SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 34-68080; File No. S7-08-11

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Clearing Agency Standards

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("SEC" or "Commission") is adopting new Rule 17Ad-22 in accordance with Section 17A of the Securities Exchange Act of 1934 ("Exchange Act"), Section 763 of Title VII ("Title VII") of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), and Section 805 of Title VIII ("Title VIII") of the Dodd-Frank Act. Rule 17Ad-22 establishes minimum requirements regarding how registered clearing agencies must maintain effective risk management procedures and controls as well as meet the statutory requirements under the Exchange Act on an ongoing basis.

EFFECTIVE DATE: [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

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SUPPLEMENTARY INFORMATION: The Commission is adopting rules for the operation of a registered clearing agency that identify minimum standards designed to enhance the regulatory framework for clearing agency supervision.

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I. Background

A. Statutory Framework for the Regulation of Clearing Agencies

1. Introduction

Congress directed the Commission to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of securities transactions when it added Section 17A to the Exchange Act as part of the Securities Acts Amendments of 1975.[1] The Commission's ability to achieve this goal and its supervision of securities clearance and settlement systems is based upon the regulation of registered clearing agencies. Over the years, clearing agencies registered with the Commission have become an essential part of the infrastructure of the U.S. securities markets. Clearing agencies help reduce the costs of securities trading and are required to be carefully structured to manage and reduce counterparty risk.

The Commission used this experience with regulating clearing agencies to help address developments recently in the over-the-counter ("OTC") derivatives markets. In December 2008, the Commission acted to facilitate the central clearing of credit default swaps (hereinafter referred to as "credit default swaps" or "CDS"), the largest category of OTC security-based swaps, by permitting certain entities that performed central counterparty ("CCP") services to clear and settle credit default swaps on a temporary, conditional basis.[2] Consequently, some

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[1] See 15 U.S.C. 78q-1 and S. Rep. No. 94-75, at 4 (1975) (the Senate Committee on Banking, Housing and Urban Affairs urging that "[t]he Committee believes the banking and security industries must move quickly toward the establishment of a fully integrated national system for the prompt and accurate processing and settlement of securities transactions").

[2] The Commission authorized five entities to clear credit default swaps. See Exchange Act Release Nos. 60372 (July 23, 2009), 74 FR 37748 (July 29, 2009), 61973 (Apr. 23, 2010), 75 FR 22656 (Apr. 29, 2010) and 63389 (Nov. 29, 2010), 75 FR 75520 (Dec. 3,

credit default swaps transactions were centrally cleared prior to the enactment of the Dodd-Frank Act.

2. Section 17A of the Exchange Act

Section 17A of the Exchange Act[3] and Rule 17Ab2-1[4] require entities to register with the Commission prior to performing the functions of a clearing agency. Under the statute, the Commission is not permitted to grant registration unless it determines that the rules and operations of the clearing agency meet the standards set forth in Section 17A.[5] If the Commission registers a clearing agency, the Commission oversees the clearing agency to facilitate compliance with the Exchange Act using various tools that include, among other things, the rule filing process for self-regulatory organizations ("SROs") and on-site examinations by Commission staff. Section 17A(d) also gives the Commission authority to adopt rules for clearing agencies as necessary or appropriate in the public interest, for the protection of

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2010) (CDS clearing by ICE Clear Europe Limited); 60373 (July 23, 2009), 74 FR 37740 (July 29, 2009), 61975 (Apr. 23, 2010), 75 FR 22641 (Apr. 29, 2010) and 63390 (Nov. 29, 2010), 75 FR 75518 (Dec. 3, 2010) (CDS clearing by Eurex Clearing AG); 59578 (Mar. 13, 2009), 74 FR 11781 (Mar. 19, 2009), 61164 (Dec. 14, 2009), 74 FR 67258 (Dec. 18, 2009), 61803 (Mar. 30, 2010), 75 FR 17181 (Apr. 5, 2010) and 63388 (Nov. 29, 2010), 75 FR 75522 (Dec. 3, 2010) (CDS clearing by Chicago Mercantile Exchange, Inc.); 59527 (Mar. 6, 2009), 74 FR 10791 (Mar. 12, 2009), 61119 (Dec. 4, 2009), 74 FR 65554 (Dec. 10, 2009), 61662 (Mar. 5, 2010), 75 FR 11589 (Mar. 11, 2010) and 63387 (Nov. 29, 2010), 75 FR 75502 (Dec. 3, 2010) (CDS clearing by ICE Trust US LLC); 59164 (Dec. 24, 2008), 74 FR 139 (Jan. 2, 2009) (temporary CDS clearing by LIFFE A&M and LCH.Clearnet Ltd.) (collectively, "CDS Clearing Exemption Orders"). LIFFE A&M and LCH.Clearnet Ltd. allowed their order to lapse without seeking renewal.

[3] See 15 U.S.C. 78q-1(b). See also Pub. L. No 111-203 § 763(b) (adding subparagraph (g) to Section 17 of the Exchange Act).

[4] See 17 CFR 240.17Ab2-1.

[5] Specifically, Sections 17A(b)(3)(A)–(I) identify determinations that the Commission must make about the rules and structure of a clearing agency prior to granting registration. See 15 U.S.C. 78q-1(b)(3)(A)–(I). The staff of the Commission provided guidance on meeting the requirements of Section 17A in its Announcement of Standards for the Registration of Clearing Agencies. See Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (June 23, 1980).

investors, or otherwise in furtherance of the purposes of the Exchange Act and prohibits a registered clearing agency from engaging in any activity in contravention of these rules and regulations.[6] Pursuant to Section 21(a) of the Exchange Act, the Commission can invoke its enforcement powers to initiate and conduct investigations to determine violations of the federal securities laws, including those specifically applicable to clearing agencies.[7] In so doing, the Commission may institute civil actions seeking injunctive and other equitable remedies and/or administrative proceedings to, among other things, suspend or revoke registration, impose limitations upon a clearing agency's activities, functions, or operations, or impose other sanctions.[8]

3. The Dodd-Frank Act

On July 21, 2010, President Barack Obama signed the Dodd-Frank Act into law.[9] The Dodd-Frank Act was enacted to, among other things, promote the financial stability of the United States by improving accountability and transparency in the financial system.[10]

a. Title VII of the Dodd-Frank Act

Title VII of the Dodd-Frank Act ("Title VII") provides the Commission and the Commodity Futures Trading Commission ("CFTC") with enhanced authority to regulate certain OTC derivatives in response to the recent financial crisis.[11] The Dodd-Frank Act is intended to bolster the existing regulatory structure and provide regulatory tools to oversee the OTC

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6 See 15 U.S.C. 78q-1(d).

7 See 15 U.S.C. 78u.

8 See id.; see also 15 U.S.C. 78s(h).

9 The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

10 See id.

11 See id. §§701-774.

derivatives market, which has grown exponentially in recent years and is capable of affecting significant sectors of the U.S. economy. Title VII provides that the CFTC will regulate "swaps," the Commission will regulate "security-based swaps," and the CFTC and the Commission will jointly regulate "mixed swaps."[12]

Title VII was designed to provide greater certainty that, wherever possible and appropriate, swap and security-based swap contracts formerly traded exclusively in the OTC market are centrally cleared.[13] The swap and security-based swap markets traditionally have been characterized by privately negotiated transactions entered into by two counterparties, in which each assumes the credit risk of the other counterparty.[14] Clearing of swaps and security-based swaps was at the heart of Congressional reform of the derivatives markets in Title VII.[15] Clearing agencies are broadly defined under the Exchange Act and undertake a variety of

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12 Section 712(d) of the Dodd-Frank Act provides that the Commission and the CFTC, in consultation with the Board of Governors of the Federal Reserve System, shall further define the terms "swap," "security-based swap," "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," "eligible contract participant" and "security-based swap agreement." The Commission and the CFTC jointly adopted rules to further define the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant" and eligible contract participant." Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", Securities Exchange Act Release No. 34-66868 (Apr. 27, 2012).

13 See, e.g., Report of the Senate Committee, supra note 11, at 34 (stating that "[s]ome parts of the OTC market may not be suitable for clearing and exchange trading due to individual business needs of certain users. Those users should retain the ability to engage in customized, uncleared contracts while bringing in as much of the OTC market under the centrally cleared and exchange-traded framework as possible.").

14 See, e.g., Financial Stability Board, Implementing OTC Derivatives Market Reforms (Oct. 25, 2010), available at http://www.financialstabilityboard.org/publications/r_101025.pdf.

15 As previously noted, the Dodd-Frank Act seeks to ensure that, wherever possible and appropriate, derivatives contracts formerly traded exclusively in the OTC market be cleared. See supra note 11.

functions.[16] One such function is to act as a CCP, which is an entity that interposes itself between the counterparties to a trade.[17] For example, when a security-based swap contract between two counterparties that are members of a CCP is executed and submitted for clearing, it is typically replaced by two new contracts – separate contracts between the CCP and each of the two original counterparties. At that point, the original parties to the transaction are no longer counterparties to each other. Instead, each acquires the CCP as its counterparty, and the CCP assumes the counterparty credit risk of each of the original counterparties that are members of the CCP.[18] Structured and operated appropriately, CCPs may improve the management of counterparty risk and may provide additional benefits such as multilateral netting of trades.[19] The Dodd-Frank Act amended the Exchange Act to require, among other things, that transactions in security-based swaps must be cleared through a clearing agency if they are of a type that the

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16 Section 3(a)(23)(A) of the Exchange Act defines the term "clearing agency" to mean any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for the comparison of data regarding the terms of settlement of securities transactions to reduce the number of settlements of securities transactions or the allocation of securities settlement responsibilities. Such term also means any person, such as a securities depository, who (i) acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned or pledged by bookkeeping entry without physical delivery of securities certificates, or (ii) otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates. 15 U.S.C. 78c(a)(23)(A).

17 See id. An entity that acts as a CCP for securities transactions is a clearing agency as defined in the Exchange Act and is required to register with the Commission.

18 See Cecchetti, Gyntelberg and Hollanders, Central Counterparties for Over-the-Counter Derivatives, Bank for International Settlement Quarterly Review (Sept. 2009), available at http://www.bis.org/publ/qtrpdf/r_qt0909f.pdf.

19 See id. at 46; see also Bank for International Settlements' Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, Guidance on the Application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC Derivatives CCPs: Consultative Report (May 2010), available at http://www.bis.org/publ/cpss89.pdf.

Commission determines must be cleared, unless an exemption from mandatory clearing applies.[20] Title VII of the Dodd-Frank Act also added new provisions to the Exchange Act that require entities that act as a clearing agency with respect to security-based swaps ("security-based swap clearing agencies") to register with the Commission[21] and require the Commission to adopt rules with respect to security-based swap clearing agencies.[22] Compliance with any such rules is a prerequisite to the registration of a clearing agency with the Commission and is also a condition to the maintenance of its continued registration.[23] Finally, Title VII provided that some of the entities that the Commission permitted to clear and settle credit default swaps on a temporary, conditional basis prior to the July 21, 2010, enactment of the Dodd-Frank Act were deemed to be registered clearing agencies (the "Deemed Registered Provision").[24]

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20 See 15 U.S.C. 78c-3; Exchange Act Release No. 34-63557 (Dec. 15, 2010), 75 FR 82490 (Dec. 30, 2010); Exchange Act Release No. 34-67286 (June 28, 2012); 34-63556 (Dec. 15, 2010), 75 FR 79992 (Dec. 21, 2010).

21 15 U.S.C. 78q-1(g) (adding subparagraph (g) to Section 17A of the Exchange Act). Pursuant to Section 774 of the Dodd-Frank Act, the requirement in Section 17A(g) of the Exchange Act for security-based swap clearing agencies to be registered with the Commission took effect on July 16, 2011.

