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Division of
Clearing and Risk

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CFTC Letter No. 12-08
Interpretation
September 14, 2012
Division of Clearing and Risk

<u>ELECTRONIC MAIL</u>

Lisa Dunsky
Executive Director and Associate General Counsel
Chicago Mercantile Exchange Inc.
20 S. Wacker Drive
Chicago, IL 60606

Re: <u>Request for Interpretation of Commission Regulation 39.13(g)(8)(ii)</u>

Dear Ms. Dunsky:

This letter responds to your request for an interpretation regarding the implementation of Commodity Futures Trading Commission ("Commission") Regulation 39.13(g)(8)(ii) ("Customer Margin Rule")[1] by registered derivatives clearing organizations ("DCOs"). In this regard, by letter dated August 29, 2012, you have asked for clarification as to:

1. The meaning of the term "non-hedge positions" as used in the Customer Margin Rule, specifically addressing the treatment of member-customers;
2. Confirmation that CME may continue to apply higher customer initial margin requirements to clearing member affiliate accounts and other non-customer accounts that clear in the house origin;[2]
3. The treatment of non-clearing futures commission merchant ("FCM") customer omnibus accounts at clearing FCMs in connection with the higher customer initial margin requirement; and
4. The standard a DCO should apply in setting "margin greater than 100% of the derivatives clearing organization's initial margin requirements."

[1] *See* 76 Fed. Reg. 69,334, 69,439 (Nov. 8, 2011). Commission regulations referred to herein are found at 17 C.F.R. Chapter 1 (2012).

[2] The term "house origin" or "house account" is defined in Commission Regulation 39.2.

I. Adoption of the Customer Margin Rule

A. Background

The Commission adopted the Customer Margin Rule on October 18, 2011 as part of a comprehensive final rulemaking that implemented DCO Core Principles set forth in Section 5b of the Commodity Exchange Act ("CEA").[3] The rule provides as follows:

> *Customer initial margin requirements.* A derivatives clearing organization shall require its clearing members to collect customer initial margin, as defined in §1.3 of this chapter, from their customers, for non-hedge positions, at a level that is greater than 100 percent of the derivatives clearing organization's initial margin requirements with respect to each product and swap portfolio. The derivatives clearing organization shall have reasonable discretion in determining the percentage by which customer initial margins must exceed the derivatives clearing organization's initial margin requirements with respect to particular products or swap portfolios. The Commission may review such percentage levels and require different percentage levels if the Commission deems the levels insufficient to protect the financial integrity of the clearing members or the derivatives clearing organization.[4]

As explained in the preamble to the final rulemaking, the primary purpose of the Customer Margin Rule is to shift the responsibility for establishing minimum customer initial margin requirements from designated contract markets ("DCMs") to DCOs. The Commission explained the basis for this transfer of responsibility as follows:

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

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

[4] 76 Fed. Reg. at 69,439.

> their clearing members, are able to meet their margin obligations. [Emphasis added.] [5]

This shifting of responsibility from the DCM to the DCO reflects the confluence of two significant factors: (1) DCOs may provide clearing services for unaffiliated DCMs, swap execution facilities ("SEFs"), or parties to a bilateral swap;[6] and (2) DCOs are responsible for risk management, and establishing appropriate margin requirements is a component of that function.[7] The Commission also noted its belief that requiring an FCM to collect higher customer initial margin for what the Customer Margin Rule refers to as "non-hedge" positions (generally speaking, what CME referred to as "public customers" in its May 3, 2012 extension request) provides a valuable cushion of readily available customer margin collateral.[8]

The Customer Margin Rule is intended to maintain the current practice of "two-tier" margining applied to different categories of customers, but with DCOs setting customer initial margin requirements, *i.e.*, determining the percentage by which the customer initial margin requirement exceeds the clearing initial margin requirement, and determining which categories of customers are eligible to post initial margin at the clearing initial margin level. The Division of Clearing and Risk ("Division") expects that DCOs and DCMs (and as applicable, SEFs) will continue to work together in setting initial margin requirements for customers.[9]

B. <u>Customer Margin Rule Definitions</u>

In order to provide clarity with respect to the guidance contained in this interpretative letter, the Division notes the following defined terms:

- "<u>Initial margin</u>" is defined in Commission Regulation 1.3(ccc) and means "money, securities, or property posted by a party to a futures, option, or swap as performance bond to cover potential future exposures arising from changes in the market value of the position."[10]

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[5] *Id*. at 69,377.

