability of the United States.” Section 805(a)(2)(B) of the Dodd-Frank Act.

²⁷ Section 805(b) of the Dodd-Frank Act.

Committee on Payment and Settlement Systems (“CPSS”) and the Technical Committee of the International Organization of Securities Commissions (“IOSCO”) (collectively, “CPSS-IOSCO”).²⁸ The Commission notes that the adoption and implementation of the PFMI by numerous foreign jurisdictions highlights the role these principles play in creating a global, unified set of international risk management standards for central counterparties (“CCPs”).²⁹ Moreover, the Commission, which is a member of the Board of IOSCO, is working towards implementing rules and regulations that are fully consistent with the PFMI by the end of 2013.³⁰

²⁸ 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,” (April 2012), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD377.pdf> ; see also Financial Stability Board, “OTC Derivatives Market Reforms: Third Progress Report on Implementation,” (June 15, 2012), available at http://www.financialstabilityboard.org/publications/r_120615.pdf (noting publication of the PFMI as achieving “an important milestone in the global development of a sound basis for central clearing of all standardised OTC derivatives”).

²⁹ In Asia, Singapore has adopted the PFMI into its financial regulations pertaining to FMI. See Monetary Authority of Singapore, “Supervision of Financial Market Infrastructures in Singapore,” (January 2013), available at <http://www.mas.gov.sg/~media/MAS/About%20MAS/Monographs%20and%20information%20papers/MASMonograph%20Supervision%20of%20Financial%20Market%20Infrastructures%20in%20Singapore%202.pdf>. In addition, Australia, Canada and the European Union have publicly indicated their intent to adopt the PFMI. See Reserve Bank of Australia, “Consultation on New Financial Stability Standards,” (August 2012), available at <http://www.rba.gov.au/payments-system/clearing-settlement/consultations/201208-new-fin-stability-standards/index.html>; Canadian Securities Administrators Consultation Paper 91-406 “Derivatives: OTC Central Counterparty Clearing,” (June 20, 2012), available at http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20120620_91-406_counterparty-clearing.pdf; and Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories, preamble paragraph 90, 2012 O.J. (L 201), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:FULL:EN:PDF>.

In the United States, the SEC adopted a final rule that incorporates heightened risk management standards for CCPs that clear security-based swaps, based on, in part, the PFMI’s “cover two” standard for CCPs engaged in a more complex risk profile or that are systemically important in multiple jurisdictions. See 17 CFR 240.17Ad-22(b)(3) (2013) (requiring, in relevant part, SEC-registered clearing agencies (*i.e.*, CCPs) to maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which they have the largest exposure in extreme but plausible conditions, provided that a security-based swap clearing agency, (*i.e.*, a CCP that clears security-based swaps) shall maintain sufficient financial resources to withstand, at a minimum, a default by the two participant families to which it has the largest exposure in extreme but plausible market conditions).

³⁰ Part 39 of the Commission’s regulations was informed by the consultative report for the PFMI and incorporates the vast majority of the standards set forth in the PFMI. See Financial Resources Requirements for Derivatives Clearing Organizations, 75 FR 63113 (Oct. 14, 2010); Risk Management Requirements for Derivatives Clearing Organizations, 76 FR 3698 (Jan. 20, 2011); see also 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,” (March 2011), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD350.pdf> (“CPSS-IOSCO Consultative Report”).

The PFMIs establish international risk management standards for financial market infrastructures (“FMIs”), including CCPs, that facilitate clearing and settlement.³¹ In February 2010, CPSS-IOSCO launched a review of the existing sets of international standards for FMIs in support of a broader effort by the Financial Stability Board (“FSB”)³² to strengthen core financial infrastructures and markets by ensuring that gaps in international standards are identified and addressed.³³ CPSS-IOSCO endeavored to incorporate in its review process lessons from the 2008 financial crisis and the experience of using the existing international standards, as well as policy and analytical work by other international committees including the Basel Committee on Banking Supervision (“BCBS”).³⁴ The PFMIs replace CPSS-IOSCO’s previous recommendations applicable to CCPs.³⁵ In issuing the PFMIs, CPSS-IOSCO sought to strengthen and harmonize existing international standards and incorporate new specifications for CCPs clearing OTC derivatives.³⁶ The stated objectives of the PFMIs are to enhance the safety and efficiency of FMIs and, more broadly, reduce systemic risk and foster transparency and financial stability.³⁷

³¹ The PFMIs define a “financial market infrastructure” as a “multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities, derivatives, or other financial transactions.” See PFMIs, Introduction, 1.8.

³² The FSB is an international organization that coordinates with national financial authorities and international policy organizations to develop and promote effective regulatory, supervisory, and other financial sector policies. See generally <http://www.financialstabilityboard.org>.

³³ PFMIs, Background, 1.6.

³⁴ Id.

³⁵ The international standards for FMIs, prior to the publication of the PFMIs, included the “Recommendations for Securities Settlement Systems” published by CPSS in 2001, the “Core Principles for Systemically Important Payment Systems” published by CPSS-IOSCO in 2001, and the “Recommendations for Central Counterparties” published by CPSS-IOSCO in 2004 (collectively the “CPSS-IOSCO Principles and Recommendations”). See PFMIs, Background, 1.4 and 1.5.

³⁶ Id. at Introduction, 1.2.

³⁷ Id. at Background, 1.15.

The PFMI's set out 24 principles addressing various risk components of an FMI's operations, including, as most relevant to this final rule, credit and operational risk.³⁸

2. Principle 4: Credit Risk

Principle 4 addresses the risk that a counterparty to the CCP will be unable to fully meet its financial obligations when due.³⁹ Specifically, Principle 4 states that a “CCP should cover its current and potential future exposures to each participant fully with a high degree of confidence using margin and other prefunded financial resources.”⁴⁰ Additionally, Principle 4 provides that a CCP involved in activities with a more complex risk profile⁴¹ or that is systemically important in multiple jurisdictions should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios, including, but not limited to, the default of the two participants and their affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions.⁴²

More generally, Principle 4 states that all FMIs should establish explicit rules and procedures to address any credit losses they may face as a result of an individual or combined default among its participants with respect to any of their obligations to the FMI.⁴³ These rules

³⁸ Pursuant to the PFMI's, key risks faced by FMIs include legal, credit, liquidity, general business, custody, investment, and operational risks. See id. at Overview of Key Risks in Financial Market Infrastructures, 2.1.

³⁹ The PFMI's define “credit risk” as the “risk that a counterparty, whether a participant or other entity, will be unable to meet fully its financial obligations when due, or at any time in the future.” Id. at Annex H: Glossary.

⁴⁰ Id. at Principle 4: Credit Risk, Key Consideration 4.

⁴¹ Such activities “with a more complex risk profile” include clearing financial instruments that are characterized by discrete jump-to-default price changes or that are highly correlated with potential participant defaults. Id. at Principle 4: Credit Risk, Explanatory Note 3.4.19.

⁴² Id. at Principle 4: Credit Risk. Financial resources sufficient to cover the default of the two participants and their affiliates creating the largest credit exposure in extreme but plausible circumstances are sometimes referred to as cover two. All other CCPs, under the PFMI's, are required to maintain financial resources sufficient to cover a wide range of potential stress scenarios, which includes, but is not limited to, the default of the participant and its affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions, otherwise known as “cover one.” Id.

⁴³ Id. at Principle 4: Credit Risk, Key Consideration 7.

and procedures should also address how potentially uncovered credit losses would be allocated, how the funds an FMI may borrow from liquidity providers would be repaid, and how an FMI would replenish the financial resources used during a stress event, such as a default, so that the FMI can continue to operate in a safe and sound manner.⁴⁴

3. Principle 17: Operational Risk

Principle 17 addresses the risk of deficiencies in information systems or internal processes, human errors, management failures, or disruptions from external events that will result in the reduction or deterioration of services provided by the FMI.⁴⁵ Principle 17 states that “[b]usiness continuity management should aim for timely recovery of operations and fulfilment [sic] of the FMI’s obligations, including in the event of a wide-scale or major disruption.”⁴⁶ Additionally, an FMI’s business continuity plan “should incorporate the use of a secondary site and should be designed to ensure that critical information technology (IT) systems can resume operations within two hours following disruptive events.”⁴⁷

4. The Role of the PFMI in International Banking Standards

Where a CCP is prudentially supervised in a jurisdiction that does not have domestic rules and regulations that are consistent with the PFMI, the implementation of certain international banking regulations will have significant cost implications for that CCP and its market participants.

⁴⁴ Id.

⁴⁵ Id. at Overview of Key Risks in Financial Market Infrastructures, 2.9.

⁴⁶ Id. at Principle 17: Operational Risk.

⁴⁷ Id. at Key Consideration 6.

In July 2012, the BCBS,⁴⁸ the international body that sets standards for the regulation of banks, published the “Capital Requirements for Bank Exposures to Central Counterparties” (“Basel CCP Capital Requirements”), which sets forth interim rules governing the capital charges arising from bank exposures to CCPs related to OTC derivatives, exchange-traded derivatives, and securities financing transactions.⁴⁹ The Basel CCP Capital Requirements create financial incentives for banks⁵⁰ to clear financial derivatives with CCPs that are licensed in a jurisdiction where the relevant regulator has adopted rules or regulations that are consistent with the PFMIs. Specifically, the Basel CCP Capital Requirements introduce new capital charges based on counterparty risk for banks conducting financial derivatives transactions through a CCP.⁵¹ These new capital charges relate to a bank’s trade exposure and default fund exposure to a CCP.⁵²

⁴⁸ The BCBS is comprised of senior representatives of bank supervisory authorities and central banks from around the world, including Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. See Bank for International Settlements’ Basel Committee on Banking Supervision, “Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems,” (December 2010; revised June 2011), available at <http://www.bis.org/publ/bcbs189.htm> (“Basel III: A Global Regulatory Framework”).

⁴⁹ See Bank for International Settlements’ Basel Committee on Banking Supervision, “Capital Requirements for Bank Exposures to Central Counterparties,” (July 2012), available at www.bis.org/publ/bcbs227.pdf (“Basel CCP Capital Requirements”). The Basel CCP Capital Requirements are one component of Basel III, a framework that is part of “a comprehensive set of reform measures, developed by the [BCBS], to strengthen the regulation, supervision and risk management of the banking sector.” See Bank for International Settlements’ website for a compilation of documents that form the regulatory framework of Basel III, available at <http://www.bis.org/bcbs/basel3.htm>.

⁵⁰ “Bank” is defined in accordance with the Basel framework to mean bank, banking group, or other entity (*i.e.*, bank holding company) whose capital is being measured. See Basel III: A Global Regulatory Framework, Definition of Capital, paragraph 51, at 12. The term “bank,” as used herein, also includes subsidiaries and affiliates of the banking group or other entity. The Commission notes that a bank may be a client and/or a clearing member of a SIDCO.

⁵¹ See Basel CCP Capital Requirements, Annex 4, section II, 6(i).