22 15 U.S.C. 78q-1(i) and (j). Pub. L. No. 111-203 § 763(b) (adding subparagraphs (i) and (j) to Section 17A of the Exchange Act).

23 Under the Exchange Act, a clearing agency can be registered with the Commission only if the Commission makes a determination that the clearing agency satisfies the requirements set forth in paragraphs (A) through (I) of Section 17A(b)(3) of the Exchange Act. 15 U.S.C. 78q-1(b)(3).

24 See 15 U.S.C. 78q-1(l). The Deemed Registered Provision applies to certain depository institutions that cleared swaps as multilateral clearing organizations and certain derivatives clearing organizations ("DCOs") that cleared swaps pursuant to an exemption from registration as a clearing agency. As a result, ICE Clear Credit LLC, ICE Clear Europe Limited and the Chicago Mercantile Exchange, Inc. were deemed registered clearing agencies with the Commission on July 16, 2011, solely for the purpose of clearing security-based swaps. Under this Deemed Registered Provision, an eligible clearing agency is deemed registered for the purpose of clearing security-based swaps and is therefore required to comply with all requirements of the Exchange Act, and the rules thereunder, applicable to registered clearing agencies, including, for example, the obligation to file proposed rule changes under Section 19(b) of the Exchange Act.

b. Title VIII of the Dodd-Frank Act

In addition to the provisions from Title VII that expand the Commission's authority under the Exchange Act to include activities related to security-based swaps, Title VIII of the Dodd-Frank Act, entitled the Payment, Clearing, and Settlement Supervision Act of 2010 ("Clearing Supervision Act"), establishes an enhanced supervisory and risk control system for systemically important clearing agencies and other financial market utilities ("FMUs").[25] In part, the Clearing Supervision Act provides that the Commission, considering relevant international standards and existing prudential requirements, may prescribe regulations that contain risk management standards for the operations related to payment, clearing, and settlement activities ("PCS

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[25] See infra note 29. Under Section 803 of the Clearing Supervision Act, clearing agencies may be FMUs. Therefore, the Commission may be the Supervisory Agency of a clearing agency that is designated as systemically important ("Designated Clearing Entity") by the Financial Stability Oversight Council ("Council"). See 12 U.S.C. 5463. The definition of "FMU," which is contained in Section 803(6) of the Clearing Supervision Act, contains a number of exclusions including, but not limited to, designated contract markets, registered futures associations, swap data repositories, swap execution facilities, national securities exchanges, national securities associations, alternative trading systems, security-based swap data repositories, security-based swap execution facilities, brokers, dealers, transfer agents, investment companies and futures commission merchants. 12 U.S.C. 5462(6)(B). The designation of systemic importance hinges on a determination by the Council that the failure of, or a disruption to, the functioning of the FMU could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States. See 12 U.S.C. 5463(a)(2)(A)–(E). The designation of an FMU is significant, in part, because it will subject such designated entity to heightened oversight consistent with the terms of the Clearing Supervision Act. For example, the Clearing Supervision Act requires the Supervisory Agency to examine at least once annually any FMU that the Council has designated as systemically important. The Commission intends to conduct such annual statutory cycle examinations on the Commission's fiscal year basis. The Commission staff anticipates conducting the first annual statutory cycle examination of any designated FMU for which it is the Supervisory Agency in the annual cycle following such designation.

Activities")[26] of a Designated Clearing Entity or the conduct of designated activities by a Financial Institution.[27] In prescribing such standards, the Commission must consult the Board of Governors of the Federal Reserve System ("Federal Reserve" or "the Board") and the Financial Stability Oversight Council ("Council"). On July 11, 2011, the Council published a final rule concerning its authority to designate FMUs as systemically important,[28] and on July 18, 2012, the Council designated The Depository Trust Company ("DTC"), Fixed Income Clearing Corporation ("FICC"), National Securities Clearing Corporation ("NSCC") and The Options Clearing Corporation ("OCC") as systemically important. [29]

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26 Certain post-trade processing activities that are not captured by the Clearing Supervision Act may nevertheless be subject to regulation by the Commission under the Exchange Act. See infra note 100 and accompanying text.

27 See Section 805(a)(2) of the Clearing Supervision Act. Those regulations may govern "(A) the operations related to payment, clearing, and settlement activities of such designated clearing entities; and (B) the conduct of designated activities by such financial institutions." 12 U.S.C. 5464(a)(2). PCS Activities are defined in Section 803(7) of the Clearing Supervision Act. 12 U.S.C 5462(7).

The definition of "financial institution," which is contained in Section 803(5) of the Clearing Supervision Act, outlines numerous exclusions but defines financial institution as a branch or agency of a foreign bank, an organization operating under Section 25 or 25A of the Federal Reserve Act, a credit union, a broker or dealer, an investment company, an insurance company, an investment adviser, a futures commission merchant, commodity trading advisor or commodity pool operator and any company engaged in activities that are financial in nature or incidental to a financial activity. 12 U.S.C. 5462(5)(A).

28 See 76 FR 44763 (July 27, 2011) (the Council also expects to address the designation of payment, clearing, or settlement activities as systemically important in a separate rulemaking).

29 See 12 U.S.C. 5321 (establishing the Council and designating its voting and nonvoting members); see also 12 U.S.C. 5463 (designation of systemic importance). In accordance with Section 804 of the Clearing Supervision Act, the Council has the authority, on a non-delegable basis and by a vote of not fewer than two-thirds of the members then serving, including the affirmative vote of its chairperson, to designate those FMUs that the Council determines are, or are likely to become, systemically important. The Council may, using the same procedures, rescind such designation if it determines that the FMU no longer meets the standards for systemic importance. Before making either determination, the Council is required to consult with the Board and the relevant

B. International Considerations

Section 17A(i) of the Exchange Act provides that the Commission, in establishing clearing agency standards and in its oversight of clearing agencies, may conform such standards and such oversight to reflect evolving international standards.[30] Section 805(a) of the Clearing Supervision Act directs the Commission to take into consideration relevant international standards and existing prudential requirements for clearing agencies that are designated as FMUs.[31] The current international standards most relevant to risk management of clearing agencies are the standards developed by the International Organization of Securities Commissions ("IOSCO") and the Committee on Payment and Settlement Systems ("CPSS") that are contained in the report entitled Principles for Financial Market Infrastructures ("FMI Report").[32] The final FMI Report was published on April 16, 2012, and replaces CPSS and IOSCO's previous standards applicable to clearing agencies that were contained in the following reports: Recommendations for Securities Settlement Systems (2001) ("RSSS") and Recommendations for Central Counterparties (2004) ("RCCP") (collectively, "CPSS-IOSCO Recommendations").[33] These international standards were formulated by securities regulators

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Supervisory Agency as determined in accordance with Section 803(8) of the Clearing Supervision Act. Section 804 also sets forth procedures that give entities 30 days advance notice and an opportunity for a hearing prior to being designated as systemically important.

30 15 U.S.C. 78q-1(i).

31 12 U.S.C. 5464(a)(1).

32 CPSS-IOSCO, Principles for Financial Market Infrastructures (Apr. 2012), available at http://www. iosco.org/library/pubdocs/pdf/IOSCOPD377.pdf.

33 The complete RSSS and RCCP Reports are available on the website of the Bank for International Settlements at http://www. iosco.org/library/pubdocs/pdf/IOSCOPD123.pdf and http://www.iosco.org/library/pubdocs/pdf/IOSCPD176.pdf respectively.

The Board applies these standards in its supervisory process and expects systemically important systems, as determined by the Board and subject to its authority, to complete a

and central banks to promote sound risk-management practices and encourage the safe design and operation of entities that provide clearance and settlement services. The FMI Report harmonizes and, where appropriate, strengthens the previous international standards; it also incorporates additional guidance for OTC derivatives CCPs.[34]

II. Overview of Proposal and General Comments Received on the Proposing Release and Commission Response

A. Summary of the Clearing Agency Standards Proposing Release

On March 3, 2011, the Commission proposed for comment a series of rules related to standards for the operation and governance of clearing agencies ("Proposing Release").[35] The Proposing Release contained the following proposals:

(1) Proposed Rule 17Ad-22, which would require certain minimum standards for all clearing agencies registered with the Commission;

(2) Proposed Rule 17Aj-1, which would require dissemination of pricing and valuation information by security-based swap CCPs;

(3) Proposed Rule 17Ad-23, which would require all clearing agencies to have adequate safeguards and procedures to protect the confidentiality of trading information of clearing agency participants;

(4) Proposed Rule 17Ad-24, which would exempt certain security-based swap dealers and security-based swap execution facilities from the definition of clearing agency;

(5) Proposed Rule 17Ab2-1, which would amend an existing Commission rule concerning registration of clearing agencies to account for security-based swap clearing agencies and to make other technical changes;

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self-assessment against the standards set forth in the policy. See Policy on Payment System Risk, 72 FR 2518 (Jan. 12, 2007).

34 See FMI Report, supra note 32.

35 See Exchange Act Release No. 34-64017 (Mar. 3, 2011), 76 FR 14472 (Mar. 16, 2011) ("Proposing Release"), available at http://www.sec.gov/rules/proposed/2011/34-64017fr.pdf.

(6) Proposed Rule 17Ad-25, which would require all clearing agencies to have procedures that identify and address conflicts of interest;

(7) Proposed Rule 17Ad-26, which would require clearing agencies to set standards for all members of their boards of directors or committees; and

(8) Proposed Rule 3Cj-1, which is modeled on Section 3C(j) of the Exchange Act and would require all clearing agencies to designate a chief compliance officer.

The Commission also noted in the Proposing Release that the definition of clearing agency under Section 3(a)(23)(A) of Exchange Act includes any person who:

- acts as an intermediary in making payments or deliveries or both in connection with transactions in securities;
- provides facilities for the comparison of data regarding the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities;
- acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry, without physical delivery of securities certificates (such as a securities depository); or
- otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates (such as a securities depository).[36]

Based on the Exchange Act definition, the Commission stated its preliminary view that certain post-trade processing services may fall within the clearing agency definition and asked for comments regarding the Commission's preliminary interpretation.

[36] 15 U.S.C. 78c(a)(23)(A).