[6] In this regard, the Commission stated that "it is anticipated that some DCOs will clear fungible swaps that may be listed on multiple SEFs. SEFs may or may not impose customer initial margin requirements on their members for cleared swaps. Requirements set by DCOs may be less susceptible to pressure to being lowered for competitive reasons. Finally, DCOs will be the only self-regulatory organizations that will be in a position to set customer initial margin requirements for swaps that are executed bilaterally, and voluntarily cleared." *Id.* at 69,377-78.

[7] *See generally* Sections 5b(c)(2)(D)(iii)-(v) of the CEA, 7 U.S.C. 7a-1(c)(2)(D)(iii)-(v) ("Core Principle D") (requiring, respectively, that DCOs limit exposure to potential losses "through margin requirements and other risk control mechanisms," that clearing member margin be sufficient to cover potential exposures in normal market conditions, and that each model and parameter used in setting margin requirements be risk-based and reviewed on a regular basis); and Commission Regulation 39.13(g) (provisions implementing Core Principle D).

[8] 76 Fed. Reg. at 69,378.

[9] Historically, a DCO and the DCM(s) for which it clears will confer and together establish customer initial margin requirements. The DCO then creates a risk array for use by FCMs.

[10] Although the term "performance bond" has historically been used in the context of futures markets, the revised terminology referring to "initial margin" was adopted by the Commission to harmonize with the nomenclature of the

- "Clearing initial margin" is defined in Commission Regulation 1.3(aaa) and means "initial margin posted by a clearing member with a derivatives clearing organization."

- "Customer initial margin" is defined in Commission Regulation 1.3(bbb) as "initial margin posted by a customer with a futures commission merchant, or by a non-clearing member futures commission merchant with a clearing member."

The initial margin definitions above refer to *all* collateral posted by the clearing member or customer, as applicable. The Customer Margin Rule, however, pertains to "customer initial margin *requirements*" and is referring to the minimum amount of margin collateral required to be posted by the customer.

Accordingly, under a "two-tiered" margining approach and as used in this letter:

- "Clearing initial margin requirement" refers to the *lower* initial margin requirement. This lower or base amount has historically been referred to by different terms including: the "maintenance margin requirement," "MMR,"[11] "base margin," "exchange minimum margin," "clearing performance bond," "original margin," "hedge margin," or the "hedge rate."

- "Customer initial margin requirement" refers to the *higher* initial margin requirement. This higher amount has historically been referred to by different terms including: the "initial margin requirement," "IMR,"[12] "bumped up margin," "speculative margin," or the "spec rate."

II. Extension of Time for Compliance with the Customer Margin Rule

On January 20, 2011, the Commission published the proposed Customer Margin Rule for public comment.[13] The initial comment period closed on March 21, 2011, and the comment period was later re-opened until August 25, 2011.[14] The Customer Margin Rule was finalized on

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CEA (*e.g.*, Core Principle D refers to "margin requirements") and the Bank for International Settlements Committee on Payment and Settlement Systems ("CPSS") and the Technical Committee of the International Organization of Securities Commissioners *Principles for financial market infrastructures. See* CPSS Publ'n No. 101 (April 2012), available at http://www.bis.org/publ/cpss101a.pdf.

[11] *See* the Joint Audit Committee ("JAC"), Margins Handbook page 1-3 (2nd ed.1999) (Definitions), available at http://www.wjammer.com/jac/. The JAC is a representative committee of U.S. futures exchanges and regulatory organizations that participate in a joint audit and financial surveillance program applicable to FCMs.

[12] *Id.*

[13] 76 Fed. Reg. 3698, 3721 (Jan. 20, 2011).

