

**MEMO# 25596**

October 28, 2011

## **CFTC Approves Core Principles for Derivatives Clearing Organizations**

[25596]

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 43-11  
SEC RULES MEMBERS No. 126-11 RE: CFTC APPROVES CORE PRINCIPLES FOR DERIVATIVES CLEARING ORGANIZATIONS

Section 725(c) of the Dodd-Frank Act amended Section 5b(c)(2) of the Commodity Exchange Act (“CEA”), which sets forth core principles with which a derivatives clearing organization (“DCO”) must comply to be registered and to maintain such registration. The Dodd-Frank Act revised the 14 existing core principles and added four new ones. On October 18, 2011, the Commodity Futures Trading Commission (“CFTC”) issued final rules that establish standards for compliance with 15 of the 18 core principles applicable to DCOs. [\[1\]](#) The final rules address requirements for DCO financial resources, DCO risk management, and segregation of customer funds, among others. The final rules will become effective 60 days after publication in the Federal Register and are briefly summarized below.

The CFTC’s final rules establish standards for compliance with the following DCO core principles found in the CEA: Core Principles A (Compliance), B (Financial Resources), C (Participant and Product Eligibility), D (Risk Management), E (Settlement Procedures), F (Treatment of Funds), G (Default Rules and Procedures), H (Rule Enforcement), I (System Safeguards), J (Reporting), K (Recordkeeping), L (Public Information), M (Information Sharing), N (Antitrust Considerations) and R (Legal Risk). [\[2\]](#) The remaining core principles, O (Governance Fitness Standards), P (Conflicts of Interest), and Q (Composition of Governing Boards), will be addressed in future rulemaking. The final rules generally mirror the rules as they were proposed, although there are some differences.

The final rules address permitted types of financial resources, computation, valuation, liquidity, and reporting requirements for DCOs. Notably, letters of credit, which currently are allowed in futures markets, are not listed among acceptable financial resources for swaps. In addition, reflecting a change from the proposed rules, the final rules require 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,” and to cover its operating costs for at least one year. As proposed, the rules would have required “systemically important” DCOs to maintain enough funds to cover the default of their two largest members.

The rules provide that a DCO’s risk management framework must include margin methodology and coverage, price data, daily review, periodic back tests, and other risk control mechanisms (including risk limits, review of large trader reports, stress tests, and reviews of clearing members’ risk management policies and procedures). They also require DCOs to submit certain periodic and event-specific reports, and all registrants must file new Form DCO with the CFTC.

Further, the final rules prohibit DCOs from setting a minimum capital requirement greater than \$50 million for any entity seeking to become a clearing member. According to the Release, this threshold, which is designed to address open access, is set at a level that likely will allow many futures commission merchants (“FCMs”) to satisfy the capital requirements to become a clearing member of a DCO or allow FCMs to qualify as clearing members at multiple DCOs. While this may enhance investor choice of FCMs, it also may reduce the general caliber of clearing member FCMs because DCOs may have to admit some FCMs to membership that otherwise would be denied such entry. Commenters on the proposed rules suggested that DCOs may have to increase margin requirements, guarantee funds, or put in place other risk control mechanisms to cover the added risk to their models from these FCMs. The costs related to these changes likely will be passed on to the customer.

In addition, the final rules update and add related definitions, including, among others, “clearing initial margin,” “customer initial margin” and “systemically important derivatives clearing organization.” They also require DCOs to designate a chief compliance officer (“CCO”), specify duties and requirements of the CCO, and set forth additional related requirements, including procedures for filing the annual compliance report required by the Dodd-Frank Act. The final rules do not establish capital requirements for DCOs.

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#### **endnotes**

[1] Derivatives Clearing Organization General Provisions and Core Principles, Commodity Futures Trading Commission, RIN 3038-AC98, available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister101811.pdf> (“Release”).

[2] The rules were initially proposed in five different releases: Requirements for Processing, Clearing, and Transfer of Customer Positions (March 10, 2011); Risk Management Requirements for DCOs (January 20, 2011); Information Management Requirements for DCOs (December 15, 2010); General Regulations for DCOs (December 13, 2010); and Financial Resources Requirements for DCOs (October 14, 2010).

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