Since the publication of the Proposing Release, the Commission has received 25 comment letters on the Proposing Release from a broad range of market participants, and the Commission and staff also had discussions with representatives of clearing agencies, trade associations, public interest groups and other interested parties.[37] The Commission has taken into consideration international initiatives and consulted with other U.S. financial regulators as

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[37] The comment file is published on the Commission's website, available at http://www.sec.gov/comments/s7-08-11/s70811.shtml. See Letter from American Benefits Council, dated May 6, 2011 ("ABC Letter"); letter from Chris Barnard, dated March 21, 2011 ("Barnard Letter"); letter from Dennis M. Kelleher, President & CEO and Steven W. Hall, Securities Specialist, Better Markets, Inc., dated April 29, 2011 ("Better Markets Letter"); letter from Joanne Medero, Richard Prager and Supurna VedBrat, BlackRock, dated April 29, 2011 ("BlackRock Letter"); letter from Craig S. Donohue, CME Group, dated April 29, 2011 ("CME Letter"); letter from Glenn Davis, Senior Research Associate, Council of Institutional Investors, dated April 14, 2011 ("CII Letter"); letter from Ernst & Young, dated April 29, 2011 ("ENY Letter"); letter from Mark Beeston, Chief Executive Officer of Portfolio Risk Services, ICAP®, dated July 7, 2011 ("ICAP Letter"); letter from R. Trabue Bland, Intercontinental Exchange, Inc., dated April 29, 2011 ("ICE Letter"); letter from Robert Pickel, Executive Vice Chairman, International Swaps and Derivatives Association, dated April 29, 2011 ("ISDA Letter"); letter from Ian Axe, CEO, LCH.Clearnet Group Limited, dated April 28, 2010 ("LCH Letter"); letter from Stuart J. Kaswell and Carlotta King, Managed Funds Association, dated March 24, 2011 ("MFA (Kaswell/King) Letter"); letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association, dated April 29, 2011 ("MFA (Kaswell) Letter"); letter from Kevin Gould, President, Markit™, dated April 29, 2011 ("Markit™ (April) Letter"); letter from Kevin Gould, President, Markit™, dated July 26, 2011 ("Markit™ (July) Letter"); letter from Jeff Gooch, CEO, MarkitSERV™, dated April 29, 2011 ("MarkitSERV™ (April) Letter"); letter from Jeff Gooch, CEO, MarkitSERV™, dated July 18, 2011 ("MarkitSERV™ (July) Letter"); letter from Norman Reed, General Counsel, Omgeo, dated May 5, 2011 ("Omgeo Letter"); letter from Larry E. Thompson, General Counsel, The Depository Trust & Clearing Corporation, dated April 29, 2011 ("The DTCC (April) Letter"); letter from Larry E. Thompson, General Counsel, The Depository Trust & Clearing Corporation, dated July 21, 2011 ("The DTCC (July) Letter"); letter from William H. Navin, Executive Vice President, General Counsel and Secretary, The Options Clearing Corporation, dated April 29, 2011 ("The OCC Letter"); letter from James Cawley, Co-Founder, Swaps and Derivatives Market Association, dated June 3, 2011 ("SDMA (June) Letter"); letter from Christoffer Mohammar, General Counsel, TriOptima Group, dated April 29, 2011 ("TriOptima Letter"); letter from Richard H. Baker, President & Chief Executive Officer, Managed Funds Association, dated March 24, 2011 ("MFA (Baker) Letter"); letter from James Cawley, Co-Founder, Swaps and Derivatives Market Association, dated April 19, 2011 ("SDMA (April) Letter").

appropriate, including the CFTC and the Federal Reserve, to inform the Commission's final actions. Commenters generally supported the goals of the proposal. As further discussed below, however, several commenters recommended that the proposal be amended or clarified in certain respects.

After careful review and consideration of the comments, the Commission is today adopting Rule 17Ad-22, with certain modifications discussed below, to address comments received. As adopted, Rule 17Ad-22 is meant to establish minimum requirements for registered clearing agency risk management practices and operations with due consideration given to equivalent standards of other regulators in the United States[38] and to international standards, as discussed above in Section I.B. We expect to address separately the other proposed rules and matters contained in the Proposing Release as explained in more detail in Section II.B below.

B. General Comments Received on the Proposing Release and the Commission Response

The Proposing Release was published in the Federal Register on March 16, 2011, and the comment period closed on April 29, 2011.[39] The Proposing Release contained proposed rules that cover various aspects of a clearing agency's operations and risk management that are listed in full in Section II.A. In addition to specific comments regarding the substance of the rules in the Proposing Release, a number of the comments the Commission received concern the larger framework for our rulemaking efforts involving clearing agencies and the manner in which the

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38 See Derivatives Clearing Organization General Provisions and Core Principles 76 FR 69334 (Nov. 8, 2011) (CFTC adopting final regulations to implement certain provisions of Title VII and Title VIII of the Dodd-Frank Act governing DCO activities) ("DCO Release"); Financial Market Utilities 76 FR 18445 (Apr. 4, 2011) (notice of proposed rulemaking to promulgate risk-management standards governing the operations related to the payment, clearance and settlement activities of certain financial market utilities that are designated systemically important by the Council).

39 See supra note 35.

rules may be implemented. These comments focus on issues such as ensuring that: (1) sufficient time be given to clearing agencies to implement all new standards appropriately; (2) the Commission's regulations relating to risk management standards in particular be given careful consideration and recognize the complexity of the issues involved; (3) the Commission's regulations are consistent with those of other U.S. regulatory agencies and CPSS and IOSCO initiatives; and (4) appropriate distinctions between clearing agencies that provide CCP and central securities depository ("CSD") services from those that provide post-trade processing services are recognized in the Commission's regulations.

Set forth below is a description of the comments received by the Commission that express concerns about the general approach to clearing agency reform reflected in the Proposing Release. The Commission has carefully considered these general comments that were provided concerning the larger framework for our rule making efforts involving clearing agencies.[40] To address the concerns they raise, we have determined to take the actions described below.

1. Timing of Implementation

a. Comments Received

Three commenters asked for the implementation of the proposed rules to be subject to appropriate phase-in periods.[41] One commenter suggested that the appropriate phases should be determined by the Commission in consultation with the affected clearing agencies.[42] Another commenter requested that if the rules are adopted as proposed then they should not become

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40 See supra note 9, at Preamble.

41 See The DTCC (April) Letter at 5; The OCC Letter at 17; MFA (Kaswell/King) Letter at 2.

42 See The DTCC (April) Letter at 5.

effective for at least two years.[43] Two commenters stated that they believe that implementing all of the proposed rules in the Proposing Release at the same time would require extensive new policies and procedures, drafting, proposing and approval of rules and rule changes, raising additional financial resources, hiring and training of personnel, operational changes and many other tasks that would require clearing agencies to simultaneously respond to separate requirements promulgated under the Dodd-Frank Act.[44] Accordingly, these commenters requested that the Commission provide adequate time to implement necessary changes and expressed that phase-in periods would be appropriate.

One commenter asked the Commission to publish any modifications it may make to the proposed rules for an additional comment period.[45] Others stressed that if the Commission makes significant changes to its proposed rules, then the rules should be republished for further comment.[46]

One commenter stated that clearing agency rules such as those related to governance, conflicts of interest, registration, and financial resources should be adopted early in the implementation of rules for the security-based swap market.[47] The commenter also stated that

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43 See The OCC Letter at 17 (adding that if the Commission adopts a financial resources standard in Rule 17Ad-22(b)(3) to require a security-based swaps clearing agency that performs CCP services to have enough financial resources to be able to withstand the default of its two largest participants in extreme but plausible market conditions then that requirement should be subject to delayed implementation of at least two years).

44 See id.; The DTCC (April) Letter at 6.

45 See The DTCC (April) Letter at 2.

46 See The OCC Letter at 17.

47 See MFA (Kaswell/King) Letter at Annex A.

barriers to effective "buy-side" participation in CCPs must be eliminated early in the phase-in process to enable "buy-side" participants to clear voluntarily at the same time as dealers.[48]

b. Commission Response

In light of the request by commenters for a phased approach to implementation of the clearing agency standards set forth in the Proposing Release,[49] the Commission has decided to address the standards in stages.

- In the first stage, the Commission is adopting only Rule 17Ad-22. The compliance date for Rule 17Ad-22 will be sixty days from publication in the Federal Register.
- The second planned stage in the implementation of standards for clearing agencies is the consideration by the Commission of rules that correspond to proposed Rules 17Aj-1; 17Ad-23; 17Ad-24; 17Ab2-1 and 3Cj-1 as well as the clearing agency governance and conflict of interest concerns that its previous proposal addressed through its proposal of Rule 17Ad-25, Rule 17Ad-26 and Regulation MC.[50]
- The third planned stage is for the Commission to consider rules tailored to clearing agencies that perform certain post-trade processing services. The Commission sought comment concerning these types of clearing agencies in the Proposing Release and preliminarily intends to propose rules addressed to them as described in more detail in Sections II.B.4 and III.A below. As appropriate, the Commission may also propose rules that will incorporate principles set forth in the FMI Report.

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48 See id.

49 See supra notes 41-44 and accompanying text.

50 Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC, Exchange Act Release No. 344-63107 (Oct. 14, 2010), 75 FR 65882 (Oct. 26, 2010) ("Regulation MC").

The Commission believes the phased approach to implementation provides clearing agencies with the benefit of additional time with respect to some of the requirements contemplated in the Proposing Release, while putting into place minimum standards for operational and risk management practices of registered clearing agencies. This approach will allow the Commission to consider further the comments received on the Proposing Release and evolution of clearance and settlement activity in light of the requirements of Title VII and Title VIII of the Dodd-Frank Act, including the implementation of the mandatory clearing requirements with respect to security-based swaps mandated by the Dodd-Frank Act. Because the Commission is adopting 17Ad-22 largely as proposed, the Commission is not republishing Rule 17Ad-22 for additional comments.

We believe that the implementation of these standards is an important first step in crafting regulatory changes contemplated by Title VII and Title VIII of the Dodd-Frank Act as intended by Congress. The adoption of Rule 17Ad-22 will also allow the Commission to coordinate its activities as the supervisory agency for clearing agencies designated as systemically important financial market utilities under Title VIII of the Dodd-Frank Act with the complementary responsibilities of the Federal Reserve.[51] In addition, the Commission believes that the adoption of standards for registered clearing agencies at this time will help facilitate the development of the security-based swap market. Rule 17Ad-22 establishes minimum standards for a wide range of issues, including governance, financial resources and membership. For example, Rules 17Ad-22(b)(5), (6) and (7) are designed to prohibit membership practices that

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[51] Section 805 of the Clearing Supervision Act provides that (i) the Commission may prescribe standards for designated clearing entities in consultation with the Council and the Board and (ii) the Board may determine that the Commission's existing prudential requirements with respect to designated clearing entities are insufficient to prevent or mitigate significant credit, liquidity, operational or other risks to the financial markets or the financial stability of the United States.

may limit competition among market participants. In particular, Rule 17Ad-22(b)(6) is designed to facilitate correspondent clearing, which will allow buy-side participants to obtain access to CCP services without having to become direct members of a clearing agency.

2. Special Attention to Risk Management Standards

a. Comments Received

Generally, commenters supported the requirements of proposed Rules 17Ad-22(b)(1)–(4) that would govern the risk management standards and practices of registered clearing agencies that perform CCP services or CCPs.[52] However, in several respects, commenters asked the Commission to pay special attention to the technical nature of CCP risk management practices that are addressed by these rules. The comments received by the Commission span a range of views on these matters. But thematically, many of them coalesce around a question of whether the Commission should prescribe detailed specifications within these rules to define compliance standards more clearly or take a less prescriptive approach that affords clearing agencies greater discretion to establish, implement, maintain and enforce policies and procedures based on the facts and circumstances of the individual clearing agency.

For instance, proposed Rule 17Ad-22(b)(1) would require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to measure credit exposures to participants at least once a day and limit exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the clearing agency would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control. Of those commenters who asked the Commission to consider modifications to the proposed rule, two suggested that public disclosure requirements should

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[52] See discussion infra Section III.C.

accompany any choice made by a CCP to reduce margin requirements on the basis of an inverse or offsetting correlation between participants' positions.[53] Several others focused on what role the Commission should take in defining "normal market conditions" for purposes of the rule[54] as well as how frequently a CCP should be required to measure its credit exposures[55] and whether such measurements should be required to include the customers of participants.[56]

Proposed Rule 17Ad-22(b)(2) would require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to use margin requirements to limit its credit exposures to participants under normal market conditions and use risk-based models[57] to set margin requirements and review them at least monthly. One commenter argued that CCPs should be required to make their margin-setting methodology available to customers to help them understand the responsibilities that are commensurate with CCP participation.[58] Another commenter suggested clearing agencies should have discretion when complying with the rule to decide which aspects of a margin methodology are appropriate for monthly review.[59] Still other commenters concentrated on the extent to which the Commission should prescribe the parameters of a CCP's margin model, such as the confidence level, amount of data used to

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53 See ISDA Letter at 7; Better Markets Letter at 3-4.

54 See The OCC Letter at 7; Better Markets Letter at 3-4.

55 See LCH Letter at 2; Better Markets Letter at 5.

56 See LCH Letter at 2.

57 The term "risk-based models" is meant to encompass any models, systems and associated parameters used by clearing agencies to mitigate risks.