⁵² “Trade exposure” is a measure of the amount of loss a bank is exposed to based on the size of its position, given a CCP’s failure. Under the Basel CCP Capital Requirements, “trade exposure” is defined to include the current and potential future exposure of a bank acting as either a clearing member or a client to a CCP arising from OTC derivatives, exchange traded derivatives transactions, or securities financing transactions, as well as initial margin. See Basel CCP Capital Requirements, Annex 4, section I, A: General Terms. “Current exposure” includes variation margin that is owed by the CCP but not yet been received by the clearing member or client. *Id.* at n. 2. “Default

The capital charges for trade exposure are based upon a function that multiplies exposure by risk weight. Risk weight is a measure that represents the likelihood that the loss to which the bank is exposed will be incurred, and the extent of that loss. The risk weight assigned under the BCBS standards varies significantly depending on whether or not the counterparty is a “qualified” CCP (“QCCP”).⁵³ A “QCCP” is defined as an entity that (1) is licensed to operate as a CCP, and is permitted by the appropriate regulator to operate as such, and (2) is prudentially supervised in a jurisdiction where the relevant regulator has established and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the PFMIIs.⁵⁴ If a bank transacts through a QCCP acting either as (1) a clearing member of a CCP for its own account or for clients,⁵⁵ or (2) a client of a clearing member that enters into an OTC derivatives transaction with the clearing member acting as a financial intermediary, then the risk weight is 2 percent for purposes of calculating the counterparty risk.⁵⁶ If the CCP is non-

fund exposure” is a measure of the loss a bank acting as a clearing member is exposed to arising from the use of its contributions to the CCP’s mutualized default fund resources. See Basel CCP Capital Requirements, Annex 4, section I, A: General Terms. BIS defines “potential future exposure” as “the additional exposure that a counterparty might potentially assume during the life of a contract or set of contracts beyond the current replacement cost of the contract or set of contracts.” See Bank for International Settlements’ Committee on Payment and Settlement Systems, “A Glossary of Terms Used in Payment and Settlement Systems,” (March 2003), available at <http://www.bis.org/publ/cpss00b.pdf>.

⁵³ See id. at Annex 4, section IX., Exposures to Qualifying CCPs, paragraphs 110-119 (describing the methodology for calculating a bank’s trade exposure to a qualified CCP); see also id. at paragraph 126 (describing the methodology for calculating a bank’s trade exposure to a non-qualifying CCP).

⁵⁴ Id. at section I, A: General Terms.

⁵⁵ The term “client” as used herein refers to a customer of a bank.

⁵⁶ Id. at section IX: Central Counterparties, paragraphs 110 and 114. Client trade exposures are risk-weighted at 2 percent if the following two conditions are met: (1) the offsetting transactions are identified by the CCP as client transactions and collateral to support them is held by the CCP and/or clearing member, as applicable, under arrangements that prevent losses to the client due to the default or insolvency of the clearing member, or the clearing member’s other clients, or the joint default or insolvency of the clearing member and any of its other clients, and (2) relevant laws, regulations, contractual or administrative arrangements provide that the offsetting transactions with the defaulted or insolvent clearing member are highly likely to continue to be indirectly transacted through the CCP, or by the CCP, should the clearing member default or become insolvent. However, in certain circumstances, risk weight may increase. Specifically, if the first condition is not met (*i.e.*, where a client is not protected from losses in the case that the clearing member and another client of the clearing member jointly default or become jointly

qualifying, then the risk weight is the same as a bilateral OTC derivative trade and the bank applies the corresponding bilateral risk-weight treatment, which is at least 20 percent if the CCP is a bank, or as high as 100 percent if the CCP is a corporate financial institution.⁵⁷

With respect to default fund exposure, whenever a clearing member bank is required to capitalize for exposures arising from default fund contributions to a QCCP, the clearing member bank may apply one of two methodologies for determining the capital requirement: the risk-sensitive approach, or the 1250 percent risk-weight approach.⁵⁸ The risk-sensitive approach considers various factors in determining the risk weight for a bank's default exposure to a QCCP, such as (1) the size and quality of a QCCP's financial resources, (2) the counterparty credit risk exposures of such CCP, and (3) the application of such financial resources via the CCP's loss bearing waterfall in the event one or more clearing members default.⁵⁹ The 1250 percent risk-weight approach allows a clearing member bank to apply a 1250 percent risk weight to its default fund exposures to the QCCP, subject to an overall cap of 20 percent on the risk-weighted assets from all trade exposures to the QCCP.⁶⁰ In other words, banks with exposures to QCCPs have a

insolvent), but the second condition is met, the bank's trade exposure is risk-weighted at 4 percent. If neither condition is met, the bank must capitalize its exposure to the CCP as a bilateral trade. *Id.* at paragraphs 115 and 116.

⁵⁷ See Bank for International Settlements' Basel Committee on Banking Supervision, "Consultative Document: Capitalisation of Bank Exposures to Central Counterparties," (November 2011; revised July 2012), paragraph 28, available at <http://www.bis.org/publ/bcbs206.pdf> (stating that "the applicable risk weight [for clearing member trades with a non-qualifying CCP] would be at least 20% (if the CCP is a bank) or 100% (if it is a corporate financial institution according to the definition included in paragraph 272 of the Basel framework, revised by Basel III)"); see also Basel III: A global regulatory framework for more resilient banks and banking systems (June 2011), paragraph 102, available at <http://www.bis.org/publ/bcbs189.pdf> (revising paragraph 272 of the Basel framework).

⁵⁸ See Basel CCP Capital Requirements, Annex 4, section IX, paragraphs 121-125. The Commission notes that the 1250 percent risk weight represents the reciprocal of the 8 percent capital ratio, which is the percentage of a bank's capital to its risk-weighted assets (i.e., 1250 percent times 8 percent equals 100 percent).

⁵⁹ *Id.* at paragraph 122.

⁶⁰ *Id.* at paragraph 125. See also Basel CCP Capital Requirements, Annex 4, section IX, paragraphs 125 (explaining that "More specifically, under [the 1250 percent risk-weight] approach, the Risk Weighted Assets (RWA) for both bank i's trade and default fund exposures to each CCP are equal to: $\text{Min} \{ (2\% * TE_i + 1250\% * DFi); (20\% * TE_i) \}$ where TE_i is bank i's trade exposure to the CCP, as measured by the bank according to paragraphs 110 to 112 of this Annex; and DF_i is bank i's pre-funded contribution to the CCP's default fund.").

cap on their default fund exposure. In contrast, a clearing member bank with exposures to a non-qualified CCP must apply a risk weight of 1250 percent with no cap for default fund exposures.⁶¹

Thus, the Basel CCP Capital Requirements provide incentives for banks to clear derivatives through CCPs that are QCCPs by setting lower capital charges for exposures arising from derivatives cleared through a QCCP and setting significantly higher capital charges for exposures arising from derivatives cleared through non-qualifying CCPs. The increased capital charges for transactions through non-qualifying CCPs may have significant business and operational implications for U.S. DCOs, particularly SIDCOs that operate internationally and are not QCCPs.⁶² Specifically, banks faced with much higher capital charges might transfer their OTC derivatives business away from such SIDCO to a QCCP in order to benefit from the preferential capital charges provided by the Basel CCP Capital Requirements. Alternatively, banks might reduce or discontinue their OTC business altogether. Banks might also pass on to their customers the higher costs of transacting with a non-qualifying DCO as a result of the higher capital treatment. Accordingly, customers using such banks as intermediaries would have an incentive to transfer their business to an intermediary that clears at a QCCP. In short, a SIDCO's failure to be a QCCP may cause it to face a competitive disadvantage retaining members and customers.

As discussed further below in Section VI, the incentives noted in the foregoing paragraph have important implications for the cost and benefit considerations required by section 15(a) of the CEA.

E. Existing Prudential Requirements

⁶¹ Id. at paragraph 127.

⁶² The Commission notes that the failure of SIDCOs to be QCCPs may negatively impact the broader US derivatives market as well. For example, higher clearing costs may result in fewer transactions, and less overall liquidity.

In April 2011, a year before the PFMIIs were published, the Board proposed regulation HH, which sets forth, in part, risk management standards for those FMUs, for which the Board is the Supervisory Agency, that have been designated systemically important by the Council under Title VIII.⁶³ The Board, in proposing regulation HH, stated that the risk management standards most relevant to the risk management of FMUs, and the most appropriate basis for setting initial risk management standards under Title VIII, were the then-current international risk management standards set by CPSS-IOSCO's Principles and Recommendations.⁶⁴ The Board did note, in both its proposed and final rulemaking, that CPSS-IOSCO intended to update and replace the CPSS-IOSCO Principles and Recommendations with the PFMIIs, and the Board anticipated at that time that it would review the PFMIIs, consult with other appropriate agencies and the Council, and seek public comment on the adoption of the revised international standards.⁶⁵

F. Risk Management Standards for SIDCOs

As noted above, the CEA specifies certain core principles that all DCOs must comply with in order to register and maintain registration with the Commission. Core Principle B sets out minimum financial resources requirements for all DCOs and expressly states that a DCO must have “adequate financial, operational, and managerial resources, as determined by the Commission, to discharge each responsibility of the DCO.”⁶⁶ Moreover, under Core Principle I,

⁶³ Notice of Proposed Rulemaking for Financial Market Utilities (“Regulation HH”), 76 FR 18445 (April 4, 2011) (Financial Market Utilities) (proposing regulation HH in accordance with section 805 of the Dodd-Frank Act, which directed the Board to establish risk management standards governing the operations related to the payment, clearing, and settlement activities of those FMUs that have been designated as systemically important by the Council for which the Board is the Supervisory Agency. Note, however, that FMUs that are registered as clearing agencies with the SEC under section 17A of the Securities Exchange Act of 1934, or that are registered as DCOs with the CFTC under section 5b of the CEA are expressly exempt from regulation HH.).

⁶⁴ Id. at 18447.

⁶⁵ Id. at 18448; see also Financial Market Utilities (“Regulation HH”), 77 FR 45907, 45908 (Aug. 2, 2012) (final rule).

⁶⁶ Section 5b(c)(2)(B) of the CEA, 7 U.S.C. 7a-1(c)(2)(B) (emphasis added).

a DCO must have procedures, facilities, and a disaster recovery plan that allow it to, on an emergency basis, have a “timely recovery and resumption” of its operations, and fulfill each of its obligations and responsibilities.⁶⁷ In light of the statutory language described above, and because the failure of or a disruption to the functioning of a SIDCO could “create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States,”⁶⁸ the Commission, in accordance with section 5b(c)(2) of the Act⁶⁹ and section 805 of the Dodd-Frank Act,⁷⁰ proposed heightened requirements to increase the minimum financial resources requirements for SIDCOs,⁷¹ restrict the use of assessments in meeting such obligations,⁷² enhance the system safeguards for SIDCOs,⁷³ and grant the Commission special enforcement authority over SIDCOs pursuant to section 807 of the Dodd-Frank Act.⁷⁴

First, the Commission proposed to increase the amount of financial resources a SIDCO must maintain in order to comply with Core Principle B and Commission regulation 39.11.⁷⁵ Regulation 39.11, in part, (1) requires 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

⁶⁷ Section 5b(c)(2)(I) of the CEA, 7 U.S.C. 7a-1(c)(2)(I).

⁶⁸ See supra discussion in n.17.

⁶⁹ Section 5b(c)(2) of the CEA, 7 U.S.C. 7a-1(c)(2).

⁷⁰ See section 805(a)(2) of the Dodd-Frank Act.

⁷¹ See Financial Resources Requirements for Derivatives Clearing Organizations, 75 FR 63113, 63119-63120 (Oct. 14, 2010).

⁷² Id.

⁷³ See Risk Management Requirements for Derivatives Clearing Organizations, 76 FR 3698, 3726-3727 (Jan. 20, 2011).

⁷⁴ Id. at 3727.

⁷⁵ See section 5b(c)(2)(B)(ii)(I) of the CEA, 7 U.S.C. 7a-1(c)(2)(B)(ii)(I); see also 75 FR at 63116.

conditions, provided that if a clearing member controls another clearing member or is under common control with another clearing member, affiliated clearing members shall be deemed to be a single clearing member for the purposes of this provision;⁷⁶ and (2) permits a DCO to include the value of potential assessments, subject to a 30 percent haircut, in calculating up to 20 percent of the default resource requirements.⁷⁷ For SIDCOs, the Commission proposed a regulation that would require a SIDCO to (1) maintain sufficient financial resources to meet the SIDCO's 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,⁷⁸ and (2) only count the value of assessments, after a 30 percent haircut, to meet up to 20 percent of the resources required to meet obligations arising from a default by the clearing member creating the second largest financial exposure.⁷⁹

In addition to financial resources requirements, the Commission also proposed to improve system safeguards for SIDCOs by enhancing certain BC-DR procedures.⁸⁰ Core Principle I requires a DCO to establish and maintain emergency procedures, backup facilities, and a plan for disaster recovery that allows for the timely recovery and resumption of operations.⁸¹ Pursuant to Commission regulation 39.18, the required recovery time objective would be no later than the next business day.⁸² However, because the systemic importance of

⁷⁶ See 17 CFR 39.11(a)(1); see also 75 FR 63114 (noting that for purposes of determining the largest financial exposure for DCOs under Core Principle B, the treatment of commonly controlled affiliates as a single entity is necessary because the default of one affiliate could have an impact on the ability of the other to meet its financial obligations to the DCO).