[14] *See* 76 Fed. Reg. at 69,335, n.12 (regarding extension or re-opening of comment periods for multiple Dodd-Frank proposed rulemakings).

October 18, 2011, published in the Federal Register on November 8, 2011, and became effective on January 9, 2012. Compliance was required as of May 7, 2012.[15]

As the compliance date approached, CME and six other DCOs notified the Division that more time was needed in order to study and implement the Customer Margin Rule. In this regard, various issues were raised concerning the meaning of the rule's applicability to "non-hedge positions" and the implications for increasing the minimum margin requirements for certain categories of customers (such as exchange members) that had historically posted initial margin at the lower "clearing initial margin" level pursuant to DCM and JAC rules and practices.

In particular, CME explained in its extension request that

> [a]t the time of our comments in response to the proposed rules, we did not understand that this provision applied to member-customers in addition to public customers. We were already in full compliance as respects public customers other than members. Our members had generally been afforded hedge margin treatment for all of their positions and it was not understood that this provision would have a profound, adverse impact on their costs of doing business. . . . In addition, there is some lack of clarity exactly how this regulation impacts customer omnibus accounts as well. Given the need to avoid confusion and potential disruption in the market and to provide clearing members and other FCM's [*sic*] with comfort around the implementation of this regulation, we would also request that the 90 day extension apply to omnibus accounts."[16]

The Division granted CME and each of the other six DCOs a 90-day extension for compliance, until August 5, 2012. The Division consulted with each of the DCOs regarding the issues raised in their extension requests as well as other questions regarding the implementation of the Customer Margin Rule. The Division subsequently granted a second extension for compliance, for 60 days, until October 4, 2012.

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[15] *Id.* at 69,334.

[16] Email from Kim Taylor, President, CME Group Clearing House Division, to Ananda Radhakrishnan, Director, and John Lawton, Deputy Director, Division of Clearing and Risk (May 3, 2012) (Request for Extension on Implementing Regulation § 39.13(g)(ii)), available at http://www.cftc.gov/stellent/groups/public/@otherif/documents/ifdocs/cmeextensionrequest5-3-12.pdf.

III. Discussion

A. Maintaining Historical Margin Practices

This interpretative letter serves as notice to the CME and all other registered DCOs, that the Division interprets the Customer Margin Rule in a manner that preserves the historical customer margining practices applicable to FCMs. For example, the customer initial margin levels set by the DCO are a minimum, and FCMs are expected to continue the practice of collecting customer initial margin at a level higher than the minimum required, if such action is warranted based on the unique risk profile of an individual customer.[17] Likewise, as noted above, DCOs and DCMs are expected to continue to confer regarding product-specific minimum margin levels. In addition, the Customer Margin Rule *does not* replace the margin requirements and procedures set forth in the JAC Margins Handbook.[18]

The Division also takes this opportunity to clarify that, as is currently the practice with respect to "two-tier" margining, if a customer subject to the higher customer initial margin requirement has margin on deposit that drops below such requirement, but remains above the clearing initial margin requirement, then the FCM is not required to collect additional margin from such customer. However, if such customer's margin on deposit drops below the clearing initial margin requirement, then such customer must deposit additional margin collateral in order to bring the amount on deposit up to the customer initial margin requirement.[19]

B. Addressing CME's Specific Questions Regarding Interpretation of the Customer Margin Rule

As noted above, the Commission's stated intention in adopting the Customer Margin Rule is to simply shift the responsibility for establishing customer initial margin requirements from DCMs to DCOs. This shift in responsibility is consistent with each DCO's increased

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[17] *See* 76 Fed. Reg. at 69,378 (preamble to the final rulemaking where the Commission notes that "as is also the case today, such clearing FCMs would remain free to exercise their discretion to determine whether they will collect additional margin over and above [the amount established by the DCO] either from all of their customers, or from particular customers based on such customers' risk profiles."). *See generally* Commission Regulation 1.73, 77 Fed. Reg. 21,278, 21,306-07 (Apr. 9, 2012) (establishing requirements for clearing FCM risk management including weekly stress testing of all positions in each customer account and weekly evaluation of the clearing FCM's ability to meet initial and variation margin requirements).

