The Asset Management Industry
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SEC Adopts Amended Standards for Covered Clearing Agencies

[30305]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 19-16
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 53-16
ICI GLOBAL TRADING & MARKETS COMMITTEE No. 51-16
INVESTMENT ADVISER MEMBERS No. 20-16
SEC RULES MEMBERS No. 56-16 RE: SEC ADOPTS AMENDED STANDARDS FOR COVERED CLEARING AGENCIES

The Securities and Exchange Commission ("SEC" or "Commission") recently adopted final rules amending standards for the operation and governance of SEC-registered clearing agencies that meet the definition of a "covered clearing agency."[1] The final rules require covered clearing agencies to establish, implement, maintain, and enforce written policies and procedures reasonably designed to address the following topics: governance; financial risk management; settlement; central securities depositories and exchange-of-value-settlement systems; default management; general business and operational risk management (including custody and investment risks); access; efficiency; and transparency.[2] The final rules, which take a principles-based approach, are substantially similar to the covered clearing agency rules the Commission proposed in 2014.[3] In addition to the final rules, the Commission provided guidance that a covered clearing agency generally should consider as it develops and maintains its rules, policies, and procedures in compliance with the final rules.

We describe below a few areas that may be of particular interest to registered funds.

Segregation and Portability

The final rules require a covered clearing agency that either is a security-based swap clearing agency or a complex risk profile clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to enable the segregation and portability of positions of a member's customers and the collateral provided to the covered clearing agency with respect to those positions. Those policies and procedures effectively must protect such positions and related collateral from the default or insolvency of that member.

Despite ICI's recommendations that SEC adopt legally segregated operationally commingled ("LSOC") model as the minimum level of protection, the SEC did not amend the final rules to prescribe or mandate a specific segregation and portability framework to ensure that funds are protected in the event of a covered clearing agency bankruptcy. The SEC believes that prescribing a particular framework would be inconsistent with the principles-based approach to the final rules. Instead, the final rules provide covered clearing agencies the flexibility, subject to their obligations and responsibilities as Self-Regulatory Organizations under the Exchange Act, to determine policies and procedures with respect to the means of segregation and portability, consistent with the rules. The SEC acknowledges, however, that the LSOC model or an individual segregation model may be appropriate for a covered clearing agency operating in certain markets. The "LSOC with excess" model, where both initial and variation margin are passed on to the covered clearing agency, with all excess margin held in a segregated account, also may be a relevant approach.

Although the SEC declined ICI's recommendation to mandate a particular segregation and portability framework, the SEC noted its belief that the final rules "already [require] a mandatory threshold level of protection for swaps because it requires policies and procedures designed to both (i) enable the segregation and portability of positions of a participant's customers and the collateral provided to the covered clearing agency with respect to those positions, and (ii) protect such positions and related collateral from the default or insolvency of the participant."[4]

Under the final rules, a covered clearing agency also should have policies and procedures that facilitate porting in the normal course of business, such as when a customer ends its relationship with a member or a merger involving the member. In addition, a covered clearing agency is required to structure its portability arrangements in a way that makes it highly likely that the positions and collateral of a defaulting member's customers effectively will be transferred to one or more other members.

Further, the SEC provided the following guidance that a covered clearing agency should consider in establishing and maintaining policies and procedures for segregation and portability:[5]

- Whether it has, at a minimum, segregation and portability arrangements that effectively protect a participant's customers' positions and related collateral from the default or insolvency of that participant;
- If it additionally offers protection of such customer positions and collateral against the concurrent default of the participant and a fellow customer, whether it takes steps to ensure that such protection is effective;
- Whether it employs an account structure that enables it readily to identify positions of a participant's customers and to segregate related collateral, and whether it maintains customer positions and collateral in individual customer accounts or in omnibus customer accounts;
- Whether it structures its portability arrangements in a way that makes it highly likely that the positions and collateral of a defaulting participant's customers will be transferred to one or more other participants;
- Whether it discloses its rules, policies and procedures relating to the segregation and portability of a participant's customers' positions and related collateral, and in particular, whether it discloses whether customer collateral is protected on an individual or omnibus basis; and
- Whether it discloses any constraints, such as legal or operational constraints, that

may impair its ability to segregate or port a participant's customers' positions and related collateral.

Fund Governance

The final rules require a covered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for governance arrangements that are: clear and transparent; clearly prioritize the safety and efficiency of the covered clearing agency; support the public interest requirements in the clearing agency rules of the Exchange Act and the objectives of owners and participants; establish that the board of directors and senior management of the covered clearing agency have appropriate experience and skills to discharge their duties and responsibilities; specify clear and direct lines of responsibility; and consider the interests of participants' customers, securities issuers and holders, and other relevant stakeholders of the covered clearing agency.[6]

The SEC declined to modify the final rules in response to ICI's recommendation to require that a particular director represent the interests of buy-side and sell-side market participants on the board to minimize conflicts of interest. Although the SEC did not require public or independent representation on the covered clearing agency's board or risk committee, it modified the final rules to require policies and procedures for governance arrangements that consider the interests of participants' customers, securities issuers and holders, and other relevant stakeholders of the covered clearing agency. The Commission states that other relevant stakeholders are persons that access the national system for clearance and settlement directly, such as institutional and retail investors.

Financial Risk Management

The final rules require a covered clearing agency to have policies and procedures for marking positions to market, collecting margin at least daily, and conducting daily backtesting, monthly sensitivity analyses, and performing model validation at least annually.[7]Notably, the Commission did not establish minimum liquidation periods as part of a covered clearing agency's initial margin methodology. The Commission was of the view that liquidation periods generally should be tailored to the market conditions and risks of the products being cleared. The circumstances that could give rise to intraday margin calls at a covered clearing agency may vary significantly and may present varied challenges. Accordingly, the SEC declined to require that a covered clearing agency make an intraday margin call to net simultaneously variation margin that is payable to participants.