⁷⁷ 17 CFR 39.11(d)(2)(iii) and (iv).

⁷⁸ 75 FR at 63119.

⁷⁹ *Id.*

⁸⁰ See 76 FR at 3726-3727.

⁸¹ See section 5(c)(2)(I)(ii)(I) of the CEA, 7 U.S.C. 7a-1(c)(2)(I)(ii)(I).

⁸² See 17 CFR 39.18(e)(3).

SIDCOs carries with it a responsibility to be reliably available on a near-continuous basis to fulfill their obligations, the Commission proposed a regulation that would require a SIDCO to have a BC-DR plan with the objective of enabling, and the physical, technological, and personnel resources sufficient to enable, the SIDCO to recover its operations and resume daily processing, clearing, and settlement no later than two hours following the disruption, including a wide-scale disruption.⁸³

As part of the Commission's proposed regulations for SIDCOs, the Commission also included special enforcement authority over SIDCOs⁸⁴ pursuant to section 807(c) of the Dodd-Frank Act, which would grant the Commission authority under the provisions of subsections (b) through (n) of section 8 of the Federal Deposit Insurance Act ("FDIA")⁸⁵ 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.⁸⁶

The Commission requested comments on the proposed regulations,⁸⁷ including comments on the potential competitive effects of imposing higher risk standards on SIDCOs as a subset of DCOs.⁸⁸ The Commission received thirteen comment letters from the public regarding the

⁸³ 76 FR at 3726. Chicago Mercantile Exchange Inc. ("CME Clearing") and ICC, the two existing SIDCOs, must comply with regulation 39.30, including the two-hour recovery time objective requirement, by December 31, 2013. Thereafter, any DCO that is designated as systemically important by the Council for which the Commission is the Supervisory Agency will be required to comply with regulation 39.30 within one year after designation by the Council.

⁸⁴ *Id.* at 3727.

⁸⁵ *See* 12 U.S.C. 1818 (b)-(n) (granting authority for enforcement powers).

⁸⁶ 76 FR at 3727.

⁸⁷ The comment period for the proposed rule on Financial Resources Requirements for Derivatives Clearing Organizations, which proposed the increased financial resources requirements for SIDCOs, initially closed on December 13, 2010, but was extended until June 3, 2011. The comment period for the proposed rule on Risk Management Requirements for Derivatives Clearing Organizations, which proposed a two hour recovery time and special enforcement authority, closed on April 25, 2011.

⁸⁸ *See* 75 FR at 63117.

proposed SIDCO rules. Several commenters advocated that any new Commission regulations correspond with applicable international standards.⁸⁹

Because efforts to finalize the PFMI were ongoing, new rules could have put SIDCOs at a competitive disadvantage vis-à-vis foreign CCPs not yet subject to comparable rules, and, at the time, no DCO had been designated as systemically important by the Council, the Commission concluded it would be premature to finalize the SIDCO regulations in the Derivatives Clearing Organization Core Principles adopting release.⁹⁰ Instead, the Commission decided, consistent with section 805(a)(1) of the Dodd-Frank Act,⁹¹ to monitor domestic and international developments concerning CCPs and reconsider the proposed SIDCO regulations in light of such developments.⁹²

As discussed above, since the final adoption of subparts A and B of part 39 of the Commission's regulations implementing the DCO core principles, there have been significant domestic and international developments, including (1) the publication of the final PFMI in April 2012,⁹³ (2) the designation of two registered DCOs for which the Commission is the Supervisory Agency, as systemically important by the Council,⁹⁴ and (3) the adoption of the Basel CCP Capital Requirements in July 2012,⁹⁵ which provide for significantly less favorable capital treatment for bank exposures to CCPs unless the relevant regulator of the CCP establishes

⁸⁹ See *infra* n. 110 and 125.

⁹⁰ See 76 FR at 69352 (Derivatives Clearing Organization Core Principles)(final rule).

⁹¹ The Commission notes again that section 805(a)(1) of the Dodd-Frank Act requires the Commission to consider international standards in promulgating risk management rules.

⁹² *Id.*

⁹³ See *supra* n. 28.

⁹⁴ See *supra* n. 23, 24.

⁹⁵ See *supra* n. 48; *see also* discussion in section I. D. 4.

regulations that are consistent with the PFMI by the end of 2013.⁹⁶ Given these developments and requests from market participants to harmonize CFTC regulations with the PFMI,⁹⁷ the Commission believes the time is ripe to finalize the previously proposed SIDCO regulations.

II. Regulation 39.29

A. Proposed Regulation 39.29(a)

Regulation 39.29(a), as proposed, would have required SIDCOs to maintain sufficient financial resources to meet 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.⁹⁸

The Commission received nine comment letters from market participants regarding the specific requirements set forth in proposed regulation 39.29(a).⁹⁹ The majority of these

⁹⁶ See Bank for International Settlements' Basel Committee on Banking Supervision, "Basel III Counterparty Credit Risk and Exposures to Central Counterparties - Frequently Asked Questions," (November 2012; revised December 2012), available at <http://www.bis.org/publ/bcbs237.pdf> (stating that if (1) a CCP regulator has provided a public statement on the status of a CCP (QCCP or non-qualifying), then banks will treat exposures to this CCP accordingly. Otherwise, the bank will determine whether a CCP is qualifying based on the criteria in the definition of a QCCP in Annex 4, Section 1 of the Basel CCP Capital Requirements; (2) during 2013, if a CCP regulator has not yet implemented the PFMI, but has publicly stated that it is working towards implementing these principles, the CCPs that are regulated by the CCP regulator may be treated as QCCPs. However, a CCP regulator may still declare a specific CCP non-qualifying; and (3) after 2013, if a CCP regulator has yet to implement the PFMI, then the bank will determine whether a CCP subject to such a CCP regulator's jurisdiction is qualifying on the basis of the criteria outlined in the definition of a QCCP in Annex 4, Section 1 of the Basel CCP Capital Requirements.).

⁹⁷ See, e.g., CME Group Inc., letter dated May 3, 2013 ("CME 2013 Letter") (stating that the PFMI establish "more demanding international risk management and related standards for payment, clearing and settlement systems, including central counterparties" and that in recognition of "the systemic protections and robustness of designated CCPs who adhere to the PFMI," the Basel CCP Capital Requirements provide "capital incentives for exposures to such QCCPs relative to non-Qualified CCPs." Moreover, the letter states that it "is important to [Chicago Mercantile Exchange Inc.] to be designated a QCCP...in order for [its] market participants to obtain optimal capital treatment for their business at [Chicago Mercantile Exchange Inc. ...]").

⁹⁸ See 75 FR at 63119.

⁹⁹ Comments on proposed regulation 39.29(a) include the following: See The Options Clearing Corporation, December 10, 2010 letter ("OCC December Letter"); Michael Greenberger, December 10, 2010 letter ("Greenberger Letter"); CME Group Inc., letter dated December 13, 2010 ("CME December Letter"); CME 2013 Letter; International Swaps and Derivatives Association, Inc., letter dated December 10, 2010 ("ISDA Letter"); Americans for Financial Reform, letter dated December 13, 2010 ("AFR Letter"); Futures Industry Association, letter dated December 13, 2010 ("FIA Letter"); LCH. Clearnet Group Limited, letter dated December 10, 2010 ("LCH

commenters expressed concern that heightened requirements for SIDCOs could place them at a competitive disadvantage vis-à-vis other DCOs and foreign CCPs that clear and settle similar OTC derivatives.¹⁰⁰

Two commenters, Mr. Michael Greenberger and LCH. Clearnet Group Limited (“LCH”), generally supported the proposed financial resources requirements for SIDCOs.¹⁰¹ ICE Clear Credit LLC (“ICC”), one of the two existing SIDCOs, stated that it currently is in compliance with the proposed cover two requirement and acknowledged “the importance of clearing houses with more complex risk management requirements maintaining robust financial resources.”¹⁰² Both the International Swaps and Derivatives Association (“ISDA”) and Americans for Financial Reform (“AFR”) suggested alternative approaches to the proposed cover two requirement for SIDCOs.¹⁰³ ISDA encouraged the Commission to consider “whether the appropriate size of a SIDCO’s financial resources should be determined following an assessment by the Commission of the specific risks posed by the relevant SIDCO and the individual products it clears, rather than set to a uniform level that may be either insufficient or overly conservative.”¹⁰⁴ AFR stated that a SIDCO’s minimum financial resources requirements should be based on risk exposure as well as the number of defaults because while in “a concentrated market, a single default can have

December Letter”); ICE Clear Credit LLC, letter dated April 26, 2013 (“ICC Letter”). The comment files for each proposed rulemaking can be found on the Commission’s website at www.cftc.gov.

¹⁰⁰ See CME December Letter at 7; FIA Letter at 2; LCH December Letter at 1. More broadly, Chris Barnard argued that all DCOs are SIDCOs “[g]iven their aggregate nature and high levels of interconnectedness.” See Chris Barnard, letter, dated May 10, 2011, (“Barnard Letter”) at 2.

¹⁰¹ See Greenberger Letter at 6; LCH December Letter at 3.

¹⁰² See ICC Letter at 2.

¹⁰³ See ISDA Letter at 8; AFR Letter at 3.

¹⁰⁴ See ISDA Letter at 8.

great consequence,” and in “a more diverse market, the probability of multiple defaults is greater and is a more meaningful scenario.”¹⁰⁵

OCC, however, disagreed with the necessity to impose a cover two requirement on all SIDCOs.¹⁰⁶ OCC argued that the Commission should not impose a rigid financial resources requirement on every SIDCO because mandating the default of the two largest clearing members for purposes of calculating the financial resources requirement does not necessarily have a beneficial result in that “it restricts the ability of a DCO to measure its resources against those contingencies that it deems to be the most likely threats to its liquidity and solvency.”¹⁰⁷ OCC agreed that all clearing organizations should consider possible simultaneous defaults by multiple clearing members but that the simultaneous defaults of a clearing organization’s two largest clearing members, at least in the context of how that might occur within OCC, seem extremely implausible.¹⁰⁸ OCC did state that “the clearing of OTC derivatives presents unique risk management concerns, and, depending on the particular product and applicable risk management framework, perhaps even heightened concerns that warrant special regulatory treatment.”¹⁰⁹ Additionally, OCC argued for international consistency on this issue, and encouraged the Commission to follow the PFMI and “avoid taking final action on the Proposed Rules prior to receiving greater clarity in terms of the positions and proposals that European and U.K. legislators and regulators and CPSS[-]IOSCO eventually adopt.”¹¹⁰

¹⁰⁵ See AFR Letter at 3.

¹⁰⁶ See OCC December Letter at 2, 5, and 6.

¹⁰⁷ Id. at 2. In addition, OCC argued that the proposed regulation did not fully consider the costs associated with meeting the cover two standard nor the risk of driving clearing volume to clearinghouses that are not required to meet the cover two standard. Id.

¹⁰⁸ Id. at 6.

¹⁰⁹ Id. at 5.

¹¹⁰ Id. at 12.

