

MEMO# 27991

March 27, 2014

SEC Proposes Standards for "Covered Clearing Agencies"

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 10-14
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 22-14
INVESTMENT ADVISER MEMBERS No. 11-14
SEC RULES MEMBERS No. 11-14 RE: SEC PROPOSES STANDARDS FOR "COVERED CLEARING AGENCIES"

Recently, the Securities and Exchange Commission ("SEC" or "Commission") proposed to amend Rule 17Ad-22 and adopt Rule 17Ab2-2 under the Securities Exchange Act of 1934 to establish standards for the operation and governance of registered clearing agencies that meet the definition of a "covered clearing agency." [\[1\]](#) Covered clearing agencies would include registered clearing agencies that (1) have been designated as systemically important by the Financial Stability Oversight Council ("FSOC") and for which the SEC is the supervisory agency; [\[2\]](#) (2) provide central counterparty ("CCP") services for security-based ("SB") swaps or are involved in activities the SEC determines to be a more complex risk profile, where in either case the Commodity Futures Trading Commission ("CFTC") is not the supervisory agency for such clearing agency; or (3) are otherwise determined to be covered clearing agencies by the SEC pursuant to procedures under proposed Rule 17Ab2-2.

Comments on the Proposal are due by May 27, 2014.

General Requirements

Under the Proposal, the SEC propose to establish requirements for covered clearing agencies with respect to general organization, financial risk management, settlement, central securities depositories and exchange-of-value-settlement systems, default management, segregation and portability, general business risk and operational risk management, access, efficiency, and transparency. For these requirements, the SEC generally proposes to require a covered clearing agency to establish, implement, maintain, and enforce written policies and procedures in the areas enumerated above.

Two areas that may be of particular interest to registered funds are described in more

detail below.

Segregation and Portability

The proposed rule on segregation and portability would apply to a covered clearing agency that is either an SB swap clearing agency or a complex risk profile clearing agency. The proposed rule would require such a covered 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 and effectively protect such positions and related collateral from the default or insolvency of that member. The SB swap clearing agencies are currently not subject to rules regarding segregation and portability under existing Rule 17Ad-22.

The SEC describes the two methods – an omnibus account structure [\[3\]](#) or an individual account structure – by which segregation could be achieved and the advantages and disadvantages of each method. The SEC notes that omnibus accounts may expose a customer to “fellow-customer risk” (i.e., the risk that another customer of the same member will default) in the event of a loss that exceeds the amount of available collateral posted by the fellow customer who has defaulted and the available resources of the member, in which case the remaining commingled collateral of the member's non-defaulting customers may be exposed to the loss. The SEC explains that, to mitigate this risk, omnibus account structures can be designed to allow for operational commingling while protecting customer legally on an individual basis and cites to the CFTC's adoption of the legally segregated, operationally commingled, known as “LSOC,” model of segregation for swaps. The SEC notes that omnibus accounts may foster portability depending on whether the covered clearing agency collects margin on a gross or net basis.

Alternatively, the SEC discusses the individual account structure, which may provide a high degree of protection from the default of another customer of a member. In the event of a member failure, identification of a customer's collateral may promote portability of an individual customer's positions and collateral or expedite their return to the customer. The SEC notes, however, that maintenance of individual accounts may be operationally and resource intensive for a covered clearing agency and could impact the overall efficiency of its clearing operations.

The SEC states that a covered clearing agency subject to the proposed rule would be 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 will be effectively transferred to one or more other members.

Recovery and Orderly Wind-Down Plans

Proposed Rule 17Ad-22(e)(3)(ii) would 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. The SEC does not propose any guidance regarding the content of such plans.

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endnotes

[1] 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> ("Proposal").

[2] In 2012, FSOC designated as systemically important the following clearing agencies: CME, The Depository Trust Company ("DTC"), Fixed Income Clearing Corporation ("FICC"), ICE, National Securities Clearing Corporation ("NSCC"), and the Options Clearing Corporation ("OCC"). The SEC is the supervisory agency for DTC, FICC, NSCC and OCC.

[3] An omnibus account structure is where all collateral belonging to all customers of a particular member is commingled and held in a single account segregated from those of the member.

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