[18] *See* JAC Margins Handbook, *supra* note 11, As noted in the Preface to the JAC Margins Handbook, the JAC developed the handbook in an effort to standardize margin procedures. The Division notes that it may be necessary to revise the Margins Handbook as well as the Commission's Form 1-FR-FCM Instructions to reflect implementation of the Customer Margin Rule.

[19] *Id.* at 4-1 to 4-2 (Issuance of Margin Calls).

regulatory responsibility in connection with the oversight of its clearing members' risk management activities[20] and the DCO's own heightened risk management requirements with respect to "particular clearing members, when appropriate."[21] In this context, the Division addresses, below, each of the questions submitted by CME in its August 29, 2012 letter.

1. <u>The meaning of the term "non-hedge positions" as used in the Customer Margin Rule, specifically addressing the treatment of member-customers</u>

Commenters on the proposed regulation requested clarification regarding the meaning of "non-hedge positions."[22] In response, the Commission noted its intention to interpret "hedge positions" for purposes of the Customer Margin Rule as referring to those positions that meet either the requirements for "bona fide hedging transactions and positions" set forth in Commission Regulation 1.3(z), or the requirements for "hedging or mitigating commercial risk" set forth in Commission Regulation 1.3(ttt) (as adopted in final form for purposes of defining the term "Major Swap Participant").[23] In addition, the Commission confirmed that "as is currently the practice, it would be the customer's responsibility to identify its positions as hedge positions to its clearing FCM."[24]

The Division recognizes that historically, DCM requirements for collection of higher customer initial margin have typically been applied on an *account* basis (*e.g.*, hedge or speculative) rather than on a *position* basis. Accordingly, in general, when a customer opens an account at its FCM, the account owner is given an opportunity to request "hedge" status, which requires the completion of a hedge letter/form. Upon approval by the FCM, the account is then designated as either "hedge" or "speculative" for margin treatment purposes and is subject to either the clearing initial margin requirement or the customer initial margin requirement, respectively. Under existing rules or practices at various DCMs,[25] exchange members, market makers, market professionals, and certain other categories of customers, have typically been subject to the clearing initial margin requirement *i.e.*, such exchange member accounts are designated as "hedge" or "member" and receive the lower clearing initial margin rate even though there may be speculative positions in the account.

Allowing these categories of customers to be subject to the clearing initial margin requirement is not inconsistent with prudent risk management in that such customers are

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[20] *See* Commission Regulation 39.13(h)(5) (requiring a DCO to adopt rules regarding clearing members' risk management policies and procedures).

[21] *See id.* at 39.13(h)(6) (requiring a DCO to "take additional actions with respect to particular clearing members, when appropriate, based on the application of objective and prudent risk management standards").

[22] 76 Fed. Reg. at 69,378.

[23] *Id.* at 69,379. The definition of Major Swap Participant was adopted by the Commission on April 27, 2012, 77 Fed Reg. 30,596, 30,746-47 (May 23, 2012).

[24] 76 Fed. Reg. at 69,379.

[25] *See, e.g.*, ICE Futures U.S., Inc., Rulebook 5-3 to 5-5 (Rule 5.03, Margin), available at https://www.theice.com/publicdocs/rulebooks/futures_us/5_Margin_Rules.pdf.

professional traders and are subject to stricter standards and a higher level of review than ordinary "public" customers. For example, in order to become an exchange member, these traders are required to go through an application process that typically includes testing, interviews, and other information-gathering to establish that the traders possess the knowledge and integrity that is required in order for them to receive the benefits of exchange membership (such as lower trading fees as well as lower margin requirements). In addition, exchange members, market makers and certain other market professionals are subject to exchange rules and ongoing supervision by the exchange.