The Futures Industry Association (“FIA”) and, in its initial comment letter, CME commented that the proposed cover two requirement for SIDCOs could competitively disadvantage SIDCOs in both domestic and international markets.¹¹¹ FIA stated that the proposed regulation would create a two-tier system between those DCOs designated as systemically important and those DCOs that are not designated as such.¹¹² FIA believes that the two-tier system could put SIDCOs “at a competitive disadvantage to the extent that they need to increase margin or guaranty fund requirements to cover the additional cost of covering the risk of loss resulting from the default of the second largest clearing member.”¹¹³ In this regard, FIA recommended that the Commission require all DCOs, not just SIDCOs, to maintain sufficient financial resources to withstand the default of the two clearing members creating the largest combined financial exposure for the DCO in extreme but plausible market conditions.¹¹⁴

CME’s initial comment letter echoed FIA’s approach, arguing that having lower financial resources requirements for DCOs that are not SIDCOs would allow those DCOs to offer lower guaranty fund and margin requirements.¹¹⁵ According to CME, this “would likely attract additional volume to at least some non-systemically important DCOs and transform them into de facto SIDCOs.”¹¹⁶ CME argued that until such time as a “de facto SIDCO” was designated as systemically important by the Council, SIDCOs would be competitively disadvantaged because the “de facto SIDCO” would be operating under the lower and less costly general regulatory

¹¹¹ See FIA Letter at 2, CME December Letter at 7-8.

¹¹² See FIA Letter at 2.

¹¹³ Id.

¹¹⁴ Id.

¹¹⁵ See CME December Letter at 7.

¹¹⁶ Id.

standards for DCOs.¹¹⁷ CME argued that such a result would disregard the objectives of Title VIII.¹¹⁸ CME suggested that the Commission, in lieu of adopting the proposed regulation, adopt a regulation that subjects SIDCOs to more frequent stress testing (e.g., bi-monthly rather than monthly) and reporting requirements (e.g., monthly rather than quarterly).¹¹⁹ Following publication of the PFMI and the Basel CCP Capital Requirements, CME submitted a supplemental comment letter stating that its subsidiary, CME Clearing began offering clearing services for the interest rate swap and credit default swap markets.¹²⁰ As a result, CME Clearing has three distinct guaranty funds: one for interest rate swap products (“IRS Guaranty Fund”), one for credit default swap products (“CDS Guaranty Fund”), and one for futures and other cleared OTC products (“Base Guaranty Fund”).¹²¹ Moreover, CME stated that the IRS Guaranty Fund and the CDS Guaranty Fund are already sized to the cover two standard.¹²² While CME stated that it is satisfied with the size of the Base Guaranty Fund, which is currently set to meet a cover one standard, CME anticipates that the Commission will promulgate a cover two standard as part of the Commission’s implementation of the standards set forth in the PFMI.¹²³ As such, CME requested that the Commission “consider the impact to clearing firms when specifying the timelines associated with compliance with the cover [two] standard and suggests as long a time horizon as possible for implementation,” with “an effective date of the end of 2013, or later to

¹¹⁷ Id. at 7–8.

¹¹⁸ Id. at 8.

¹¹⁹ Id.

¹²⁰ CME 2013 Letter at 2.

¹²¹ CME 2013 Letter at 2-3.

¹²² CME 2013 Letter at 3.

¹²³ Id.

the extent practicable to maintain QCCP status in accordance with BCBS 227, which we believe would assist in minimizing the impact to the clearing firm community.”¹²⁴

Additionally, LCH, which was supportive of the proposal, urged the Commission “to minimize the divergence” between U.S.-regulated CCPs and other CCPs and ensure a level playing field between SIDCOs and other large CCPs around the world by conforming as much as possible the Commission’s final rules on SIDCOs to the global standards set forth by the PFMI’s.¹²⁵

The Commission notes that Core Principle B requires DCOs to have “adequate financial, operational, and managerial resources, as determined by the Commission, to discharge each responsibility of the DCO.”¹²⁶ Pursuant to Core Principle B, at a minimum, DCOs must be able to meet a cover one requirement. As discussed above, because of the impact that the failure of or a disruption to the operations of a SIDCO could have on the U.S. financial markets, the Commission proposed increased standards for SIDCOs. However, after consideration of the comments, and consistent with the directive in section 805 of the Dodd-Frank Act to consider relevant international standards and existing prudential requirements, the Commission is adopting regulation 39.29(a) with a revision in order to harmonize U.S. regulations with international CCP risk management standards.¹²⁷

¹²⁴ Id.

¹²⁵ See LCH December Letter at 1–2 (citing to the Bank for International Settlements’ Committee on Payment and Settlement Systems September 2010 report entitled Market Structure Developments in the Clearing Industry: Implications for Financial Stability for the opinion that “regulatory complexity, and with it the potential for regulatory arbitrage, may increase, especially when competing CCPs are regulated by different authorities and/or are located in different jurisdictions.” Id. at 4.

¹²⁶ Section 5b(c)(2)(B) of the CEA, 7 U.S.C. 7a-1(c)(2)(B).

¹²⁷ The Commission finds the comments arguing for international regulatory consistency to be persuasive and recognizes the importance of harmonizing U.S. regulations with international CCP risk management standards.

Specifically, rather than apply the cover two requirement to all SIDCOs, the revised regulation 39.29(a) would parallel the financial resources standard in Principle 4 of the PFMI and only require a SIDCO that is systemically important in multiple jurisdictions or that is involved in activities with a more complex risk profile to maintain financial resources sufficient to enable it 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, provided that if a clearing member controls another clearing member or is under common control with another clearing member, affiliated clearing members shall be deemed to be a single clearing member for the purposes of this provision.¹²⁸

Thus, regulation 39.29(a) will promote consistency and efficiency in the financial markets by holding SIDCOs to the same cover two standard as similarly situated foreign CCPs. Additionally, because the PFMI set forth international risk management standards for CCPs, this international harmonization should mitigate some of the competition concerns raised by the commenters. Moreover, adoption of this revised regulation is part of the Commission's broader efforts to adopt and implement regulations that are consistent with the PFMI so that SIDCOs operating internationally can be considered QCCPs. Such QCCP status should help a SIDCO avoid competitive harm internationally by providing bank clearing members and clients with the

¹²⁸ See *supra* n. 41, 42. Moreover, the same proviso regarding the treatment of affiliate clearing members as set out in 39.11(a)(1), *i.e.*, that "if a clearing member controls another clearing member or is under common control with another clearing member, affiliated clearing members shall be deemed to be a single clearing member for the purposes of this provision" is incorporated in regulation 39.29(a) and is repeated in the rule text for clarity. See also 75 FR 63116 (stating that as DCOs, SIDCOs are still subject to Title VII and the regulations thereunder, except to the extent that the Commission proposes higher standards pursuant to Title VIII).

opportunity to obtain the more favorable capital charges set forth by the Basel CCP Capital Requirements.¹²⁹

After careful review and consideration of the comments, and in light of international standards and prudential regulations, the Commission is adopting a regulation 39.29(a), as revised, to require the cover two standard for those SIDCOs that are systemically important in multiple jurisdictions or that are involved in activities with a more complex risk profile.

B. Proposed Regulation 39.29(b)

Regulation 39.29(b), as proposed, would have precluded SIDCOs from counting the value of assessments in calculating the resources available to meet the obligations arising from a default by the clearing member creating the single largest financial exposure,¹³⁰ but would have permitted SIDCOs to count the value of assessments, after a 30 percent haircut, in calculating the resources available to meet up to 20 percent of the obligations arising from a default of the clearing member creating the second largest financial exposure.¹³¹

The Commission received five comment letters from market participants regarding the specific requirements set forth in proposed regulation 39.29(b).¹³² FIA agreed with the Commission's proposed limitation on the use of assessments by SIDCOs, stating that the proposed limitation was reasonable, prudent, and sufficient to ensure that a SIDCO does not unduly rely on its assessment power.¹³³ In contrast, AFR argued that the use of assessments in

¹²⁹ See supra section I.D.4. for a more detailed discussion on the role of the PFMI in international banking. See also CME 2013 Letter at 2 (stating that “it is important to CME [Clearing] to be designated a QCCP...in order for [its] market participants to obtain optimal capital treatment for their business at CME [Clearing]...”).

¹³⁰ See 75 FR at 63117. Accordingly, SIDCOs would have to hold a greater percentage of financial resources in margin and guaranty funds. Id.

¹³¹ Id.

¹³² See AFR Letter; FIA Letter; Barnard Letter; ICC Letter; CME 2013 Letter.

¹³³ See FIA Letter at 3.

calculating the resources available to meet a SIDCO's obligations under proposed regulation 39.29(b) should be prohibited.¹³⁴ AFR emphasized that a DCO should be financially viable at all times, regardless of whether it might be able to call on its members to provide additional capital.¹³⁵ In addition, ICC, one of the two existing SIDCOs, stated that it does not rely upon its right of assessment to meet the cover two standard¹³⁶ and CME, the parent company of the other existing SIDCO, stated that "each of [CME Clearing's] guaranty funds are pre-funded by the respective clearing members."¹³⁷ More broadly, Chris Barnard commented that the use of assessments by DCOs may cause pro-cyclical problems and increase systemic risk in times of financial stress.¹³⁸

The Commission recognizes the potential pro-cyclical effects of assessments and agrees that a SIDCO should not be permitted to use the value of assessments in calculating the resources available to meet its obligations under regulation 39.29(a). "Pro-cyclicality," as defined in the PFMI, refers to "changes in risk-management practices that are positively correlated with market, business, or credit cycle fluctuations and that may cause or exacerbate financial instability."¹³⁹ In the context of assessments, a SIDCO's call for additional capital from its clearing members in order to cover any losses in a default scenario (generally needed on an expedited basis) may trigger greater distress on the financial markets, which presumably have already been weakened. In other words, in a stressed market where credit is tightening and

¹³⁴ See AFR Letter at 3.

¹³⁵ *Id.* AFR also argued that DCOs should be prohibited from including assessments in meeting their financial resources requirements as well.

¹³⁶ See ICC Letter at 2.

¹³⁷ See CME 2013 Letter at 3, n.7.

¹³⁸ See Barnard Letter at 2.

¹³⁹ See PFMI, Definitions; see also Principle 5: Collateral, Explanatory Note 3.5.6; see also Bank for International Settlements' Committee on the Global Financial System, "The Role of Margin Requirements and Haircuts in Procyclicality," CGFS Papers No.36 (March 2010), available at <http://www.bis.org/publ/cgfs36.htm>.

margin calls are increased, a SIDCO's assessment of additional claims upon its clearing members may well exacerbate already weakened financial markets by potentially forcing clearing members and/or their customers to deleverage in falling asset markets, which will further drive down asset prices and stifle liquidity, or force clearing members to default in their obligations to the SIDCO. This in turn could start a downward spiral which, combined with restricted credit, might lead to additional defaults of clearing members and/or their customers, and would play a significant role in the destabilization of the financial markets. In striking a balance between the need for SIDCOs to effectively and efficiently use their resources and the mitigation of pro-cyclical behaviors, the Commission believes prefunding default obligations is the appropriate mechanism for SIDCOs to meet their default resource obligations.

As discussed above, Core Principle B requires DCOs to have “adequate financial, operational, and managerial resources, as determined by the Commission, to discharge each responsibility of the DCO.”¹⁴⁰ Moreover, the PFMI require a CCP to use prefunded financial resources to cover current and potential future exposures,¹⁴¹ which may include initial margin, contributions to a prefunded default arrangement (e.g., a guaranty fund), and a specified portion of the CCP's own funds.¹⁴² In addition, the PFMI encourage CCPs to address pro-cyclicality in their margin arrangements¹⁴³ and state that “a CCP could consider increasing the size of its prefunded default arrangements to limit the need and likelihood of large or unexpected margin

¹⁴⁰ Section 5b(c)(2)(B) of the CEA, 7 U.S.C. 7a-1(c)(2)(B).

¹⁴¹ See supra n. 40 and accompanying text.

¹⁴² See PFMI, Principle 4: Credit Risk, Explanatory Note 3.4.17 (stating that a CCP typically uses a sequence of prefunded financial resources, often referred to as a “waterfall,” to manage its losses caused by participant defaults. The waterfall may include a defaulter's initial margin, the defaulter's contribution to a prefunded default arrangement, a specified portion of the CCP's own funds, and other participants' contributions to a prefunded default arrangement).