58 See MFA (Kaswell) Letter at 2.

59 See The OCC Letter at 7.

inform the standard of "normal market conditions," and the use of factors such as liquidity and concentration.[60]

With respect to proposed Rule 17Ad-22(b)(3), commenters asked the Commission to give further consideration to whether it is appropriate to create different financial resources standards for a security-based swap CCP. As proposed, the rule would require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions, provided that a security-based swap clearing agency would be required to maintain sufficient financial resources to withstand, at a minimum, a default by the two participants to which it has the largest exposures in extreme but plausible market conditions. One commenter argued that characteristics of the instruments traded in the security-based swap market support differentiating the requirements of the rule[61] while other commenters advanced reasons for why it may be appropriate for the rule to employ only a single standard.[62] Commenters also highlighted that it is important for the Commission to account for the international standards in this area[63] and they expressed contrasting views about how standardized and prescriptive the Commission should be in specifying the meaning of "extreme but plausible market conditions."[64]

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60 See, e.g., ISDA Letter at 7; Better Markets Letter at 3-4; The OCC Letter at 7.

61 See Better Markets Letter at 5.

62 See LCH Letter at 2; The OCC Letter at 8; The DTCC (April) Letter at 12.

63 See The OCC Letter at 9; LCH Letter at 2-3.

64 See Better Markets Letter at 5-6; The DTCC (April) Letter at 10; The OCC Letter at 10.

Similarly, some commenters asked the Commission to reconsider how prescriptive it should be in its approach to the requirements of Rule 17Ad-22(b)(4).[65] The proposed rule would require a CCP to establish, implement, maintain and enforce policies and procedures reasonably designed to provide for an annual model validation consisting of the evaluation of the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who does not perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs those functions. In this area, commenters expressed contrasting views about the appropriate level of detail that should be embedded within the rule to guide clearing agency practices. The comments addressed matters including how frequently a model validation should be performed[66] and, when a model validation is performed, how a CCP should be required to ensure that the process represents a candid, independent and objective assessment.[67]

A more complete discussion of these comments and others that pertain to Rules 17Ad-22(b)(1)–(4) is contained in Section III.C below.

b. Commission Response

The Commission acknowledges the many thoughtful comments we received regarding the risk management standards and practices reflected in the Proposing Release and agrees that

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65 See, e.g., The DTCC (April) Letter at 13; The OCC Letter at 11; Better Markets Letter at 6.

66 See The DTCC (April) Letter at 13; Better Markets Letter at 6.

67 See The DTCC (April) Letter at 13-15; The OCC Letter at 11; Better Markets Letter at 6.

the topic deserves particular care and attention.[68] We also agree with the commenters who pointed out that:

- Many of the risk management standards and practices underlying proposed Rule 17Ad-22 require relatively significant judgments to be made and at times there are no established or definitive sources of guidance to aid decision-making. Therefore, for a CCP's risk management practices to be most effective, the CCP must have some degree of flexibility to tailor the practices appropriately to meet the demands of the specific financial markets it serves, and the Commission's interpretation of Rule 17Ad-22 should not be rigidly applied as uniform standards without variation.[69]
- The specific risk management practices most appropriate for any individual CCP and for registered clearing agencies generally are unlikely to remain static.[70] Rather, risk management practices can be expected to evolve to keep pace with changes in technology, market practices and financial professionals' understanding of the characteristics of the markets.[71]

For example, the Commission recognizes that a less prescriptive approach can help promote efficient practices and encourage regulated entities to consider how to manage their regulatory obligations and risk management practices in a way that complies with Commission

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68 See discussion supra Section II.B.

69 See infra notes 82-84 and accompanying text.

70 See infra note 79 and accompanying text.

71 See The DTCC (April) Letter at 6 ("As markets continue to globalize and standards continue to evolve, the Commission should consider additional modifications to its rules, as necessary and appropriate, to meet the important objective that the Commission's rules remain in alignment with global standards.").

rules while accounting for the particular characteristics of their business and believes the approach reflected in proposed Rule 17Ad-22 is consistent with this perspective.

The Commission believes that one outgrowth of this less prescriptive approach is that there may be additional questions from the clearing agencies regarding how various regulatory requirements apply with regard to clearance and settlement services for particular instruments or products having different market characteristics. Commenters were particularly concerned with the application of Rules 17Ad-22(b)(1)–(4) and with particular risk management standards, including, but not limited to, the proper amount of financial resources, measurement and management of credit exposures, back testing, model validation, use of concentration, liquidity and other factors to determine margin requirements, and the appropriate meaning of "extreme but plausible market conditions."

We note that the Commission or its staff may from time to time issue additional guidance to the extent necessary to address questions arising from the dynamic nature of clearing agency risk management practices, changing market practices, and technological advances.

To date, the Exchange Act and the related regulations promulgated by the Commission have not established particularized requirements regarding clearing agencies' risk management practices.[72] Nevertheless, CCPs registered as clearing agencies generally adopt margin requirements designed to cover potential losses under normal market conditions to help ensure the financial safety of the enterprise, protect the interests of clearing members, and meet or exceed standards of risk management best practices recognized in the financial services industry

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[72] See generally Section 17A of the Exchange Act (15 U.S.C. 78q-1) and Standards for Clearing Agency Regulation (Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (June 23, 1980)).

generally.[73] Additional charges, including, but not limited to, those contained in separately constituted default or guaranty funds are also used to cover losses beyond that (i.e., tail events associated with extreme but plausible market conditions).[74]

To meet this standard, the current practice of registered CCPs is to calculate daily margin requirements using risk-based models to ensure coverage at a 99% confidence interval over a designated time horizon.[75] Given the history of usage of this standard in CCP practices and international standards,[76] the Commission believes it is appropriate to codify this commonly accepted practice as the minimum benchmark for measuring credit exposures and setting margin requirements. However, the Commission also recognizes that this minimum standard may not be sufficient for all CCPs and believes the rules allow flexibility for CCPs to adopt more conservative approaches when appropriate given the nature of the financial product being cleared, the preferences of their members, or other factors consistent with the general responsibilities of clearing agencies under the Exchange Act to perfect the national clearance and settlement system.

Furthermore, the Commission notes that a CCP can develop rules and procedures that are tailored to its practices and operations in order to meet the demands of the specific financial markets it serves. When a CCP proposes to make rule changes, rule changes are required to be submitted to the Commission under Section 19(b) of the Exchange Act and are subject to review,

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73 See, e.g., NSCC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Nov. 14, 2011), available at http://www.dtcc.com/legal/compliance/NSCC_Self_Assessment.pdf.

74 See CME Group letter to CPSS-IOSCO regarding the Consultation Report: Principles for Financial Market Infrastructures (July 28, 2011), available at http://www.bis.org/publ/cpss94/cacomments/cmegroup.pdf.

75 See infra Section V.B.2 (discussion on current industry baselines).

76 See infra note 571 and accompanying text.

public comment and approval, as applicable. In addition to the SRO rule filing process, the Commission works closely with each clearing agency it oversees from the point of its application for registration with the Commission and thereafter through examinations and periodic monitoring of the clearing agency's risk management framework and operations.[77]

3. Coordinated U.S. Domestic and International Standards

a. Comments Received

Three commenters strongly encouraged the Commission and the CFTC to coordinate and cooperate in the development of their parallel regulation of clearing agencies and derivatives clearing organizations ("DCOs") to build a harmonized U.S. framework for OTC derivatives and to bring appropriate consistency to the two agencies' regulation of similar products, practices and markets.[78]

One commenter stressed that rules applicable to clearance and settlement of single name credit default swaps should be comparable to the final requirements applicable to clearance and settlement of index-based credit default swaps because clearinghouses will undoubtedly service both and therefore different sets of compliance standards could lead to unnecessary operational inefficiencies and may have the unintended consequence of tilting the market in favor of one class of instruments.[79]

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[77] See Risk Management Supervision of Designated Clearing Entities (July 2011), Report by the Commission, Board and CFTC to the Senate Committees on Banking, Housing, and Urban Affairs and Agriculture in fulfillment of Section 813 of Title VIII of the Dodd-Frank Act, at 25.

[78] See ICE Letter at 2; MFA (Kaswell) Letter at 8-9; CME Letter at 4.

[79] See CME Letter at 4.

Three commenters urged the Commission to incorporate specific requirements for processing, clearing and transfer of customer positions.[80] Two of the commenters urged the Commission to adopt specific rules in these areas that are similar to what the CFTC has proposed for DCOs—specifically with respect to proposed Rule 39.12(b)(7).[81]

Three commenters expressed a preference for principles-based rather than prescriptive rules.[82] One commenter expressed its belief that the CFTC's proposals for DCOs are overly prescriptive and should be eschewed in favor of case-by-case review of a clearing organizations' proposed rule changes.[83] The commenter added that less prescriptive rules will be easier to reconcile between the two regulatory agencies.[84]

One commenter strongly encouraged the Commission to avoid final action on its proposed rules before it has clarity on what clearinghouse regulations are ultimately adopted by European and United Kingdom regulators and what approaches to regulation are embraced by the final FMI Report.[85] The commenter argued that this approach would allow the Commission

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80 See MFA (Kaswell) Letter at 8-9; SDMA (June) Letter at 19; Barnard Letter at 2.

81 See MFA (Kaswell) Letter at 8-9; SDMA (June) Letter at 19 (citing proposed rule 39.12(b)(7) from the CFTC's Requirements for Processing, Clearing and Transfer of Customer Positions, 76 FR 13101 (Mar. 10, 2011) which would require "each derivatives clearing organization to coordinate with each swap execution facility and designated contract market that lists for trading a product that is cleared by the derivatives clearing organization, in developing rules and procedures to facilitate prompt and efficient processing of all contracts, agreements, and transactions submitted to the derivatives clearing organization for clearing."). The CFTC reserved this rule section in its DCO Release but has not yet adopted the proposed rule as a final requirement.

82 See CME Letter at 3; The DTCC (April) Letter at 6; The OCC Letter at 2.

83 See The OCC Letter at 2.

84 See id.

85 See The OCC Letter at 3.

to adopt rules that would not unknowingly force market activity into other jurisdictions by virtue of associated regulatory costs.[86]

b. Commission Response

We recognize that both domestic and foreign regulators may be undertaking similar regulatory initiatives with respect to risk management and operation of clearing agencies. We believe that adopting Rule 17Ad-22 now, largely in the form proposed, and the phased implementation schedule set forth above[87] will ensure that the Commission's rulemaking for clearing agencies will be coordinated with equivalent processes being undertaken by the CFTC and the Federal Reserve in the United States and foreign regulators. As discussed above, the CPSS-IOSCO Recommendations served as the benchmark for the operations of the CCPs and CSDs around the world since the publication of the RSSS in 2001 and the RCCP in 2004, respectively. In addition, the CFTC and Federal Reserve have also considered the CPSS-IOSCO Recommendations in their rulemaking efforts with respect to the clearance and settlement process. Consequently, the final rules that the CFTC recently adopted to govern the activities of a DCO[88] and the rules proposed by the Federal Reserve for certain CCPs and CSDs[89] each borrow from the principles in the CPSS-IOSCO Recommendations and reflect requirements that we believe are consistent with the minimum requirements for registered clearing agencies that the Commission is adopting in Rule 17Ad-22. Because Rule 17Ad-22 will generally codify existing practices that similarly reflect the CPSS-IOSCO Recommendations, the Commission does not believe it will conflict with regulatory requirements that are being implemented by other

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86 See id.

87 See supra Section II.B.

88 See Derivatives Clearing Organization General Provisions and Core Principles, supra note38.

89 See Financial Market Utilities, supra note 25.

regulators or in other jurisdictions.