Recovery and Orderly Wind-Down Plans

The final rules require a covered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to ensure it establishes plans for the recovery and orderly wind-down of the covered agency necessitated by credit losses, liquidity shortfalls, losses from general business risk, or any other losses.[8]

The SEC did not specify requirements for all recovery and wind-down plans. Instead, the SEC noted that recovery and wind-down plans should be considered holistically, considering the covered agency's governance structure, products cleared, loss allocation rules, and mutualized structure. According to the SEC, available recovery tools will vary depending on the products cleared.

Even though the SEC did not establish any specific requirement for recovery and wind-down plans, the SEC noted that the recovery and wind-down plans should be subject to public comment and SEC review as a proposed rule change under Section 19(b) of the Exchange

Act and, for designated clearing agencies, an advance notice under the Clearing Supervision Act. The SEC stated that the transparent governance arrangements can help ensure that members, their customers, and the public have sufficient means to provide input on any recovery tools ultimately included in recovery and wind-down plans.

The SEC noted that the final rules would require covered clearing agencies' policies and procedures to provide for comprehensive public disclosure that describes material rules, policies, and procedures regarding recovery and wind-down plans, updated every two months or more frequently as necessary so that disclosure remains accurate in all material respects.[9]

The SEC also provided guidance to covered clearing agencies on developing recovery tools:[10]

- Whether it has risk management policies, procedures, and systems that enable it to identify, measure, monitor, and manage the range of risks that arise in or are borne by the covered clearing agency and whether the risk management frameworks are subject to periodic review;
- Whether it provides incentives to participants and, where relevant, their customers to manage and contain the risks they pose to the covered clearing agency;
- Whether it regularly reviews the material risks it bears from and poses to other entities (including other clearing agencies, settlement banks, liquidity providers, and service providers) as a result of interdependencies and develops appropriate risk management tools to address these risks;
- Whether it can identify scenarios that may potentially prevent it from being able to provide its critical operations and services as a going concern and assess the effectiveness of a full range of options for recovery or orderly wind-down, and whether it has prepared appropriate plans for its recovery or orderly wind-down based on the results of that assessment; and
- Whether it has provided relevant authorities with the information needed for purposes of recovery and resolution planning.

Effective and Compliance Dates

The final rules will become effective 60 days following publication in the Federal Register. Covered clearing agencies have 120 days after the effective date to comply with the requirements.[11]

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endnotes

[1] *See* Standards for Covered Clearing Agencies, Securities Exchange Act Release No. 78961 (Sept. 28, 2016), *available at* https://www.sec.gov/rules/final/2016/34-78961.pdf. A "covered clearing agency" includes a registered clearing agency that (i) has been designated as systemically important by the Financial Stability Oversight Council and for which the SEC is the supervisory agency, or (ii) provides central counterparty services for

security-based swaps or is involved in activities the SEC determines to have a more complex risk profile, unless the Commodity Futures Trading Commission is the supervisory agency under the Clearing Supervision Act. In conjunction with adopting the final rules, the Commission also proposed to apply the amendments to other categories of securities clearing agencies, including all SEC-registered central counterparties, central securities depositories, or securities settlement systems. See Definition of "Covered Clearing Agency," Securities Exchange Act Release No. 78963 (Sept. 28, 2016), *available at* https://www.sec.gov/rules/proposed/2016/34-78963.pdf

[2] The final rules also provide the SEC with procedures to make determinations on: whether a registered clearing agency should be considered a covered clearing agency; whether a covered clearing agency meets the definition of "systemically important" in multiple jurisdictions; and whether the activities of a clearing agency providing central counterparty services have a more complex risk profile ("complex risk profile clearing agency"). See rule 17Ab2-2 under the Securities Exchange Act of 1934. In addition, the final rules include new definitions and codify the SEC's statutory authority to implement such rules. See rules 17Ad-22(a) and (f) under the Exchange Act.

[3] *See* Standards for Covered Clearing Agencies, 79 FR 16865 (Mar. 26, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-03-26/pdf/2014-05806.pdf. For a summary of the proposed rules, see ICI Memorandum No. 27991 (Mar. 27, 2014), *available at* http://www.ici.org/my_ici/memorandum/memo27991. *See* also Letter from Dorothy M. Donohue, Acting General Counsel, ICI, to Kevin M. O'Neill, Deputy Secretary, SEC, dated May 21, 2014, *available at* http://www.sec.gov/comments/s7-03-14/s70314-9.pdf; Letter from Timothy W. Cameron and Laura Martin, SIFMA; David W. Blass and Jennifer S. Choi, ICI, to Stephen Luparello, Director, and Gary Goldsholle, Deputy Director, SEC, dated May 12, 2016, available at https://www.sec.gov/comments/s7-03-14/s70314-38.pdf.

[4] *See* adopting release at 184.

[5] *See* adopting release at 190.

[6] *See* rule 17Ad-22(e)(2) under the Exchange Act.

[7] *See* rule 17Ad-22(e)(6) under the Exchange Act.

[8] *See* rule 17Ad-22(e)(3)(ii) under the Exchange Act.

[9] *See* rule 17Ad-22(e)(23)(iv) and (v) under the Exchange Act.

[10] *See* adopting release at 98.

[11] The SEC also seeks comments on the proposed rules, which must be submitted 60 days after publication in the Federal Register. *See supra* note 1.

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