¹⁴³ Id. at Principle 6: Margin, Explanatory Note 3.6.10.

calls in times of market stress.”¹⁴⁴ Prefunding financial resources requires market participants to pay more during times of relative market stability and low-market volatility through prefunded default arrangement contributions.¹⁴⁵ However, paying more during a period of economic stability or even an upturn may “result in additional protection and [be] potentially less costly and less disruptive adjustments in periods of high market volatility.”¹⁴⁶

The Commission believes the role of a SIDCO, in part, is to add stability and confidence in the financial markets, and to the extent that the prohibition of the inclusion of the value of assessments by SIDCOs in meeting their default resource requirements helps to stem pro-cyclicality and the potential weakening of financial markets, the Commission is in favor of this approach. Moreover, prohibition of the inclusion of the value of assessments will help ensure that a SIDCO has, when needed, adequate resources to discharge each of its responsibilities.

Accordingly, after consideration of the comments, relevant international standards, and existing prudential requirements, the Commission is adopting regulation 39.29(b) with a revision to prohibit the use of assessments by SIDCOs in calculating financial resources available to meet the SIDCO’s obligations under regulation 39.29(a).

III. Regulation 39.30

Regulation 39.30(a), as proposed, would have required a SIDCO to have a BC-DR plan, that has the objective of, and the physical, technological, and personnel resources sufficient to, enable the SIDCO to recover operations and resume daily processing, clearing, and settlement no later than two hours following a disruption,¹⁴⁷ including a wide-scale disruption.¹⁴⁸

¹⁴⁴ Id.

¹⁴⁵ Id.

¹⁴⁶ Id.

¹⁴⁷ See 76 FR at 3726.

In order to achieve the specified recovery time objective (“RTO”) in proposed regulation 39.30(a), proposed regulation 39.30(b) would have required SIDCOs to maintain a geographic dispersal of physical, technological, and personnel resources.¹⁴⁹ Pursuant to proposed regulation 39.30(b)(1), physical and technological resources would have to be located outside the relevant area of the infrastructure the entity normally relies upon to conduct activities necessary to the clearance and settlement of existing and new contracts, and the entity could not rely on the same critical transportation, telecommunications, power, water, or other critical infrastructure components the entity normally relies upon for such activities.¹⁵⁰ Additionally, proposed regulation 39.30(b)(2) would have required SIDCOs to maintain personnel sufficient to meet the RTO after interruption of normal clearing by a wide-scale disruption affecting the relevant area, who live and work outside the relevant area.¹⁵¹ To avoid duplication and maximize flexibility, proposed regulation 39.30(b)(3)¹⁵² provided that SIDCOs could use the outsourcing provisions applicable to non-SIDCO DCOs as set forth in regulation 39.18(f).¹⁵³

¹⁴⁸ The following definitions pertaining to system safeguards were codified at 17 C.F.R. 39.18(a):

A “recovery time objective” is defined as “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.” A “wide-scale disruption” is defined 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.” “Relevant area” is defined as “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.”

¹⁴⁹ See 76 FR at 3726-3727.

¹⁵⁰ Id.

¹⁵¹ Id. at 3727.

¹⁵² Id.

¹⁵³ See 17 CFR 39.18(f) (stating, in relevant part, that a DCO may maintain the resources required under BC-DR procedures enumerated in regulation 39.18(e)(1) by “either (1) Using its own employees as personnel, and property that it owns, licenses, or leases (own property); or (2) Through written contractual arrangements with another derivatives clearing organization or other service provider (outsourcing).”)

Regulation 39.30(c), as proposed, would have required that each SIDCO conduct regular, periodic tests of its BC-DR plans and resources, and of its capacity to achieve the required RTO in the event of a wide-scale disruption.¹⁵⁴ Additionally, proposed regulation 39.30(c) incorporated the provisions of regulation 39.18(j) concerning testing by DCOs, including the purpose of the testing, the conduct of the testing, and reporting and review of the testing.¹⁵⁵

The Commission received five comment letters regarding the specific requirements set forth in proposed regulation 39.30(a).¹⁵⁶ One commenter stated that the recovery time for its technology systems is currently approximately two hours based upon past disaster recovery tests,¹⁵⁷ and three commenters opposed the two-hour RTO.¹⁵⁸ ICC, one of the two existing SIDCOs, acknowledged “the importance of maintaining market integrity during disruptive

¹⁵⁴ See 76 FR at 3727.

¹⁵⁵ See id.; see also 17 CFR 39.18(j) which states the following:

39.18(j)(1): Purpose of testing:

A [DCO] 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 [DCOs] back up resources are sufficient to meet the requirements of [regulation 39.18(e)].

39.18(j)(2): Conduct of testing:

Testing shall be conducted by qualified, independent professionals. Such qualified, independent professionals may be independent contractors or employees of the DCO, but shall not be persons responsible for development or operation of the systems or capabilities being tested.

39.18(j)(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 DCO. Protocols of tests which result in few or no exceptions shall be subject to more searching review.

¹⁵⁶ Comments on proposed regulation 39.30 include the following: See Intercontinental Exchange, Inc. letter dated March 21, 2011 (“ICE Letter”); OCC letter dated March 21, 2011 (“OCC Letter”); CME Group Inc., letter dated March 21, 2011 (“CME March Letter”); ICC Letter; and CME 2013 Letter. The Commission received no comments regarding proposed regulation 39.30(b) or 39.30(c).

¹⁵⁷ See ICC Letter at 2.

¹⁵⁸ See ICE Letter at 7-8; CME March Letter at 14-15; OCC Letter at 19-20.

events” and noted that a two-hour RTO is consistent with Principle 17 of the PFMIIs.¹⁵⁹ In addition, ICC stated that the “two-hour benchmark is unlikely to require [it] to hire additional personnel or to require a different level of cross-training related to its wide-scale disruption plan,” and that it “is unlikely that [ICC] will incur any additional backup technology costs related to the CFTC’s proposed RTO.”¹⁶⁰

Both Intercontinental Exchange, Inc. (“ICE”) and CME, on the other hand, expressed concern that requiring a more stringent RTO for SIDCOs would impose significant costs.¹⁶¹ ICE argued that “assigning an RTO to a SIDCO instead of assigning the objective the RTO is intended to achieve adds significant cost to a SIDCO’s business continuity program but does not necessarily increase overall resilience of the financial system.”¹⁶² ICE and CME also highlighted the approach referenced in the Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System (the “Sound Practices Paper”),¹⁶³ published in 2003, which argued for a same-business-day RTO with a two-hour RTO as an aspirational goal for clearing and settlement organizations.¹⁶⁴ CME urged the Commission to adopt the same approach as the Sound Practices Paper for SIDCOs, *i.e.*, the same-business-day RTO with a two-hour RTO on a voluntary basis.¹⁶⁵ In addition, CME stated that “[m]oving to a 2-hour RTO would impose enormous costs on SIDCOs, and the CFTC has provided no cost/benefit analysis

¹⁵⁹ ICC Letter at 2.

¹⁶⁰ Id.

¹⁶¹ See ICE Letter at 7; CME March Letter at 14.

¹⁶² ICE Letter at 8.

¹⁶³ See the Federal Reserve Board, the Office of the Comptroller of the Currency and the Securities and Exchange Commission, “Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System” (the “Sound Practices Paper”), 68 FR 17809 (April 11, 2003).

¹⁶⁴ Id. at 17812 (stating that core clearing and settlement organizations should develop the capacity to recover and resume clearing and settlement activities within the business day on which the disruption occurs with the overall goal of achieving recovery and resumption within two hours after an event).

¹⁶⁵ CME March Letter at 15.

in connection with this aspect of the proposed Regulation.”¹⁶⁶ Nonetheless, in a supplemental comment letter, CME stated that “in light of the systemic importance of CME [Clearing]’s clearing functions and the intended benefits, including compliance with the PFMI requirements for critical information technology, CME [Clearing] has obtained budget approval and allocated resources towards a two hour RTO and will be working throughout 2013 towards achieving a two hour RTO.”¹⁶⁷

OCC commented that, though a laudable goal, a two-hour RTO was not consistently achievable without sacrificing core DCO functions and increasing the risks of error and backlogs.¹⁶⁸ In addition, OCC argued that in its experience, it often takes three hours to fully recover and meet its responsibilities and avoid significant market disruption.¹⁶⁹ OCC also argued that further efforts to reduce RTO would not be cost-effective and could increase rather than decrease reliability risk.¹⁷⁰

With respect to commenters’ concerns that the proposed regulation will significantly increase costs on SIDCOs, the Commission recognizes these concerns but notes that a systemic importance designation under Title VIII means that the failure of a SIDCO to meet its obligations will have a greater impact on the U.S. financial system than the failure of a DCO not so designated. Thus, the Commission believes the financial system has a vested interest in enhancing risk management requirements for SIDCOs to increase a SIDCO’s financial resiliency and to mitigate the risk of significant liquidity or credit problems spreading among financial

¹⁶⁶ CME March Letter at 14.

¹⁶⁷ CME 2013 Letter at 4 (CME also acknowledges that “Principle 17 of the PFMIs states that a BC-DR Plan should be designed to ensure that critical information technology systems can resume operations within two hours following disruptive events.”) (emphasis added).

¹⁶⁸ OCC Letter at 19.

¹⁶⁹ Id.

¹⁷⁰ Id.

institutions or markets, threatening the stability of the U.S. financial system. In the event of a wide-scale disruption, the resiliency of the U.S. financial markets might depend on the rapid recovery of SIDCOs to support critical market functions and thereby allow other market participants (i.e., the counterparties) to process their transactions. In addition, in such a scenario, it is reasonable to assume that there will be other market participants in locations not affected by the disruption that will need to clear and settle pending transactions as well. In short, the failure of a SIDCO to complete core clearing and settlement functions within a rapid period could create systemic liquidity and credit dislocations on a global scale.

Additionally, the Commission notes that while it may be true that a two-hour RTO was an aspirational goal in 2003, standards and technology have advanced in the last ten years. As discussed above, the current international standard for CCPs, as set forth by the PFMI, is to have a BC-DR plan that incorporates a two-hour RTO.¹⁷¹ Specifically, the PFMI states that an FMI's business continuity plan "should incorporate the use of a secondary site and should be designed to ensure that critical information technology systems can resume operations within two hours following disruptive events."¹⁷² Because the two-hour RTO is the international standard and foreign CCPs are anticipated to operate under this timeframe, any competitive disadvantages to SIDCOs in implementing this regulation should be mitigated because all similarly situated CCPs will likely be operating under this standard. Indeed, ICC, one of the two existing SIDCOs, has stated that it is unlikely that it will need to hire additional personnel or incur additional technology costs to meet this standard.¹⁷³ Moreover, as discussed above, CME Clearing, the other existing SIDCO, "has obtained budget approval and allocated resources

¹⁷¹ See supra n. 46, 47 (referring to the PFMI, Principle 17: Operational Risk).

¹⁷² Id.

¹⁷³ See supra n. 160 and accompanying text.

towards a two hour RTO and will be working throughout 2013 towards achieving a two hour RTO.”¹⁷⁴

The Commission believes that enhancing the system safeguard requirements a SIDCO must maintain under Core Principle I will increase stability in the financial markets and is therefore consistent with Title VIII’s objectives. Moreover, regulation 39.30(a) will promote regulatory consistency for SIDCOs and similarly situated CCPs because the two-hour RTO is the international standard, under the PFMI, for CCPs operating in other jurisdictions. As discussed above, the Commission is fully committed to adopting and implementing regulations that are consistent with the PFMI to ensure that SIDCOs are QCCPs under the Basel CCP Capital Requirements so that banks transacting through SIDCOs can receive preferential capital treatment.¹⁷⁵ Therefore, the Commission is adopting regulation 39.30(a) as proposed.