4. Appropriate Distinctions between Clearing Agencies

a. Comments Received

In the Proposing Release, the Commission identified certain services in the area of post-trade securities processing that may be captured by the definition of a clearing agency in the Exchange Act. Two commenters generally supported the distinctions the Commission proposed for rules that should apply to all types of clearing agencies versus those that should apply only to CCPs.[90] Several commenters argued that entities that perform certain post-trade processing services (i.e., comparison of trade data, collateral management and tear-up/compression) are not performing services that fall within the definition of a clearing agency under the Exchange Act and consequently entities that perform these services should not be required to register as a clearing agency or comply with Rule 17Ad-22.[91]

b. Commission Response

We are not persuaded by commenters who suggested that post-trade processing services should be automatically excluded from the definition of a clearing agency in the Exchange Act.[92] We believe that view is inconsistent with the plain meaning of the clearing agency definition because the definition of clearing agency in Section 3(a)(23)(A) of the Exchange Act covers any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities and provides facilities for the comparison of data regarding the terms of settlement of securities transactions, to reduce the number of settlements of securities

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90 See TriOptima Letter at 5; ICE Letter at 2.

91 See generally TriOptima Letter; Markit (April) Letter; Markit (July) Letter; MarkitSERV (April) Letter; MarkitSERV (July) Letter; Omgeo Letter.

92 See supra note 91 and accompanying text.

transactions, or for the allocation of securities settlement responsibilities.[93] That view also is inconsistent with prior interpretive guidance from the Commission addressing the broader spectrum of activities that are associated with that term.[94] The determination of whether particular activities meet the definition of a clearing agency depends on the totality of the facts and circumstances involved.[95]

On July 1, 2011, the Commission published a conditional, temporary exemption from clearing agency registration for entities that perform certain post-trade processing services for security-based swap transactions.[96] The order facilitated the Commission's identification of entities that operate in that area and that accordingly may fall within the clearing agency definition. Several entities complied with the conditions of that order and remain exempt from

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93 See supra note 36.

94 See Confirmation and Affirmation of Securities Trades; Matching, Exchange Act Release No. 34-39829 (Apr. 6, 1998), 63 FR 17943 (Apr. 13, 1998) (noting that "[t]he Commission is of the view that matching constitutes a clearing agency function within the meaning of the clearing agency definition under Section 3(a)(23) of the Exchange Act. Specifically, matching constitutes 'comparison of data respecting the terms of settlement of securities transactions.'").

95 See, e.g., supra note 1, at 91 (the Senate Committee on Banking, Housing and Urban affairs acknowledging that through the intended breadth of the clearing agency definition the Commission even retains authority "to negate, by rule, exclusions in this category in order to assure the prompt and accurate clearance and settlement of securities transactions or to prevent evasions of the Exchange Act").

96 See, e.g., Exchange Act Release No. 34-64796 (July 1, 2011), 76 FR 39963 (July 7, 2011) (providing an exemption from registration under Section 17A(b) of the Exchange Act, and stating that "[t]he Commission is using its authority under section 36 of the Exchange Act to provide a conditional temporary exemption [from clearing agency registration], until the compliance date for the final rules relating to registration of clearing agencies that clear security-based swaps pursuant to sections 71A(i) and (j) of the Exchange Act, from the registration requirement in Section 17A(b)(1) of the Exchange Act to any clearing agency that may be required to register with the Commission solely as a result of providing Collateral Management Services, Trade Matching Services, Tear Up and Compression Services, and/or substantially similar services for security-based swaps").

clearing agency registration under its terms.[97] By allowing potential clearing agency registrants to elect temporary, conditional exemption from registration, the order has given the Commission more time to consider whether these entities meet the clearing agency definition and, if registration is required, to consider what form of regulation may be most appropriate for those services.

The Commission preliminarily agrees with commenters that it is appropriate to consider a tailored framework of regulation for clearing agencies that perform certain post-trade processing services because such activities do not involve the same credit, market and operational risk concerns that are presented by clearing agencies that perform CCP or CSD services.[98] Accordingly, the Commission intends to separately address clearing agencies that perform only post-trade processing services. The Commission has previously distinguished entities that provide certain post-trade services and fall within the definition of clearing agency from those

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97 The Commission notes further that its adoption of Rule 17Ad-22 does not have any effect on the Commission's order granting a conditional temporary exemption from clearing agency registration for entities that perform certain post-trade processing services for security-based swap transactions. See supra note 96 and accompanying text. The temporary exemption is conditioned on these entities providing the Commission with identifying information and a detailed description of the types of services they provide. Section 17A(g) of the Exchange Act contains a registration requirement for security-based swaps clearing agencies. Section 17A(j) of the Exchange Act requires the Commission to adopt rules governing persons that are registered as clearing agencies for security-based swaps under the Exchange Act, and Section 17A(i) requires security-based swaps clearing agencies to comply with such standards as the Commission may establish by rule as a condition to being registered or maintaining registration. As the Commission previously indicated with respect to the effective date for Section 17A(g), if a Title VII provision requires a rulemaking, such provision will not go into effect "not less than" 60 days after publication of the final related rule. 76 FR 36287, 36302 (June 22, 2011). The Commission has not adopted any rules applicable to clearing agencies that perform services; therefore, the registration requirement of Section 17A(g) will not be applicable to such clearing agencies until the date when rules with respect to such clearing agencies are adopted pursuant to Section 17A(i).

98 See supra notes 90-91 and accompanying text.

entities that provide services more commonly associated with the functions of a clearing agency (e.g., CCP and CSD services).[99] As part of its future rulemaking regarding these types of clearing agencies, the Commission may consider whether to apply the future rules to clearing agencies engaged in activities that were separately identified by Congress as PCS Activities in the Clearing Supervision Act. In particular, the Clearing Supervision Act identifies the following as PCS Activities:

(1) calculation and communication of unsettled financial transactions between counterparties;

(2) netting of transactions;

(3) provision and maintenance of trade, contract, or instrument information;

(4) management of risks and activities associated with continuing financial transactions;

(5) transmittal and storage of payment instructions;

(6) movement of funds;

(7) final settlement of financial transactions; and

(8) other similar functions that the Council may determine.[100]

Accordingly, at this time, the Commission does not intend for Rule 17Ad-22 to apply to clearing agencies that perform post-trade processing services. The scope of Rule 17Ad-22 will be limited to clearing agencies that are registered with the Commission and the rule will not apply to any clearing agencies operating pursuant to an exemption from registration as a clearing agency granted by the Commission, unless the terms of future exemptions specifically

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[99] See, e.g., Exchange Act Order No. 34-44188 (Apr. 17, 2001) (providing an exemption from registration as a clearing agency to a subsidiary of Omgeo conducting electronic trade confirmation and matching services).

[100] 12 U.S.C. 5462(7).

contemplate its application, in whole or in part. The Commission has clarified this as part of the final Rule 17Ad-22 adopted today by adding the word "registered" before the term "clearing agency" appearing in the first instance in paragraphs (b), (c)(1), (c)(2), and (d). For this reason, references to the term "clearing agency" in this release are generally intended to capture only registered clearing agencies, unless the context suggests otherwise. The Commission may consider at a later time whether rules tailored to clearing agencies that provide post-trade processing services would be appropriate.

III. Description of Rule 17Ad-22

A. Overview and Scope

The Commission is adopting Rule 17Ad-22 with minor modifications from the proposal to implement the statutory provisions for clearing agencies under the Exchange Act. Rule 17Ad-22 requires registered clearing agencies to establish, implement, maintain and enforce written policies and procedures that are reasonably designed to meet certain minimum requirements for their operations and risk management practices on an ongoing basis. These minimum requirements will work in tandem with the requirements in Section 17A that the Commission must make certain determinations regarding a clearing agency's rules.

The Commission anticipates that the clearing agency's rules and procedures will likely continue to evolve so that the clearing agency can adequately respond to changes in technology, legal requirements, trading volume, trading practices, linkages between financial markets and the financial instruments traded in the markets that a clearing agency serves. Accordingly, registered clearing agencies must evaluate continually and make appropriate updates and improvements to their operations and risk management practices to facilitate the prompt and

accurate clearance and settlement of securities transactions and to safeguard securities and funds in their custody or control.

Rule 17Ad-22 consists of the following parts: (1) Rule 17Ad-22(a) provides definitions for certain terms; (2) Rule 17Ad-22(b) contains risk management and participation requirements for registered CCPs; (3) Rule 17Ad-22(c) establishes a reporting requirement for registered clearing agencies with respect to certain matters including financial resources and methodologies used to calculate financial requirements; and (4) Rule 17Ad-22(d) requires registered clearing agencies, as applicable, to meet certain minimum standards.

As noted above, at this time, the Commission intends for Rule 17Ad-22 to apply only to registered clearing agencies. The Commission may consider at a later time whether any additional rules tailored to clearing agencies that perform post-trade processing services would be appropriate. In addition, Rule 17Ad-22 will not apply to any clearing agencies operating pursuant to an exemption from registration as a clearing agency granted by the Commission unless the terms of future exemptions specifically contemplate its application, in whole or in part.

B. Definitions – Rule 17Ad-22(a)

1. Proposed Rule

Proposed Rule 17Ad-22(a) contains five definitions. Proposed Rule 17Ad-22(a)(1) would define “central counterparty” as a clearing agency that interposes itself between counterparties to securities transactions to act functionally as the buyer to every seller and as the seller to every buyer. Proposed Rule 17Ad-22(a)(2) would define “central securities depository services” to mean services of a clearing agency that is a securities depository as described in

Section 3(a)(23) of the Exchange Act.[101] Proposed Rule 17Ad-22(a)(3) would define "participant," for the limited purposes of Rules 17Ad-22(b)(3) and 17Ad-22(d)(14), to mean that if a participant controls another participant, or is under common control with another participant, then the affiliated participants shall be collectively deemed to be a single participant. Proposed Rule 17Ad-22(a)(4) would define "normal market conditions," for the limited purposes of Rules 17Ad-22(b)(1) and (2), to mean conditions in which the expected movement of the price of cleared securities would produce changes in a clearing agency's exposures to its participants that would be expected to breach margin requirements or other risk control mechanisms only one percent of the time.[102] Proposed Rule 17Ad-22(a)(5) would define "net capital," for the limited purpose of Rule 17Ad-22(b)(7), to have the same meaning as set forth in Rule 15c3-1 under the Exchange Act for broker-dealers or any similar risk adjusted capital calculation for all other prospective clearing members.[103]

2. Comments Received

Commenters generally supported proposed Rule 17Ad-22(a)(3) because it would require a clearing agency to take account of an entire group of affiliated entities when complying with the financial resources requirements of proposed Rule 17Ad-22(b)(3), as well as the requirements in proposed Rule 17Ad-22(d)(14) for risk controls to address participants' failures to settle.[104] However, one commenter recommended that the rule employ the phrase "participant family" because "participant" on its own may be easily confused with other uses of that term in

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101 See supra note 36 and accompanying text.

102 The definition of normal market conditions in Rule 17Ad-22(a)(4) is consistent with the corresponding explanation established in the CPSS-IOSCO Recommendations. See RCCP, supra note 33, at 21 (explanatory note number 1).

103 As appropriate, the clearing agency may develop risk-adjusted capital calculations for prospective clearing members that are not broker-dealers.

104 See The DTCC (April) Letter at 9-10.

the Exchange Act and in the rules and regulations thereunder.[105] Accordingly, the commenter suggested that "participant family" should be defined to mean each participant that controls, is controlled by or is under common control with another participant.[106] The commenter recommended that the standard of control for this purpose should be defined as the disclosed ownership of 50% or more of the voting securities or other interests in a participant and that it should be based on information available to the clearing agency.[107]

One commenter expressed concern about the definition of "normal market conditions" as conditions in which the expected movement of the price of cleared securities would produce changes in a clearing agency's exposures to its participants that would be expected to breach margin requirements or other risk control mechanisms only one percent of the time.[108] The commenter argued that it would be unusual to define normal market conditions this way (i.e., using margin requirements as a standard of measure) because margin models are designed to adjust during periods of market turbulence.[109]

The Commission received no comments on proposed Rules 17Ad-22(a)(1), (2) and (5).