As noted above, the Division interprets the Customer Margin Rule to preserve the historic practices applicable to FCMs, except that customer initial margin requirements are to be established by the DCO and not the exchange. Accordingly, the DCO may continue the practice of establishing customer initial margin requirements based on the type of customer account and by applying prudential standards that result in FCMs collecting customer initial margin at levels commensurate with the risk presented by each type of customer account. This is the case even if the differentiation between accounts is not stated specifically in terms of "hedge" and "non-hedge" accounts.

The Division notes that some DCOs have collected initial customer margin without differentiating between categories of customers or between customers and clearing members, *i.e.*, a single customer initial margin requirement is the same as the clearing initial margin requirement. Consistent with the treatment of two-tiered customer initial margin, a DCO that collects non-differentiated initial margin may continue to do so as long as the customer initial margin requirement results in the application of prudential standards that result in FCMs collecting initial margin at levels commensurate with the risk presented by each type of customer account.

2. <u>Confirmation that CME may continue to apply higher customer initial margin requirements to clearing member affiliate accounts and other non-customer accounts that clear in the house origin</u>

CME has represented to the Division that certain clearing member house accounts (*i.e.*, accounts of clearing member affiliates that are not exchange members and accounts of clearing member owners that engage in speculative trading) are subject to the higher customer initial margin requirements. CME has requested confirmation that it may continue its practice of applying higher initial margin requirements to such non-customer accounts.

As explained above, the Division interprets the Customer Margin Rule in a manner that permits DCOs to preserve the historic practices applicable to FCMs in setting customer initial margin requirements. Moreover, the Customer Margin Rule, which applies to customer initial margin requirements and not to initial margin requirements applicable to house accounts, does not impact a DCO's authority to set higher minimum initial margin requirements for certain accounts within a house account.

3. The treatment of non-clearing FCM customer omnibus accounts at clearing FCMs in connection with the higher customer initial margin requirement

Historically, and consistent with the JAC Margins Handbook,[26] customer omnibus accounts may be subject to clearing initial margin requirements. In this regard, a non-clearing FCM's customer omnibus account held at a clearing FCM may be comprised of both hedge accounts and speculative accounts. The clearing FCM typically does not know the identity of the underlying customers in an omnibus account. As described above, the customer's non-clearing FCM sets customer initial margin requirements based on whether the customer account is designated as "hedge" or "speculative." Thus, a speculative account included within an omnibus account would have already been assessed the higher customer initial margin requirement by such customer's non-clearing FCM. Accordingly, the clearing FCM is not required to apply the higher customer initial margin rate to the entire customer omnibus account as this would require either (1) the non-clearing FCM to post more collateral with the clearing FCM than the amount actually collected from its hedge customers in the omnibus account or (2) the non-clearing FCM to collect the higher customer initial margin requirement from its hedge customers so that it can post this collateral with the clearing FCM. The Division further understands that some clearing FCMs treat all customer omnibus accounts as speculative while other clearing FCMs apply lower clearing initial margin requirements to omnibus accounts as has been permitted historically.

The Division interprets the Customer Margin Rule to permit DCOs to preserve the historic practices applicable to FCMs in setting customer initial margin requirements. Accordingly, a DCO may continue the current practice of applying clearing initial margin requirements to customer omnibus accounts so long as the DCO applies prudential standards in making this determination, and it results in the collection of initial margin in an amount that is commensurate with the risk presented by such customer omnibus accounts.

4. The standard a DCO should apply in setting "margin greater than 100% of the derivatives clearing organization's initial margin requirements"

In proposing the Customer Margin Rule, the Commission explained that the cushion provided by the higher customer initial margin requirement "would enable clearing members to deposit additional margin with a DCO on behalf of their customers, as necessitated by adverse market movements, without the need for the clearing members to make frequent margin calls to their customers."[27] The Commission further observed that "[a] DCO would be familiar with the risk characteristics of particular products and swap portfolios that it clears, which should enable

[26] Chapter 7 of the JAC Margins Handbook provides: "Omnibus accounts are margined using only maintenance margin requirements at exchanges; thus, initial margin requirements do not apply. An omnibus account's initial margin requirement equals the account's maintenance margin requirement." JAC Margins Handbook, *supra* note 11, at page 7-1.