The Commission did not receive any comments regarding proposed regulations 39.30(b) or 39.30(c). Therefore, for reasons stated in the proposal, the Commission is adopting regulations 39.30(b) and 39.30(c) as proposed.¹⁷⁶ However, to mitigate costs, the Commission notes that regulation 39.30(b) should be interpreted in a manner consistent with the PFMI, which state “[a] particular site may be primary for certain functions and secondary for others. It is not intended that an FMI would be required to have numerous separate secondary sites for each of its essential functions.”¹⁷⁷

IV. Regulation 39.31

¹⁷⁴ CME 2013 Letter at 4.

¹⁷⁵ See *supra* section I.D.4.

¹⁷⁶ See 76 FR at 3726-3727.

¹⁷⁷ See PFMI, Principle 17: Operations Risk.

Regulation 39.31 proposed to codify the special enforcement authority granted to the Commission over SIDCOs pursuant to section 807(c) of the Dodd-Frank Act, which states that for purposes of enforcing the provisions of Title VIII of the Dodd-Frank Act, a SIDCO is subject to, and the Commission has authority under, provisions (b) through (n) of section 8 of the FDIA¹⁷⁸ 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.¹⁷⁹ The Commission did not receive any comment letters on this proposed regulation, which tracks the statutory text in section 807 of the Dodd-Frank Act. Therefore, for reasons stated in the proposal, the Commission is adopting regulation 39.31 as proposed.

V. Effective Date and Compliance 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 three comments, however, requesting additional time to come into compliance with these rules. Regarding the compliance date of regulation 39.29, OCC requested that DCOs be afforded a reasonable amount of time to raise “any material amount of additional resources” and requested a delayed implementation of two years.¹⁸⁰ CME stated that the financial resources that DCOs are required to maintain will increase dramatically and requested

¹⁷⁸ See also 12 U.S.C. 1818 (b)-(n) (granting authority for enforcement powers).

¹⁷⁹ 76 FR at 3727. The Commission notes that Title VIII preserved and expanded the CFTC’s examination and enforcement authority with respect to designated entities within its jurisdiction. See Cong. Rec. 156 S5924-5 (daily ed. July 14, 2010) (statement of Sen. Lincoln that Title VIII “preserves and expands the CFTC’s and SEC’s examination and enforcement authorities with respect to designated entities within their respective jurisdictions,” and that “the authorities granted in Title VIII are intended to be both additive and complementary to the authorities granted to the CFTC and SEC in Title VII and to those agencies’ already existing legal authorities. The authority provided in Title VIII to the CFTC and SEC with respect to designated clearing entities and financial institutions engaged in designated activities would not and is not intended to displace the CFTC’s and SEC’s regulatory regime that would apply to these institutions or activities.”).

¹⁸⁰ OCC December Letter at 11.

an implementation period of no less than 180 days.¹⁸¹ Regarding the compliance date of regulation 39.30, the Commission had proposed a compliance date of one year after publication of the final rules or July 12, 2012.¹⁸² OCC commented that this is a short and burdensome deadline that will be difficult to meet and encouraged the Commission to adopt a two-year compliance period for the requirements applicable to SIDCOs.¹⁸³ The Commission received no comments regarding regulation 39.31.

Given the mandate to implement these standards, and the necessity of SIDCOs to fulfill their obligations on a near continuous basis, after careful consideration of the comments received, the Commission is extending the compliance date for regulations 39.29 and 39.30 to December 31, 2013.

VI. Consideration of Costs and Benefits.

A. Introduction

Section 15(a) requires the Commission to consider the costs and benefits of its actions before promulgating a regulation under the CEA or issuing certain orders.¹⁸⁴ Section 15(a) further specifies that the costs and benefits shall 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. The Commission's cost and benefit considerations in accordance with section 15(a) are discussed below.

¹⁸¹ CME December Letter at 8.

¹⁸² See 76 FR at 3714.

¹⁸³ OCC March Letter at 21.

¹⁸⁴ 7 U.S.C. 19(a).

B. Background

In this final rulemaking, the Commission is adopting regulations to implement enhanced risk management standards for SIDCOs.¹⁸⁵

As noted above, consistent with the DCO core principles and section 805 of the Dodd-Frank Act, which requires the Commission to consider relevant international and existing prudential requirements when prescribing risk management standards for SIDCOs, the Commission proposed the following enhanced requirements for SIDCOs:¹⁸⁶

(1) regulation 39.29(a) which would require a SIDCO to maintain sufficient resources to meet a “cover two” standard in order to comply with Core Principle B;¹⁸⁷ (2) regulation 39.29(b) which would strictly limit the value of assessments that could be used in meeting that requirement;¹⁸⁸ (3) regulation 39.30 which would require a SIDCO to have a BC-DR plan with a two-hour RTO in order to comply with Core Principle I (“two-hour RTO”);¹⁸⁹ and (4) regulation 39.31 which, under section 807(c) of the Dodd-Frank Act, grants the Commission special enforcement authority over SIDCOs.¹⁹⁰

As also discussed above, after the Commission proposed the SIDCO risk management standards and received comments, the PFMIIs were published.¹⁹¹ The PFMIIs establish international risk management standards for FMIs, including CCPs, that facilitate clearing and

¹⁸⁵ See supra section I.A. through I.F. for a more detailed discussion on the risk management standards for SIDCOs, including the designation process for SIDCOs and standards for SIDCOs under Title VIII of the Dodd-Frank Act.

¹⁸⁶ See supra section I.F. for discussion on the risk management standards for SIDCOs proposed by the Commission.

¹⁸⁷ Id.

¹⁸⁸ Id.

¹⁸⁹ Id.

¹⁹⁰ Id.

¹⁹¹ See supra section I.D.1. for a general discussion on the PFMIIs.

settlement.¹⁹² The PFMI's also play a significant role in the Basel CCP Capital Requirements, which introduce new capital charges based on counter party risk for banks conducting financial derivatives transactions through a CCP.¹⁹³ These capital charges vary significantly depending on whether or not the counterparty is a QCCP, that is, a CCP that is subject to regulations consistent with the PFMI's.¹⁹⁴ Effectively, the Basel CCP Capital Requirements incentivize banks to clear derivatives through QCCPs by setting lower capital charges for exposures arising from derivatives cleared through a QCCP and setting significantly higher capital charges for exposures arising from derivatives cleared through non-qualifying CCPs.¹⁹⁵ As discussed further below, these differences in capital charges are extremely important in considering whether to adopt requirements for SIDCOs, which are consistent with the PFMI's, or requirements that fall short of that standard.

In light of the directive of section 805 of the Dodd-Frank Act to consider relevant international standards and existing prudential requirements when prescribing risk management standards for designated systemically important FMUs, as well as the recent publication of the PFMI's, and public comments on the proposed SIDCO regulations, the Commission has determined it is necessary and appropriate to finalize the proposed enhanced risk management standards for SIDCOs. However, in order to harmonize the proposed regulations with the existing international standards set forth by the PFMI's, as requested by some commenters,¹⁹⁶ the

¹⁹² Id.

¹⁹³ See supra section I.D.4. for a discussion on the role of the PFMI's in international banking standards.

¹⁹⁴ Id.

¹⁹⁵ Id.

¹⁹⁶ See OCC December Letter at 12 (OCC requesting that the Commission avoid taking final action on the proposed SIDCO regulations until the adoption of the PFMI's to ensure consistency with international regulations) and LCH December Letter at 1-2 (LCH urging the Commission to conform as much as possible the Commission's final rules on SIDCOs to the global standards set forth in the PFMI's).

Commission has revised proposed regulation 39.29(a) and 39.29(b). Rather than apply the cover two requirement to all SIDCOs, revised regulation 39.29(a) parallels the financial resources standard in Principle 4 of the PFMIs and only requires a SIDCO that is systemically important in multiple jurisdictions or that is involved in activities with a more complex risk profile to maintain financial resources sufficient to meet the cover two requirement.¹⁹⁷ Revised regulation 39.29(b), which is also consistent with Principle 4 of the PFMIs, prohibits a SIDCO from the use of assessments in calculating its financial resources available to meet the SIDCO's obligations under regulation 39.29(a).¹⁹⁸

The Commission considered the following alternatives: (1) not to adopt any of the proposed SIDCO risk management regulations, (2) to adopt the SIDCO risk management regulations only as proposed, or (3) to adopt the proposed SIDCO risk management regulations with revisions consistent with relevant international standards and existing prudential requirements. As detailed above, the Commission has concluded it is necessary and appropriate in this final rulemaking to adopt regulation 39.29, as revised, regulation 39.30, as proposed, and regulation 39.31, as proposed.¹⁹⁹

In the discussion that follows, the Commission considers the costs and benefits of the final rulemaking in light of the comments it received and section 15(a) of the CEA. As the requirement in regulation 39.31 is imposed by the Dodd-Frank Act, any associated costs and benefits are the result of statutory directives as determined by Congress, not an act of Commission discretion.

¹⁹⁷ See supra section II. for a discussion on the proposed and revised rule text of regulation 39.29.

¹⁹⁸ Id.

¹⁹⁹ See supra discussion I.C. and I.F.

For the remaining regulations in this rulemaking, 39.29(a) (cover two), 39.29(b) (prohibition of assessments) and 39.30 (two-hour RTO), the Commission considers the costs and benefits attributable to these enhanced requirements against the DCO regulatory framework established in part 39, which provides minimum risk standards for DCOs and sets the baseline for cost and benefit considerations. Specifically, regulation 39.11 (implementing DCO Core Principle B) sets a cover one standard as the minimum financial resources requirement for all DCOs whereas regulation 39.29(a) sets a cover two financial resources requirement for all SIDCOs engaged activities with a more complex risk profile or that are systemically important in multiple jurisdictions. Regulation 39.11 permits the inclusion of assessment powers, to a limited extent, in calculating whether a DCO meets its default resources requirement, whereas regulation 39.29(b) prohibits the use of assessments by SIDCOs in meeting those obligations. Regulation 39.18 requires a DCO to have an RTO of no later than the next business day following the disruption of its operations whereas regulation 39.30 (implementing DCO Core Principle I) requires SIDCOs to have a BC-DR plan with a two-hour RTO following the disruption of its operations.

The Commission invited public comment on all aspects of the proposed SIDCO rulemaking but did not receive any comments with quantitative data from which the Commission could calculate the costs and benefits of the proposed enhanced requirements. The Commission did receive qualitative comments on the Commission's proposed consideration of costs and benefits generally, as well as specifically to the requirements central to this final rule: cover two, use of assessments and two-hour RTO. These comments are summarized below in connection with the Commission's consideration of the costs and benefits of the final rules being promulgated herein.

C. Benefits and Costs of the Final Rule

1. Benefits

As explained in the subsections that follow, this final rule promotes the financial strength, operational security and reliability of SIDCOs, reduces systemic risk, and increases the stability of the broader U.S. financial system. In addition, the regulations harmonize U.S regulations with international standards which will, in important ways, place SIDCOs on a level playing field with their competitors in the global financial markets:

a. Regulation 39.29(a): Cover Two

The cover two requirement increases the financial stability of certain SIDCOs which, in turn, increases the overall stability of the US financial markets. This is so because enhancing a SIDCO's financial resources requirements from the minimum of cover one to a more stringent cover two standard helps to ensure the affected SIDCO will have greater financial resources to meet its obligations to market participants, including in the case of defaults by multiple clearing members. These added financial resources lessen the likelihood of the SIDCO's failure which, given the designation of systemically important, could threaten the stability of the US financial system.²⁰⁰ By bolstering certain SIDCOs' resources, regulation 39.29(a) contributes to the financial integrity of the financial markets and reduces the likelihood of systemic risk from spreading through the financial markets due to one of those SIDCOs' failure or disruption.

According to commenters, existing SIDCOs already fund their default resources using a cover two standard for products with a more complex risk profile.²⁰¹ Although the benefit associated with regulation 39.29(a) is somewhat lessened by the already established practice of cover two by the relevant SIDCOs, there is a long-term benefit of setting the cover two standard

²⁰⁰ See supra section I.B.