3. Final Rule

As described more fully below, the Commission is adopting Rules 17Ad-22(a)(1), (2), (4) and (5) as proposed. We are also adopting Rule 17Ad-22(a)(3) with certain modifications to address concerns of commenters.

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105 See id.

106 See The DTCC (April) Letter at 10.

107 See id.

108 See The OCC Letter at 7.

109 See id.

We agree with commenters who suggested that in the interest of clarity and to avoid confusion with use of the term "participant" elsewhere in Exchange Act regulations, Rule 17Ad-22(a)(3) should be modified so that the term defined by the rule is "participant family" instead of "participant." We are also modifying Rule 17Ad-22(a)(3) with respect to the language that describes the test for determining when a sufficient relationship of control exists between participants to qualify them as a "participant family." The definition has been expanded to include entities controlled by a participant and to cover direct and indirect relationships. Accordingly, Rule 17Ad-22(a)(3) now provides that participants will be deemed to be a "participant family" for purposes of Rules 17Ad-22(b)(3) and 17Ad-22(d)(14) when "a participant directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with, another participant." This modification is intended to respond to the recommendation of commenters and more closely conform the text of Rule 17Ad-22(a)(3) to the language in which this standard appears in other contexts within the U.S. federal securities laws.[110] At the same time, we are not narrowing the definition of control in this context to mean ownership of 50% or more of the voting securities or other interests in a participant.[111] We believe the more appropriate evaluation of control is based on the relationship between the entities and the power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. In conducting this evaluation, clearing agencies should also be guided by the definition of "control" set forth in Rule 405 under the Securities Act of 1933, using the information available to them.

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110 See, e.g., 17 CFR 230.405 (using "controls or is controlled by, or is under common control with" in the definition of affiliate found in Rule 405 under the Securities Act of 1933).

111 See supra note 107 and accompanying text.

The Commission agrees with the commenter that well-designed margin models include factors that adjust to periods of market turbulence. The Commission, however, is not persuaded by the argument that the definition of normal market conditions in Rule 17Ad-22(a)(4) is at odds with the concept of certain periods of market turbulence.[112] The rule defines "normal market conditions" as those that prevail 99 trading days out of 100. Margin models and other risk control mechanisms designed to adjust during periods of market turbulence are consistent with the definitional standard to the extent they help to reduce the number of trading days during which a clearing agency's exposure to participants are not fully covered by such measures.

The definition of "normal market conditions" in Rule 17Ad-22(a)(4) is also modeled on relevant and analogous international standards. The RCCP stipulates that a CCP should limit its exposures to potential losses from defaults by its participants in normal market conditions and defines "normal market conditions" as price movements that produce changes in exposures that are expected to breach margin requirements or other risk controls only 1% of the time.[113] The standard also comports with the international standard for bank capital requirements established by the Bank for International Settlements, which requires banks to measure market risks at a 99% confidence interval when determining regulatory capital requirements.[114]

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112 The Commission notes that the definition of normal market conditions found in Rule 17Ad-22(a) is modeled on the current international standard for determining normal market conditions in the CPSS-IOSCO Recommendations.

113 See Bank for International Settlements' Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, Recommendations for Central Counterparties (Nov. 2004), at 18-21, available at http://www.bis.org/publ/cpss64.pdf.

114 See infra Section V.B.2 (discussion on current industry practices).

C. Risk Management Requirements for Central Counterparties: Rules 17Ad-22(b)(1)–(4)

Rules 17Ad-22(b)(1)–(4) contain several requirements that address risk management practices by registered CCPs. Specifically, the proposed rules would create standards with respect to: (1) measurement and management of credit exposures; (2) margin requirements; (3) financial resources; and (4) annual evaluations of the performance of the clearing agency's margin models.

During the comment period, commenters pointed out that to properly frame these requirements requires a great deal of technical expertise and that a failure to properly allow that expertise to influence final rules adopted by the Commission could result in inefficient requirements that lack the proper degree of flexibility to achieve prudent risk management practices without being overly burdensome. In some cases, commenters argued that personnel at the clearing agencies possess the requisite levels of experience and expertise to help the Commission shape CCP risk management standards.[115]

As an initial matter, the Commission believes that Rules 17Ad-22(b)(1)–(4) are appropriate minimum standards for registered CCPs and that they are consistent with existing international standards of practice. However, we agree that the process of evaluating, testing and refining CCP risk management standards will be ongoing and necessarily include an open dialogue among the CCPs, investors, the Commission and various other interested parties. In particular, the Commission will carefully consider further input from interested parties obtained through outreach to various constituencies and in response to any rules or rule amendments that may be proposed by the Commission upon considering the international standards developed by CPSS-IOSCO in the FMI Report.

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[115] See The DTCC (April) Letter at 18–20; The OCC Letter at 12; LCH Letter at 3–4.

Further, Rules 17Ad-22(b)(1), (2), and (3) establish targets for clearing agencies to meet without prescribing a particular method. Accordingly, the rules provide clearing agencies with the flexibility to establish risk management procedures (e.g., back testing, stress testing, model validation procedures and the composition of financial resources) that are appropriately tailored to current market conditions and can be revised over time to address changes in market conditions. Given the existing use and general understanding by U.S. CCPs and CCPs and regulatory authorities around the world of the RCCP and the principles that form the basis of Rules 17Ad-22(b)(1), (2) and (3), the Commission is adopting these rules largely as proposed.

1. Rule 17Ad-22(b)(1): Measurement and Management of Credit Exposures

a. Proposed Rule

Proposed Rule 17Ad-22(b)(1), as proposed, would require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to measure its credit exposures to its participants at least once each day, and limit its exposures to potential losses from defaults by its participants under normal market conditions[116] so that the operations of the CCP will not be disrupted and non-defaulting participants will not be exposed to losses that they cannot anticipate or control.

b. Comments Received

Three commenters urged the Commission to consider adopting a more prescriptive version of the rule.[117] Of this group, one suggested that the rule should permit a CCP to use correlated positions to reduce initial margin requirements only if the CCP can demonstrate a robust correlation between those positions under stressed market conditions and the CCP

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116 See supra note 102 and accompanying text.

117 See ISDA Letter at 7; LCH Letter at 2; Better Markets Letter at 5.

publicly discloses its methodology periodically for determining the correlation and the CCP's resulting margin requirements.[118] Another commenter suggested that a CCP should be required to measure credit exposures several times each business day and to recalculate initial and variation margin for each clearing member and the clearing member's clients more than once each day.[119] The third commenter stated that Rule 17Ad-22(b)(1) should also require the CCP to perform intraday calculations of credit risk exposure when circumstances warrant, including situations where the security-based swap is illiquid, difficult to price, or highly volatile.[120]

c. Final Rule

The Commission is adopting Rule 17Ad-22(b)(1) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. We agree with commenters that the risks CCPs face are subject to change over time due to the potential for significant changes in the risk profiles of participants and if those risks are not appropriately measured and managed by the CCP, they can result in the accrual of significant liabilities.[121] The Commission believes that measuring credit exposures once each day is the minimum frequency of measurement that will permit a clearing agency to consider effectively the credit exposures it faces.

The Commission agrees with commenters that clearing agencies may need to measure credit exposures more frequently than once each day in order to ensure that the CCP can facilitate the prompt and accurate clearance and settlement of securities transactions and ensure that they operate safely and efficiently. That point of view is reflected in the rule requirement

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118 See ISDA Letter at 7.

119 See LCH Letter at 2.

120 See Better Markets Letter at 5.

121 See supra notes 119-120 (citing the Better Markets Letter and LCH Letter).

that the measurement must be performed at least once each day. However, the Commission believes that a less prescriptive and more flexible rule sets a more appropriate baseline standard. Each CCP is exposed to participants in different markets characterized by different trading patterns, volumes, liquidity, transparency and other unique market characteristics. Rather than prescribing a specific frequency for risk exposure measurements (other than the once daily minimum), the Commission believes that CCPs should monitor exposure and margin coverage on an intraday basis depending on the individual risk characteristics of their members and businesses, and adjust their risk management processes as needed. This stance is also consistent with our understanding that the practice at many CCPs is to measure credit exposures more than once daily.[122]

While the Commission also agrees with commenters who expressed the view that a CCP should provide reductions in initial margin requirements based on offsetting or inversely correlated positions only if the CCP can demonstrate a robust correlation between those positions—including under stressed market conditions,[123] the rule is being adopted as proposed. The Commission believes that the determination of whether positions are sufficiently correlated to warrant offsets or whether reductions should be provided at all, is a matter that should be determined by the CCP as it implements its risk management procedures, and submitted to the Commission for review and public comment, as part of the Section 19b-4 rule filing process. The Commission believes that the rule should allow each CCP the flexibility to set margin requirements based on the unique products and markets that it serves. Margin requirements will vary based on a number of factors, including, but not limited to, the type, volume, and volatility of the instruments cleared. It is difficult to make determinations at the rule level regarding the

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122 See id.

123 See supra note 118 and accompanying text.

suitability of margin reductions based on adequate position correlations; therefore, the Commission believes it is more appropriate to conduct such methodological evaluations during the supervisory process.

As adopted, Rule 17Ad-22(b)(1) does not require that a registered CCP publicly disclose its correlation methodology and related margin requirements.[124] Correlation methodology is generally considered confidential by clearing agencies because it is a critical element in determining their margin requirements. While CCPs generally provide this type of information to their participants, it typically is not made public. In this connection, we are adopting Rule 17Ad-22(d)(9), discussed below, which requires each registered CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide market participants with sufficient information to enable them to identify and evaluate the risks and costs associated with using its services. Rule 17Ad-22(d)(9) is intended in part to promote appropriate levels of transparency concerning a CCP's margin practices while allowing registered clearing agencies to tailor disclosure in a way that preserves incentives for business model innovations and responsible competition among clearing agencies.

We are also adopting Rule 17Ad-22(b)(1), as it was proposed, to require registered CCPs to establish, implement, maintain, and enforce written policies and procedures reasonably designed to limit their exposures to potential losses from participant defaults. By collecting sufficient margin and having other liquid resources at its disposal, the Commission expects that a clearing agency will be able to limit its exposures to potential losses from defaults by clearing members in normal market conditions.[125]

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124 See The OCC Letter at 17; The DTCC (April) Letter at 7.

125 See supra note 102 and accompanying text.

2. Rule 17Ad-22(b)(2): Margin Requirements

a. Proposed Rule

Proposed Rule 17Ad-22(b)(2) would require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to: (i) use margin requirements to limit its credit exposures to participants under normal market conditions;[126] (ii) use risk-based models to set margin requirements; and (iii) review the models at least monthly.

b. Comments Received

One commenter recommended that the rule be amended to require that the CCP's margin requirements must be sufficient to limit credit exposures to both the CCP's participants and the clients of the CCP's participants.[127] Another commenter supported standardization of the way CCPs set margin requirements and stated that the final rule should require those clearing agencies to make their margin-setting methodology available to customers.[128] The commenter argued that this disclosure would enable market participants to reasonably anticipate when additional margin may be required and would consequently promote stable liquidity in the marketplace.[129]

In response to a question asked by the Commission in the Proposing Release, one commenter stated that adopting Rule 17Ad-22(b)(2) as proposed is unlikely to create the risk that

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126 See id.