[27] 76 Fed. Reg. at 3706.

it to determine the extent of the cushion that a clearing member should have with respect to customer initial margins."[28]

In adopting the Customer Margin Rule as proposed, the Commission determined to provide DCOs with "reasonable discretion in determining the percent by which customer initial margins must exceed the [DCO's] initial margin requirements with respect to particular products or swap portfolios."[29] The Commission also provided in the Customer Margin Rule that the "Commission may review such percentage levels and require different percentage levels if the Commission deems the levels insufficient to protect the financial integrity of the clearing members or the [DCO]".[30]

Accordingly, the Division will review the determinations made by DCOs with respect to their application of the Customer Margin Rule with a view towards protecting the financial integrity of clearing members and the DCO. The Division expects DCOs to set meaningful customer initial margin requirements that are commensurate with the risk presented by each type of customer account, and that meet the standards for initial margin under Core Principle D and Commission Regulation 39.13(g).[31]

IV. Application of Customer Margin Rule to Security Futures

As a final matter, the Division takes this opportunity to clarify that the Customer Margin Rule does not apply to customer initial margin collected as performance bond for customer security futures positions.[32]

Customer margin requirements for security futures positions are governed by Section 7(c)(2) of the Securities Exchange Act of 1934, as amended ("Exchange Act"),[33] and Section 2(a)(1)(C)(v)(IV) of the CEA,[34] as amended by the Commodity Futures Modernization Act of 2000 ("CFMA"),[35] and by joint regulations issued respectively by the Securities and Exchange Commission ("SEC")[36] and the Commission.[37] The Customer Margin Rule was not intended to alter the unique customer margin framework established by the CFMA and the joint

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[28] *Id.*

[29] Commission Regulation 39.13(g)(8)(ii).

[30] *Id.*

[31] *See supra* note 7.

[32] Although this issue was not raised in comment letters on the Customer Margin Rule when proposed, the Division has received questions in connection with post-adoption implementation of the final Customer Margin Rule.

[33] Section 7(c)(2) of the Exchange Act, 15 U.S.C. 78g(c)(2).

[34] Section 2(a)(1)(C)(v)(IV) of the CEA, 7 U.S.C. 2(a)(1)(C)(v)(IV).

[35] Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).

[36] *See* 17 C.F.R. 242.400-242.406 (2012).

[37] *See* 17 C.F.R. 41.42-41.49 (2012).

Commission-SEC regulations promulgated thereunder. Moreover, the delegated authority under which the SEC and the Commission may issue security futures customer margin regulations requires that the regulations be issued jointly, by both agencies.[38]

V. Conclusion

The Division is issuing this letter in order to clarify that the Customer Margin Rule may be applied by DCOs in a manner that is consistent with historical practices with respect to both the "two-tiered" and "non-differentiated" margining approaches applied to the collection of customer initial margin by FCMs. The Division intends to study this matter further, and it will consider recommending changes to the text of the regulation to more precisely articulate the requirement imposed on DCOs in light of the Commission's objective in adopting Commission Regulation 39.13(g)(8)(ii).

This letter represents the position of the Division only and does not necessarily represent the views of the Commission or those of any other division or office of the Commission. Should you have questions regarding this matter, please contact Phyllis Dietz, Deputy Director (pdietz@cftc.gov, 202-418-5449), or Heidi Rauh, Special Counsel (hrauh@cftc.gov, 312-596-0644).

Sincerely,

Ananda Radhakrishnan
Director

[38] *See* Letter from Jennifer J. Johnson, Secretary of the Board, Federal Reserve Board, to James E. Newsome, Acting Chairman, Commission, and Laura S. Unger, Acting Chairman, SEC (Mar. 6, 2001) (delegating authority for setting security futures customer margin from the Federal Reserve Board jointly to the SEC and the Commission), reprinted as Appendix B to Exchange Act Release No. 44853 (Sep. 26, 2001), 66 Fed. Reg. 50,720, 50,741 (Oct. 4, 2001).