²⁰¹ See ICC Letter at 1. See also CME 2013 Letter at 2-3.

as the new regulatory minimum to ensure that even in periods of apparent stability and low market volatility, these SIDCOs will continue to have increased financial resource requirements and, ultimately, greater financial stability. This approach of obtaining resources in such low-stress periods avoids the need to call for additional resources from clearing members during less stable, more volatile times, which would have pro-cyclical effects on the U.S. financial markets.²⁰² In addition, the cover two requirement will apply to SIDCOs deemed systemically important in multiple jurisdictions.

b. Regulation 39.29(b): Prohibited Use of Assessments to Meet Regulation 39.29(a) Obligations

As discussed below and throughout this release, the Commission believes that prohibiting the use of assessments by a SIDCO in meeting its default resource obligations (*i.e.* those under regulations 39.11(a)(1) and 39.29(a)) increases the financial stability of the SIDCO, which in turn, increases the overall stability of the U.S. financial markets.

Assessment powers are more likely to be exercised during periods of financial market stress. If during such a period, a clearing member defaults and the loss to the SIDCO is sufficiently large to deplete (1) the collateral posted by the defaulting entity, (2) the defaulting entity's default fund contribution, and (3) the remaining pre-funded default fund contributions, a SIDCO's exercise of assessment powers over the non-defaulting clearing members may exacerbate a presumably already weakened financial market. The demand by a SIDCO for more capital from its clearing members could force one or more additional clearing members into default because they cannot meet the assessment. The inability to meet the assessment could lead clearing members and/or their customers to de-leverage (*i.e.*, sell off their positions) in falling asset markets, which further drives down asset prices and may result in clearing members

²⁰² See *supra* section II.B. for discussion on the pro-cyclical impact of assessments.

and/or their customers defaulting on their obligations to each other and/or to the SIDCO. In such extreme circumstances, assessments could trigger a downward spiral and lead to the destabilization of the financial markets. Prohibiting the use of assessments by a SIDCO in meeting default resources obligations is intended to require the SIDCO to retain more financial resources upfront, i.e. to prefund its financial resources requirement to cover its potential exposure.

The increase in prefunding of financial resources by a SIDCO may increase costs to clearing members of that SIDCO (e.g. requiring clearing members to post additional funds with the SIDCO),²⁰³ but it also reduces the likelihood that the SIDCO will require additional capital infusions during a time of financial stress when raising such additional capital is expensive relative to market norms. By increasing prefunded financial resources, a SIDCO becomes less reliant on the ability of its clearing members to pay an assessment, more secure in its ability to meet its obligations, and more viable in any given situation, even in the case of multiple defaults of clearing members. Accordingly, regulation 39.29(b) increases the financial security and reliability of the SIDCO which will thereby further increase the overall the stability of the U.S. financial markets.

c. Regulation 39.30: Two-Hour RTO

A two-hour RTO in a SIDCO's BC-DR plan increases the soundness and operating resiliency of the SIDCO, which in turn, increases the overall stability of the U.S. financial markets.

Given the significant role SIDCOs play within the financial market infrastructure and the need to preserve, to the greatest extent practicable, their near- continuous operation, regulation

²⁰³ Id.

39.30 prescribes an enhanced RTO of two hours. The two-hour RTO ensures that even in the event of a wide-scale disruption, the potential negative effects upon U.S. financial markets be minimized because the affected SIDCO will recover rapidly and resume its critical market functions, thereby allowing other market participants to process their transactions, even those participants in locations not directly affected by the disruption. The two-hour RTO increases a SIDCO's operational resiliency by requiring the SIDCO to have the resources and technology necessary to resume operations promptly. This resiliency, in turn, increases the overall stability of the U.S. financial markets.

d. Benefits of QCCP Status

As discussed above,²⁰⁴ the international Basel CCP Capital Requirements provide incentives for banks to clear derivatives through CCPs that are qualified CCPs or "QCCPs" by setting lower capital charges for exposures arising from derivatives cleared through a QCCP and setting significantly higher capital charges for exposures arising from derivatives cleared through non-qualifying CCPs.²⁰⁵ The enhanced risk management standards for SIDCOs adopted in this final rulemaking are consistent with the international standards set forth in the PFMI and address part of the remaining divergences between part 39 of the Commission's regulations and the PFMI, which will provide an opportunity for SIDCOs to gain QCCP status. The Commission believes there is a benefit for a SIDCO if it is able to offer to its clearing members and their customers the favorable capital treatment under the Basel CCP Capital Requirements.

2. Costs

The Commission requested but did not receive any quantitative data or specific cost estimates associated with the proposed regulations. However, in qualitative terms, the

²⁰⁴ See supra section I. D. 4. for a discussion of the Basel CCP Capital Requirements.

²⁰⁵ Id.

Commission recognizes that this final rule may impose important costs on SIDCOs depending on the financial resources requirements and system safeguards procedures the SIDCOs currently implement. In other words, the costs range from minimal (to the extent SIDCOs are already operating, or planning to operate, consistent with the final rules) to significant (for those who are not).²⁰⁶

To the extent costs increase, the Commission has considered that higher trading costs for market participants (*i.e.* increased clearing fees, guaranty fund contributions, and margin fees, etc.) may discourage market participation and result in decreased liquidity and reduced price discovery. However, the Commission has also considered the costs to market participants and the public if these regulations are not adopted. Significantly, without these regulations to ensure that SIDCOs operate under certain enhanced risk management standards, in a manner that is consistent with internationally accepted standards, the financial integrity and security of the U.S. financial markets would be at a greater risk relative to international markets. This, too, could adversely affect the attractiveness of the U.S. financial markets subject to the Commission's jurisdiction as compared to foreign competitors. In addition, without the final rule, SIDCOs would not have the opportunity to gain QCCP status, thereby putting them at a significant competitive disadvantage in the global financial markets which, again, would be to the detriment of their clearing members and their customers. The Commission notes that to the extent it addresses the remaining divergences between part 39 of the Commission's regulations and the PFMI through future rulemakings, and these rulemakings, along with the regulations adopted

²⁰⁶ For example, ICC, one of the two existing SIDCOs, stated that it already implements the "cover two" requirement, that it does not rely upon its right of assessment in meeting that requirement, and that it is unlikely to incur significant costs in implementing the two hour RTO. *See* ICC Letter at 1-2. In addition, CME Clearing, the other existing SIDCO, implements the "cover two" requirement for two of its three guaranty funds, has each of its guaranty funds pre-funded by the respective clearing members, and, though the cost will be significant, has already "obtained budget approval and allocated resources towards a two hour RTO." *See* CME 2013 Letter at 2-4.

herein, do not provide an opportunity for non-SIDCO DCOs to obtain QCCP status, this would place such non-SIDCO DCOs at a competitive disadvantage to SIDCOs. Moreover, the resulting cost to the DCOs would be the inability to offer the favorable capital treatment under the Basel CCP Capital Requirements to their customers and clearing members.

a. Regulation 39.29(a): Cover Two

The cost of the cover two requirement for certain SIDCOs includes the opportunity cost of the additional financial resources needed to satisfy the guaranty fund requirements for the risk of loss resulting from the default of the second largest clearing member.²⁰⁷

As discussed above in more detail, the Commission received comments from market participants addressing the costs associated with a cover two standard.²⁰⁸ OCC argued that if heightened risk management standards are imposed on a DCO in such a way as to substantially increase the costs for clearing members and their customers to clear transactions through a SIDCO rather than a non-SIDCO, there is risk of undermining the goals of both Titles VII and VIII of the Dodd-Frank Act by driving clearing volume to less-regulated clearinghouses.²⁰⁹ FIA commented that the cover two requirement would put SIDCOs at a competitive disadvantage to other DCOs to the extent that they need to increase margin or guaranty fund requirements to cover the default of the second largest clearing member.²¹⁰ FIA recommended that the Commission adopt an alternative approach by extending the cover two requirement to all DCOs,

²⁰⁷ In the event that these additional resources need to be raised by the SIDCO, as opposed to reallocated, this cost is the funding cost for raising these additional resources. In addition, to the extent that there is uncertainty over whether cover two applies (for example, as in the case of whether a DCO gets deemed to be systemically important in multiple jurisdictions or whether a given product is, indeed, of a more complex risk profile), the cost of cover two is the opportunity cost (funding cost) of the additional financial resources weighted by the likelihood that cover two will apply.

²⁰⁸ See section II. for a discussion on comments received on the proposed regulation 39.29(a).

²⁰⁹ Id.

²¹⁰ Id.

not just SIDCOs, and allow ample time for DCOs to come into compliance.²¹¹ CME stated that a cover two requirement would allow some DCOs to offer lower guaranty fund and margin requirements, which would attract additional volume to that DCO and make it a de facto SIDCO. SIDCOs would then be at a competitive disadvantage relative to the de facto SIDCO until such time as the de facto SIDCO was designated as a SIDCO.²¹² ICC, one of the two existing SIDCOs, on the other hand, is in compliance with the cover two requirement and therefore, would not incur additional costs to meet the cover two requirement.²¹³

As noted above, and in comment letters from CME and ICC,²¹⁴ SIDCOs already implement the cover two standard for products with a more complex risk profile, and therefore, the costs of compliance with cover two should be mitigated given these existing practices.²¹⁵

However, there are likely to be costs associated with the uncertainty as to whether a SIDCO is deemed systemically important in multiple jurisdictions and what constitutes a product with a more complex risk profile. These costs are associated with business planning, i.e. how to fund a cover two requirement. In addition, the possibility exists that some market participants will port their positions from a SIDCO that either (1) is deemed systemically important in multiple jurisdictions or (2) clears products of a more complex risk profile to another SIDCO for which neither (1) nor (2) applies or to another DCO that is not systemically important because the value of the cover two protection to these market participants is less than the price at which that protection is being offered. These market participants will transact with DCOs that operate under cover one, which is a lower financial resources requirement, and thus, get the benefit of

²¹¹ Id.

²¹² Id.

²¹³ ICC Letter at 2.

²¹⁴ See supra n. 23 (designation of CME and ICC as SIDCOs).

²¹⁵ See ICC Letter at 1-2. See also CME 2013 Letter at 2-3.

lower transactional fees and forego the enhanced protections associated with the SIDCOs. Such an event adversely impacts the reduction in systemic risk that the cover two standard affords. However, the potential cost to the SIDCO and to the goal of systemic risk reduction is likely mitigated because (a) not every product offered by the SIDCO is available at other DCOs and (b) a SIDCO may offer benefits not available to a DCO that is not designated as systemically important,²¹⁶ thereby reducing the likelihood that market participants will port their positions to other DCOs.

b. Regulation 39.29(b): Prohibition on the Use of Assessments in Calculation of Default Resources to Meet Obligations under Regulation 39.29(a)

The costs associated with the prohibited use of assessments by SIDCOs in calculating the SIDCO's obligations under regulation 39.29(a) include the opportunity cost of the additional financial resources needed to replace the value of such assessments. This may require an infusion of additional capital. The cost of this regulation should be mitigated for SIDCOs because neither CME Clearing nor ICC, the two existing SIDCOs, rely on assessments to meet their default fund obligations for products with a more complex risk profile.²¹⁷ Additionally, analogous to the case with the cover two standard, market participant demand may shift from a SIDCO to a DCO with a lower capitalization requirement.

c. Regulation 39.30: Two-Hour RTO

The Commission recognizes that a two-hour RTO may increase operational costs for SIDCOs by requiring additional resources, including personnel, technological and geographically dispersed resources, in order to comply with the final rule. Moreover, the

²¹⁶ For example under Title VIII, a SIDCO may establish and maintain an account with the Federal Reserve Bank if permitted to do so by such Federal Reserve Bank and by the Board. See section 806(a) of the Dodd-Frank Act.