127 See LCH Letter at 2.

128 See MFA (Kaswell) Letter at 2.

129 See id. (noting that if the Commission requires the creation of these transparent conditions with respect to margin in its final rules, then the commenter would fully support the ability of clearing agencies to have flexibility to modify margin requirements as necessary, including by imposing special margin requirements or requiring intraday posting of margin).

CCPs will lower margin standards to compete for business.[130] The commenter asserted that integrity in risk management is the primary focus of CCPs, and that a CCP would suffer severe reputational harm if it risked using guaranty fund resources to cover margin deficiencies of clearing members.[131] In addition, according to the commenter, CCPs do not alter margin requirements based on the identity of the individual counterparty.[132]

One commenter contended that certain aspects of a CCP's margin methodology, such as choice of confidence levels (used to estimate expected shortfall), the number of days' data relied on, and the various weights used to determine stress test charges do not need to be reviewed on a monthly basis.[133] If the final rule does require a monthly review, the commenter suggested that the Commission should make clear that CCPs have substantial discretion to determine which aspects of the model are appropriate for the monthly review.[134] In contrast, another commenter asked the Commission to consider a more prescriptive approach to the rule. It suggested that Rule 17Ad-22(b)(2) should be modified to require a clearing agency to use two to three years of historical price data when establishing normal market conditions, consider liquidity and the amount of time necessary to replace a position once a default occurs, and make a showing of significant and reliable correlation of price risks before it is allowed to net initial margin using long and short positions.[135]

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130 See id.

131 See id.

132 See MFA (Kaswell) Letter at 2-3.

133 See The OCC Letter at 7.

134 See id.

135 See Better Markets Letter at 3–4.

One commenter focused more narrowly on the appropriate confidence level that should be applied to initial margin collected by a clearing agency.[136] The commenter argued that setting the appropriate confidence level is directly tied to the degree of mutualization performed by a clearing agency (i.e., the lesser the degree of mutualization the higher the appropriate confidence level because the amount of funds available to manage a default will be reduced).[137]

c. Final Rule

The Commission is adopting Rule 17Ad-22(b)(2) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. This requirement recognizes that the collection of assets (e.g., cash or securities) from participants provides the clearing agency with assets to limit its exposure to a participant in the event of a participant default. By limiting its credit exposure in this manner, a CCP is less likely to be subject to disruptions in its operations as a result of a participant default, thereby facilitating the prompt and accurate clearance and settlement of securities transactions.

The Commission does not believe it is necessary to amend the rule to state that a registered CCP's margin requirements must limit credit exposures to customers of participants as well as participants.[138] Margin requirements applicable to a customer's securities positions are established in accordance with regulations specifically governing customer margin practices[139] and in some cases through additional margin requirements imposed by the participant to address

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136 See ISDA Letter at 7.

137 See id. (stating, for example, that if the clearing agency performs mutualization in its default fund and for clients in omnibus client accounts then a 99% confidence level is completely appropriate. By contrast, if the clearing agency imposes a requirement for individualized client accounts instead of an omnibus account, then the commenter believes that a confidence level greater than 99% is likely appropriate).

138 See supra note 127 and accompanying text.

139 See, e.g., 17 CFR 240.15c3-3 (Customer protection—reserves and custody of securities and Regulation T, 12 CFR 220).

its credit risk to the customer. As a result, even when a participant is transacting on the behalf of a customer, the CCP enters into a transaction only with the participant, and therefore it is the participant's creditworthiness that the clearing agency's margin requirements must adequately address.

The Commission is aware that some CCPs may already have the ability to measure credit exposures to customers of participants as well as to participants. To the extent that such margin practices are already in place or develop over time to help ensure prompt and accurate clearance and settlement in the market the clearing agency serves, we believe those practices can be effective in limiting aggregate credit exposures of clearing agencies. We agree that the ability to limit credit exposures to customers of participants using margin may help inform and shape appropriate credit risk management practices in certain cases – for example, where (i) direct access to a clearing agency by some participants may be relatively more constrained by the operational or financial demands commensurate with participation; (ii) open interest periods associated with the instruments cleared by the clearing agency are relatively significant; or (iii) customer margin requirements are established independently from the CCP (e.g., pursuant to regulation or by agreement with a participant). However, we believe that, at this time, individual CCPs should develop rules and procedures to address these specific circumstances consistent with their general responsibilities as clearing agencies under the Exchange Act and that rules of this kind would be subject to the rule filing procedures of Section 19b-4.

The Commission is not amending Rule 17Ad-22(b)(2) to specify which aspects or components of the CCP's risk-based models must be reviewed in the context of the CCP's monthly review.[140] The Commission recognizes that some assumptions that underlie model

[140] See supra note 134 and accompanying text.

parameters may be widely accepted by current convention, and those components therefore may be less likely to become outdated from month to month. On the other hand, the Commission notes that market conditions and risks are constantly changing and CCPs will need to exercise discretion in how they administer their review of those components.

The Commission notes that, to the extent a CCP believes that an assumption in a model or parameter does not lend itself to empirical testing, a review of that assumption can in some cases be accomplished by the CCP performing a theoretical assessment of that assumption compared to alternative assumptions. For example, a CCP may evaluate the appropriateness of the number of days of market data used in its margin model or the expected amount of time needed to liquidate a security in an event of default by comparing the performance of the margin model when a range of representative values is input.

Also consistent with the intent of preserving appropriate flexibility for clearing agencies to tailor their methods of achieving compliance, the Commission is not prescribing a particular confidence level for initial margin in Rule 17Ad-22(b)(2).[141] Rather, subject to Commission oversight, Rule 17Ad-22(b)(2) allows a confidence level determination to be made by the clearing agency as part of the development of its margin parameters and risk-based models. In arriving at an appropriate confidence level, we agree with commenters that the extent of mutualization of financial resources performed by a CCP in its risk management practices and the particular use of individualized client accounts or an omnibus account structure are appropriate factors to consider.[142] The Commission also chose not to stipulate specific requirements pertaining to the scope of historical price data, liquidity and replacement considerations, and the correlation of price risks used in calculating margin requirements, again

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141 See supra note 136 and accompanying text.

142 See supra note 137 and accompanying text.

opting for a more flexible standard. While a clearing agency may take such factors into consideration when determining margin requirements, each registered CCP should be free to develop the best margin methodology to accommodate its unique products and markets. Accordingly, the Commission believes that it should not attempt to prescribe the appropriate margin methodologies for each CCP or financial instrument.[143]

We agree with commenters who asserted that a CCP's disclosure of its margin-setting methodology to customers facilitates prompt and accurate clearance and settlement by enabling market participants to better plan for margin costs associated with the use of the clearing agency.[144] As noted above, registered CCPs must submit their risk management procedures, including margin methodology, to the Commission for review and public comment as a proposed rule change under Rule 19b-4. The Rule 19b-4 process provides for public disclosure, as well as an opportunity for interested parties to comment on the proposed rule change. In addition, the Commission believes that any reasonable process for implementing risk management practices will involve further, more detailed communication with clearing members and their customers regarding the particular expected results of the practices in identified circumstances. Such communication may involve both direct contacts with members and their customers or indirect contacts through general information published by the CCP on its website or in other generally available resources.

3. Rule 17Ad-22(b)(3): Financial Resources

a. Proposed Rule

Proposed Rule 17Ad-22(b)(3) would require a CCP to establish, implement, maintain and

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143 See Section 17A discussion supra Section I.A.2 and accompanying text.

144 See supra note 59.

enforce written policies and procedures reasonably designed to maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions, provided that a security-based swap clearing agency would be required to maintain sufficient financial resources to withstand, at a minimum, a default by the two participants (also referred to as the "cover two" standard) to which it has the largest exposures in extreme but plausible market conditions.[145]

b. Comments Received

Commenters expressed a wide range of views concerning proposed Rule 17Ad-22(b)(3). Some commenters generally supported the proposed rule.[146] Others expressed concern that the introduction of two different financial resources standards may discourage CCPs from extending their services to security-based swaps or may discourage prospective participants from seeking membership in CCPs for security-based swaps, which would disrupt the goal of the Dodd-Frank Act to promote central clearing.[147] One commenter stated its opinion that no historical or empirical case has been made for changing the way that CCPs currently measure the sufficiency

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145 See proposed Rule 17Ad-22(a)(3), supra Section III.B.1 (defining "participant" for purposes of proposed Rule 17Ad-22(b)(3)).

146 See Better Markets Letter at 5 (supporting the rule and stating that it appropriately differentiates between security-based swap and non security-based swap clearing agencies due to unique features of the security-based swap markets, such as jump-to-default risk); see also Barnard Letter at 1 (supporting generally the thrust of the Commission's proposals in the Proposing Release, particularly proposed Rule 17Ad-22 concerning standards for clearing agencies); BlackRock Letter at 2 (supporting Rules 17Ad-22(b)(1)–(7) because these rules will benefit the markets by reducing concentration risk, increasing the diversity of market participants involved in governance, enhancing competition and lowering costs for customers of clearing members); MFA (Kaswell) Letter at 2 (generally supporting the rules proposed under 17Ad-22(b) because they would establish reasonable, objective, risk-based criteria for fair and open access).

147 See LCH Letter at 2; The OCC Letter at 9.

of their financial resources and that no cost-benefit analysis has been done on the impact of any such change on the operations and economics of CCPs.[148]

A commenter also suggested that CCPs should consider the simultaneous default of multiple clearing members when sizing their financial resources but that a simultaneous default of the two largest clearing members is an extremely implausible occurrence, and accordingly it is not a scenario that should be embedded as a fixed requirement in the Commission's rules.[149] That commenter stated that it is reasonable to assume a default by the two largest participants would take place in conditions of heightened market volatility, which would cause a CCP to collect more financial resources because of the risk-based nature of margin requirements.[150]

One commenter disagreed with assertions in the Proposing Release that the performance of CCP services for security-based swaps entails risks that are unique to those products and that those unique risks support the proposed "cover two" requirement.[151] The commenter also stated that accounting for the jump-to-default risk of certain security-based swap instruments (i.e., credit-default swaps) should be addressed through calculation of financial resource requirements using more extreme market scenarios instead of adjusting the number of participant defaults.[152] The commenter urged the Commission to consider how changes taking place to the infrastructure

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148 See The DTCC (April) Letter at 12.

149 See The OCC Letter at 8.

150 See The OCC Letter at 9.

151 See The OCC Letter at 8 (expressing by way of example that a total return security-based swap on a single underlying security of a company that has a large market capitalization is a lower risk management challenge for a clearing agency that performs CCP services than a put or a call option on the same underlying security. It expressed a belief that the risk is much the same as a security future on the same underlying).

152 See id.

and risk management practices in the securities markets due to the Dodd-Frank Act may render irrelevant certain risks that are associated with security-based swaps today.[153]

Commenters supported the position that the Commission's regulatory standards for CCPs should be modified where appropriate to account for the relevant work of international standard setters such as the CPSS and IOSCO.[154] However, commenters pointed out that a "cover two" standard would be inconsistent with the existing CPSS-IOSCO Recommendations for financial resources.[155] They also urged the Commission not to require any CCP to increase its liquidity resources or otherwise re-engineer its risk management controls unless and until there is industry and regulatory consensus on the changes that should be made.[156] These commenters encouraged the Commission to ensure that its final rulemakings are aligned with the existing CPSS-IOSCO Recommendations to the closest extent possible.[157]

Commenters disagreed over what role the Commission should play in defining the term "extreme but plausible market conditions" as that term appears in proposed Rule 17Ad-22(b)(3).[158] One commenter favored a significant role for the Commission.[159] Other

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153 See id.

