INVESTMENT COMPANY INSTITUTE

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SEC Issues Final Order Permitting Portfolio Margining of Cleared Credit Default Swaps and Security-Based Credit Default Swaps

[33900]

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TO: ICI Members
Derivatives Markets Advisory Committee
Operations Committee
Securities Operations Advisory Committee SUBJECTS: Derivatives
Operations
Trading and Markets RE: SEC Issues Final Order Permitting Portfolio Margining of Cleared Credit Default Swaps and Security-Based Credit Default Swaps

The Securities and Exchange Commission recently issued an exemptive order ("Final Order")[1] that provides conditional relief from certain provisions of the Securities Exchange Act of 1934 ("1934 Act") in connection with a program to portfolio margin customer and affiliate positions in cleared credit default swaps (CDSs) that are swaps and security-based swaps (SBSs) in a segregated account established and maintained in accordance with Section 4d(f) of the Commodity Exchange Act (CEA). The Final Order, which was effective November 1, 2021, is summarized below.

Background

The Final Order supersedes and replaces the SEC's 2012 order ("2012 Order") that granted relief for portfolio margining of swaps and SBSs that are cleared CDSs.[2] In October 2020, the Commission published a proposed order that would modify or eliminate several of the conditions in the 2012 Order.[3]

ICI and others submitted comments on the proposed order.[4] ICI generally supported the SEC's proposed changes to the 2012 Order and, more broadly, encouraged the SEC to take a harmonized approach to portfolio margining with the Commodity Futures Trading Commission (CFTC). We did not object to the SEC's proposed elimination of conditions in the 2012 Order that contemplated potentially providing customers with the option to portfolio margin cleared CDSs in an SBS account subject to SEC regulation. We explained that regulated funds are limited in their ability to engage in portfolio margining arrangements in a securities account or an SBS account and, therefore, would not object to the elimination of these conditions, as regulated funds typically do not engage in portfolio margining in these accounts.

We also supported the SEC's proposed modification of the conditions in the 2012 Order regarding the obligation of a broker-dealer (BD)/futures commission merchant (FCM) to enter into a nonconforming subordination agreement. We requested that the SEC confirm that the revised language in the proposed modified conditions would be required to be included in affirmations only on a going-forward basis for new cleared swap customers and that existing cleared swap customers would not need to amend their agreements to provide the revised affirmations.

Final Order

Like the 2012 Order, the Final Order applies to (1) SEC-registered clearing agencies that are also registered with the CFTC as derivative clearing organizations ("clearing agency/DCOs") and (2) SEC-registered BDs that are also registered with the CFTC as FCMs. The Final Order similarly provides relief from certain provisions of the 1934 Act for these entities to engage in portfolio margining of cleared SBSs and cleared swaps that are CDSs in a segregated account established and maintained in accordance with Section 4d(f) of the CEA in the case of a cleared swaps customer, or a cleared swaps proprietary account in the case of an affiliate. The Final Order also provides relief to calculate margin requirements on a portfolio basis.

The Final Order includes conditions consistent with those in the 2012 Order, but modifies or eliminates certain conditions of the 2012 Order, generally as proposed by the SEC and consistent with ICI's recommendations in our December 2020 comment letter. The Final Order:

- Eliminates the conditions in the 2012 Order that contemplated potentially providing customers with the option to portfolio margin cleared CDSs in an SBS account subject to SEC regulation, as an alternative to a CFTC cleared swaps account.[5]
- Modifies the conditions in the 2012 Order requiring non-conforming subordination agreements to clarify that the scope of the subordination only extends to money, securities, or other property held in the subordinating person's CFTC cleared customer or proprietary account, and that the person need not subordinate claims to money, securities, or other property held in the subordinating person's CFTC cleared customer or proprietary account to the claims of general creditors.[6]
- Eliminates the condition in the 2012 Order that required approval of a BD/FCM's margin methodology by the SEC or its staff. Instead, under the Final Order, a BD/FCM must have an internal risk management program that meets the standards set out in the Final Order and has been approved in advance by the SEC or its staff.[7]

Related CFTC Relief

In connection with the Final Order, the CFTC issued an order to Banque Centrale de Compensation (doing business as LCH SA), a CFTC-registered DCO, under Section 4d(f) of the CEA. The CFTC's order provides conditional relief for LCH and its clearing members that are dually registered as FCMs with the CFTC and broker-dealers with the SEC to: (1) hold swaps and SBSs that are CDSs in a cleared swaps account subject to Section 4d(f) of the CEA; and (2) portfolio margin such cleared swaps and cleared SBSs held in the cleared swaps customer account.[8]

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endnotes

[1] The Final Order is *available at* https://www.sec.gov/rules/exorders/2021/34-93501.pdf.

[2] The 2012 Order is *available at* https://www.sec.gov/rules/exorders/2012/34-68433.pdf.

[3] The SEC's 2020 proposed order is *available at* https://www.sec.gov/rules/exorders/2020/34-90276.pdf.

[4] ICI's comment letter is *available at* https://www.ici.org/system/files/attachments/32969a.pdf.

[5] The SEC acknowledges that there are greater efficiencies and potential cost reductions available under the current CDS portfolio margining programs available in CFTC cleared swaps accounts and that market participants have not expressed a desire to portfolio margin cleared CDSs in an SEC SBS account. The Commission clarifies that single-name CDSs that are held in a CFTC cleared swaps account and are not part of a CDS portfolio margining program (i.e., an account at a BD/FCM that holds at all times only single-name CDS positions) would be outside the scope of the Final Order. In response to a comment that a cleared swaps account is the only currently available option to clear single-name CDSs, the SEC notes that that a clearing agency/DCO could offer an SEC SBS account option to market participants to clear single-name CDSs that are not part of a CDS portfolio margining program. See Final Order at 11-12.

[6] The SEC notes that, if a BD/FCM's existing subordination arrangements are in compliance with the Final Order, the BD/FCM will not need to amend or re-document these arrangements.

[7] These standards are drawn from letters issued by the staff of the SEC's Division of Trading and Markets in connection with the approval of margin methodologies under the 2012 Order. The SEC explains that these staff letters will be withdrawn, but any BD/FCM that received such a letter approving its margin methodology prior to the issuance of the Final Order is deemed to have an approved internal risk management program for purposes of the Final Order.

[8] The CFTC issued similar relief to ICE Clear Credit and ICE Clear Europe in 2013. See https://www.cftc.gov/sites/default/files/stellent/groups/public/@requestsandactions/documents/ifdocs/icecleareurope4dfcds040913.pdf.