²¹⁷ See ICC Letter at 2 (stating that ICC “does not rely upon (count) [its] right of assessment to meet the [“cover two” requirement]”). See also CME 2013 Letter at 3, n.7.

implementation of a two-hour RTO is expected to impose one-time costs to set up the enhanced resources as well as recurring costs to operate the additional resources. However, as noted above, the Commission requested but did not receive quantitative data from which to estimate the dollar costs associated with implementing a two-hour RTO, and in particular the costs of moving from a next day RTO, the minimum standard established by the DCO core principles and regulation 39.18, to a two-hour RTO as required by regulation 39.30. The Commission did, however, receive qualitative comments regarding the costs associated with the two-hour RTO, which are discussed in more detail above. For example, CME, ICE and OCC all initially opposed the enhanced RTO, citing to the increase of costs associated with the proposed regulation 39.30. However, more recently, the Commission received comments from CME and ICC acknowledging the importance of the two-hour RTO and their intent to implement a two-hour RTO.²¹⁸

D. Section 15(a) Factors

1. Protection of Market Participants and the Public

The enhanced financial resources requirements and system safeguard requirements for SIDCOs, as set forth in this final rulemaking, will further the protection of market participants and the public by increasing the financial stability and operational security of SIDCOs, and more broadly, increase the stability of the U.S. financial markets. A designation of systemic importance under Title VIII means the failure of a SIDCO or the disruption of its clearing and settlement activities could create or increase the risk of significant liquidity or credit problems

²¹⁸ See ICC Letter at 2 (noting that the two-hour RTO is consistent with Principle 17 of the PFMI, and stating that it is unlikely to incur “any significant additional personnel training cost associated with the CFTC’s proposed RTO of two hours” or “any additional backup technology costs related to the CFTC’s proposed RTO.”). See also CME 2013 Letter at 4 (noting that “in light of the systemic importance of CME [Clearing]’s clearing functions and the intended benefits, including compliance with the PFMI requirements for critical information technology, CME [Clearing] has obtained budget approval and allocated resources towards a two hour RTO and will be working throughout 2013 towards achieving a two hour RTO.”).

spreading among financial institutions or markets, thereby threatening the stability of the U.S. financial markets. The regulations contained in this final rule are designed to help ensure that SIDCOs continue to function even in extreme circumstances, including multiple defaults by clearing members and wide-scale disruptions. While there may be increased costs associated with the implementation of the final rules, these costs are mitigated by the countervailing benefits of the increased safety and soundness of the SIDCOs and the reduction of systemic risk, which protect market participants and the public from the adverse consequences that would result from a SIDCO failure or a disruption in its functioning.

2. Efficiency, Competitiveness, and Financial Integrity

The regulations set forth in this final rulemaking will promote financial strength and stability of SIDCOs, as well as, more broadly, efficiency and greater competition in the global markets. The regulations promote efficiency insofar as SIDCOs that operate with enhanced financial resources as well as increased system safeguards are more secure and are less likely to fail. The regulations promote competition because they are consistent with the international standards set forth in the PFMI and will help to ensure that SIDCOs are afforded the opportunity to gain QCCP status and thus avoid an important competitive disadvantage relative to similarly situated foreign CCPs that are QCCPs. Additionally, by increasing the stability and strength of the SIDCOs, the regulations in the final rule help to ensure that SIDCOs can meet their obligations in the most extreme circumstances and can resume operations even in the face of wide-scale disruption, which contributes to the financial integrity of the financial markets. In requiring more SIDCO financial resources to be pre-funded by (1) expanding the potential losses those resources are intended to cover and (2) restricting the means for satisfying those resource requirements, *i.e.* through prohibiting the use of assessments in determining guarantee fund contributions, the requirements of this final rule seek to lessen the incidence of pro-cyclical

demands for additional funding resources and, in so doing, promote both financial integrity and market stability.²¹⁹

3. Price Discovery

The regulations in the final rulemaking enhance risk management standards for SIDCOs which may result in increased public confidence, which, in turn, might lead to expanded participation in the affected markets, i.e. products with a more complex risk profile. The expanded participation in these markets (i.e. greater transactional volume) may have a positive impact on price discovery. Conversely, the Commission notes that these enhanced risk management standards are also associated with additional costs and to the extent that SIDCOs pass along the additional costs to their clearing members and customers, participation in the affected markets may decrease and have a negative impact on price discovery. However, it is the Commission's belief that such higher transactional costs should be greatly offset by the lower capital charges granted to clearing members and customers clearing derivative transactions through SIDCOs that are deemed QCCPs.

4. Sound Risk Management Practices

The regulations in the final rulemaking contribute to the sound risk management practices of SIDCOs because the requirements promote the safety and soundness of the SIDCOs by (1) enhancing the financial resources requirements, which provide greater certainty for market participants that all obligations will be honored by the SIDCOs and (2) enhancing system safeguards to facilitate the continuous operation and rapid recovery of activities, which provide certainty and security to market participants that potential disruptions will be **reduced** and, by extension, the risk of loss of capital and liquidity will be **reduced**.

²¹⁹ See supra n. 139 and accompanying text for a discussion of pro-cyclicality.

5. Other Public Interest Considerations

The Commission notes the strong public interest for jurisdictions to either adopt the PFMI or establish standards consistent with the PFMI in order to allow CCPs licensed in the relevant jurisdiction to gain QCCP status. As emphasized throughout this rulemaking, SIDCOs that gain QCCP status will avoid a competitive disadvantage in the financial markets by avoiding the much higher capital charges imposed by the Basel CCP Capital Requirements. Moreover, because “enhancements to the regulation and supervision of systemically important financial market utilities ... are necessary ... to support the stability of the broader financial system,”²²⁰ adopting these rules promotes the public interest in a more stable broader financial system.

VII. Related Matters.

A. 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 §§ 39.28, 39.29, 39.30, and 39.31 (DCO) imposes no new information collection requirements on registered entities within the meaning of the Paperwork Reduction Act.²²¹ The OMB has previously assigned control numbers for the required collections of information under a prior related final rulemaking to which this rulemaking relates.²²² The titles for the previous collections of information are “Part 40, Provisions Common to Registered Entities”, OMB control number 3038-0093, “Financial Resources Requirements for Derivatives Clearing Organizations, OMB control number 3038-0066,” “Information Management Requirements for Derivatives Clearing Organizations, OMB

²²⁰ See section 804(a)(4) of the Dodd-Frank Act (Congressional findings).

²²¹ 44 U.S.C. 3501 et seq.

²²² 76 FR 69334 at 69428.

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.” This rulemaking is applicable to a subset of DCOs designated as SIDCOs, who must comply with existing information collection requirements for DCOs.

B. 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. The rules proposed by the Commission will affect only DCOs designated as SIDCOs. 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. The Commission has previously determined that DCOs are not small entities for the purpose of the RFA.²²³

Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed rules will not have a significant economic impact on a substantial number of small entities.

²²³ See “A New Regulatory Framework for Clearing Organizations,” 66 FR 45604, 45609 (Aug. 29, 2001), “17 CFR part 40 Provisions Common to Registered Entities,” 75 FR 67282 (November 2, 2010), and “Provisions Common to Registered Entities,” 76 FR 44776, 44789 (July 27, 2011).

List of Subjects

Commodity futures, Risk management, System safeguards, Financial Resources, Enforcement

Authority.

For the reasons stated in the preamble, amend 17 CFR part 39 as follows:

1. Amend the Part 39 table of contents to add the following:

Subpart C – Provisions Applicable to Systemically Important Derivatives Clearing

Organizations

39.28 Scope.

39.29 Financial resources requirements.

39.30 System safeguards.

39.31 Special enforcement authority.

2. The authority citation for part 39 is revised to read as follows:

Authority: 7 U.S.C. 2 and 7a-1 as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376; Subpart C also issued under 12 U.S.C. 5464.

3. Add subpart C to read as follows:

Subpart C—Provisions Applicable to Systemically Important Derivatives Clearing

Organizations

§ 39.28 Scope.

(a) The provisions of this subpart C apply to any derivatives clearing organization, as defined in section 1a(15) of the Act and § 1.3(d) of this chapter,

(1) 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; and

(2) Which is a systemically important derivatives clearing organization as defined in § 39.2 of this part.

(b) A systemically important derivatives clearing organization is subject to the provisions of subparts A and B of this part 39 except to the extent different requirements are imposed by provisions of this subpart C.

(c) A systemically important derivatives clearing organization shall provide notice to the Commission in advance of any proposed change to its rules, procedures, or operations that could materially affect the nature or level of risks presented by the systemically important derivatives clearing organization, in accordance with the requirements of § 40.10 of this chapter.

§ 39.29 Financial resources requirements.

(a) General rule. Notwithstanding the requirements of § 39.11(a)(1) of this part, a systemically important derivatives clearing organization that is systemically important in multiple jurisdictions or that is involved in activities with a more complex risk profile shall maintain financial resources sufficient to enable it 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 systemically important 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, affiliated clearing members shall be deemed to be a single clearing member for the purposes of this provision.

(b) Valuation of financial resources. Notwithstanding the requirements of § 39.11(d)(2) of this part, assessments for additional guaranty fund contributions (i.e., guarantee fund contributions that are not pre-funded) shall not be included in calculating the financial resources available to

meet a systemically important derivatives clearing organization's obligations under paragraph (a) of this section.

§ 39.30 System safeguards.

(a) Notwithstanding § 39.18(e)(3) of this part, the business continuity and disaster recovery plan described in § 39.18(e)(1) for each systemically important derivatives clearing organization shall have the objective of enabling, and the physical, technological, and personnel resources described in § 39.18(e)(1) shall be sufficient to enable, the derivatives clearing organization to recover its operations and resume daily processing, clearing, and settlement no later than two hours following the disruption, for any disruption including a wide-scale disruption.

(b) To ensure its ability to achieve the recovery time objective specified in paragraph (a) of this section in the event of a wide-scale disruption, each systemically important derivatives clearing organization must maintain a degree of geographic dispersal of physical, technological and personnel resources consistent with the following:

(1) For each activity necessary to the clearance and settlement of existing and new contracts, physical and technological resources, sufficient to enable the entity to meet the recovery time objective after interruption of normal clearing by a wide-scale disruption, must be located outside the relevant area of the infrastructure the entity normally relies upon to conduct that activity, and must not rely on the same critical transportation, telecommunications, power, water, or other critical infrastructure components the entity normally relies upon for such activities;

(2) Personnel, sufficient to enable the entity to meet the recovery time objective after interruption of normal clearing by a wide-scale disruption affecting the relevant area in which the personnel the entity normally relies upon to engage in such activities are located, must live and work outside that relevant area;

(3) The provisions of § 39.18(f) of this part shall apply to these resource requirements.

(c) Each systemically important derivatives clearing organization must conduct regular, periodic tests of its business continuity and disaster recovery plans and resources and its capacity to achieve the required recovery time objective in the event of a wide-scale disruption. The provisions of § 39.18(j) of this part apply to such testing.

(d) The requirements of this section shall apply to a derivatives clearing organization not earlier than one year after such derivatives clearing organization is designated as systemically important.

§ 39.31 Special enforcement authority.

For purposes of enforcing the provisions of Title VIII of the Dodd-Frank Act, a systemically important derivatives clearing organization shall be subject to, and the Commission has authority under the provisions of subsections (b) through (n) of section 8 of, the Federal Deposit Insurance Act (12 U.S.C. 1818) in the same manner and to the same extent as if the systemically important derivatives clearing organization were an insured depository institution and the Commission were the appropriate Federal banking agency for such insured depository institution.

Issued in Washington, DC on August 9, 2013, by the Commission.

Melissa D. Jurgens

Secretary of the Commission

Appendices to Final Rule on Enhanced Risk Management Standards for Systemically Important Derivatives Clearing Organizations —Commission Voting Summary

Note: The following appendix will not appear in the Code of Federal Regulations

Appendix 1 – Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Chilton, O'Malia, and Wetjen voted in the affirmative.