154 See The OCC Letter at 9 (citing CPSS-IOSCO Recommendation for Central Counterparties, Recommendation 3).

155 See id.

156 See The DTCC (April) Letter at 12.

157 See LCH Letter at 2–3; The OCC Letter at 9.

158 See Better Markets Letter at 5–6; The DTCC (April) Letter at 10.

159 See Better Markets Letter at 5–6 (stressing that the Commission should provide concrete guidance on the meaning of "extreme but plausible market conditions" to prevent lax or self-serving interpretation of that standard and to promote consistent practices among clearing agencies that will prevent the adoption of lower standards designed to reduce costs and attract business volume at the expense of stability and risk mitigation. The commenter also expressed that the Commission's definition of the standard should focus on unprecedented periods of illiquidity, volatility and interconnectedness that lead to multiple defaults).

commenters agreed that CCPs should be primarily responsible for determining the parameters of the standard because of their unique access to market data and understanding of the range of applicable market conditions.[160] Those commenters stated that Rule 17Ad-22(b)(3) should clarify that a CCP is responsible for determining what constitutes "extreme but plausible market conditions."

c. Final Rule

The Commission is adopting Rule 17Ad-22(b)(3) with certain modifications to address concerns raised by commenters, including but not limited to the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies and clarifications relating to the term "participant family" as discussed above.[161] The Commission believes that requiring a registered CCP, other than a security-based swap CCP, to maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which it has the largest exposure in extreme but plausible market conditions, reduces the likelihood that a default would create losses that disrupt the operations of the CCP and adversely affect the clearing agency's non-defaulting participants.

While the Commission is sensitive to the consequences of establishing a different standard for CCPs that clear security-based swaps, the Commission believes that the financial resources of the entity must be robust enough to accommodate the risks that are particular to each market served – irrespective of whether such analysis results in different standards. The Commission believes that requiring a security-based swap CCP to cover its two largest potential exposures is the appropriate standard due to the nature of these products. Security-based swaps

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160 See The DTCC (April) Letter at 10; The OCC Letter at 10.

161 See supra note 146 (supporting the rule as proposed); see also supra section III.B.3 (discussing the term "participant family").

pose unique risk management issues. In particular, credit default swaps, a subset of security-based swaps, are non-linear financial instruments subject to additional risk factors such as jump-to-default risk[162] and asymmetrical risk allocation between short and long counterparties. Unlike other products that also exhibit these characteristics (e.g., Long-Term Equity Anticipation Securities (LEAPS)), credit default swaps are unique in their size relative to their underlying markets. Recent research shows that notional outstandings in credit default swaps are often close to or greater than the outstanding value of the underlying instruments.[163] The traditional procedures for a clearing agency to handle a default may not be effective and may entail

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162 Jump-to-default risk refers to the expected change in the value of a CDS contract if a credit event were to occur with respect to a reference entity under the terms of the CDS contract, triggering an obligation for the seller of protection under the contract to make a lump sum payment to the protection buyer. Jump-to-default only refers to the incremental information in the determination that a credit event has occurred because the market already prices the probability of a credit event. In practice, credit events are largely anticipated such that jump-to-default results in small changes in value as opposed to a first order pricing effect. Jump-to-default risk exists for all CDS, not merely those on reference entities perceived as risk credits. While the decline in contract value from a credit event is usually bigger for creditworthy reference entities (because the initial contract value is higher and thus has farther to fall), jump-to-default risk can also be measured for distressed reference entities that are expected to suffer a credit event in the near future. As a hypothetical example, market participants might have measured the jump-to-default risk in "Hypothetical Risky Corporation" five-year CDS when the CDS was trading at 70% upfront (that is, a seller would need to receive an up-front payment of 70% of notional value to write the contract) and the expected value in default was 80% upfront (implying a 20% recovery rate) as being equal to 10% of notional value; equally, they might have measured the jump-to-default risk of "Hypothetical Safe Corporation" five-year CDS when it was trading at 0.30% per annum and no up-front payment (roughly equivalent to an up-front payment of 1.5%) with an expected value in default of 60% upfront (implying a 40% recovery rate) as being equal to approximately 58.5% of notional value. See generally Darrell Duffie and Haoxiang Zhu, Does a Central Clearing Counterparty Reduce Counterparty Risk? (Stanford Univ. 2010), available at http://www.stanford.edu/~duffie/DuffieZhu.pdf.

163 See, e.g., Stavros Peristiani, Vanessa Savino, "Are Credit Default Swaps Associated with Higher Corporate Defaults?", Federal Reserve Bank of New York Staff Report No. 494 (May 2011); Alessandro Fontana and Martin Scheicher, "An analysis of euro area sovereign CDS and their relation with government bonds," European Central Bank Working Paper Series, No. 1271 (Dec. 2010).

significant risk to a CCP clearing security-based swaps.[164] To address this concern, CCPs have implemented procedures that provide for the management and oversight of the liquidation or transfer of the defaulting member's positions by a default management committee comprising senior CCP staff and representatives from member institutions.[165]

The Commission does not believe that changes in the security-based swap market resulting from the Dodd-Frank Act (e.g., mandatory clearing requirements, the establishment of the Council, etc.) have eliminated or will eliminate the additional risk management challenges of security-based swaps noted above. Therefore, the Commission believes that it should codify the existing standard for maintenance of financial resources established by CCPs currently clearing security-based swaps.

The Commission notes that current industry participants recognize the need for more stringent financial resource requirements for CCPs that clear credit default swaps.[166] This point is evidenced by the fact that the "cover two" standard has been employed since before the enactment of the Dodd-Frank Act and prior to the adoption of the European Market

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164 For example, when a participant defaults, the CCP terminates all of its contracts with the defaulting participant. The traditional procedures for handling a default, which are used by CCPs for most exchange-traded derivatives, call for the CCP to promptly enter the market and replace the contracts, so as to hedge against further losses on the open positions created by termination of the defaulter's contracts. However, if the markets for the contracts cleared by the CCP are illiquid, entering the market may induce adverse price movements, especially if the defaulting participant's positions are large relative to the overall market for the contracts. See Bank for International Settlement's Committee on Payment and Settlement Systems, New Developments in Clearing and Settlement Arrangements for OTC Derivatives (Mar. 2007).

165 See id.

166 See, e.g., ISDA Letter at 1; see also Letter to William C. Dudley from the OTC Derivatives Supervisors Group, dated March 31, 2011, available at http://www.newyorkfed.org/newsevents/news/markets/2011/SCL0331/pdf (generally supporting enhancing the framework for OTC derivatives risk management).

Infrastructure Regulation ("EMIR")[167] by the major CCPs clearing credit default swaps, both in the United States and internationally. For example, both of the registered CCPs providing clearing services for credit default swap transactions to customers in the United States, ICE Clear Credit and ICE Clear Europe, already meet a "cover two" standard as does CME Group ("CME") with respect to its clearing service for index credit default swaps, which is registered with the Commission but does not yet provide CCP services for security-based swaps.[168] LCH.Clearnet, a leading CCP for OTC derivatives in Europe, maintains a "cover two" standard for its credit default swap CCP activities.[169] These practices are consistent with the "cover two" financial resources requirement for European CCPs contained in EMIR.[170]

Given that both of the registered CCPs providing clearing services for security-based swap transactions already meet the proposed standard, and that CME, which proposes to provide such services, is currently following a "cover two" standard in index credit default swap clearing, the Commission believes that Rule 17Ad-22(b)(3) does not represent a change in existing market

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167 Regulation No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, 2012 O.J. (L 201).

168 See CFTC-SEC Staff Roundtable on Clearing of Credit Default Swaps (Oct. 2010), at 123, available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission7_102210-transcrip.pdf (Stan Ivanov, ICE Clear Credit stating "at ICE we look at two simultaneous defaults of the two biggest losers upon extreme conditions…."). See also CDS Clearing Solution ICE Clear Europe (June 2012), at 6, available at https://www.theice.com/publicdocs/clear_europe/ICE_Clear_Europe_CDS_Clearing_Overview.pdf ("Guaranty Fund covers simultaneous default of 2 largest Clearing Members"); CME Rulebook, Chapter 8H, Rule 8H07, available at http://www.cmegroup.com/rulebook/CME/I/8H/07.html.

169 See LCH.Clearnet CDS Clearing Rulebook, Chapter 4, Article 4.4.1.2 (May 5, 2012), available at http://www.lchclearnet.com/Images/CDSClear%20Rulebook_tcm6-61343.pdf.

170 See supra note 167, at 43.

practices and would not hinder the growth of existing security-based swap CCPs.[171] Furthermore, the Commission does not believe the rule poses an overly burdensome barrier to entry for future CCPs wishing to clear security-based swaps, as we do not intend the rule to require a registered CCP clearing security-based swaps to cover its two largest participant exposures in the event of default for all of its products. A CCP can choose to maintain a separate default fund for security-based swaps, limiting the overall financial burden.[172]

We are adopting Rule 17Ad-22(b)(3) with modifications intended to recognize different types of structures currently employed by CCPs clearing security-based swaps and similar structures that may be developed in the future. The final rule allows that the policies and procedures may provide that the additional financial resources required to be held under the "cover two" standard may be maintained for the entire CCP or in separately maintained funds. This modification from the proposal recognizes that clearing agencies' practices may be structured as (i) conducting security-based swap clearing activities in a separate legal entity or (ii) maintaining within one legal entity separate rules, membership requirements, risk management practices, and financial resources specifically designed to cover the CCP's exposures to a separate pool of instruments that includes security-based swaps. The Commission also believes that as security-based swap CCPs introduce new products for clearing on an incremental basis in the future, the adopted rule will provide them with appropriate flexibility to

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171 See supra note 168.

172 See CME Rulebook, Chapter 8, Rule 802, available at http://www.cmegroup.com/rulebook/CME/I/8/02.html ("The Clearing House shall establish a guaranty fund (the "Base Guaranty Fund") for products other than CDS Products…"); see also CME Rulebook, Chapter 8H, Rule 8H07, available at http://www.cmegroup.com/rulebook/CME/I/8H/07.html ("The Clearing House shall establish a financial safeguards package to support CDS clearing, and each CDS Clearing Member shall make a CDS Guaranty Fund deposit with the Clearing House."); see generally discussion infra Section V.B.1.iii.c.

organize their operations to obtain additional financial resources to cover exposures for each new security-based swap product in the manner most appropriate for their organization.[173]

Some commenters argued that the Commission should not adopt a standard for the level of financial resources that may be inconsistent with the FMI Report and that there should be industry and regulatory consensus on the level of financial resources that must be maintained.[174] The FMI Report states that CCPs should maintain financial resources to cover the default of the largest two participants when the CCP is involved in activities with a more-complex risk profile.[175] The FMI Report describes a more-complex risk profile as "clearing financial instruments that are characterized by discreet jump-to-default price changes or that are highly correlated with potential participant defaults."[176] The vast majority of security-based swaps by

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173 The Commission is also aware that clearing agencies that provide CCP services for security-based swap transactions generally do not separate their operations and risk management practices between swap and security-based swap instruments. For example, we understand that some registered clearing agencies may wish to accept customer assets used to margin customer positions consisting of swaps and security-based swaps in commingled customer omnibus accounts and are already offering clearing services for swaps and security-based swaps in commingled proprietary accounts. Accordingly, where a clearing agency's operations and risk management practices are commingled, the clearing agency will be subject to the "cover two" requirement applicable to security-based swap CCPs under Rule 17Ad-22(b)(3). See Letter from Winston & Strawn LLP, dated Nov. 7, 2011 (requesting exemptive relief for ICE Clear Credit LLC in connection with a program to commingle customer funds and implement portfolio CDS).

174 See supra note 156.

175 See FMI Report, supra note 32, at 36 (Principle 4: Credit risk "In addition, a CCP that is involved in activities with a more-complex risk profile or that is systemically important in multiple jurisdictions should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the two participants and their affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions. All other CCPs should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions.").

176 See id.

notional value and other measures are credit default swaps products with such characteristics, and, accordingly, the Commission believes that the standard being adopted today with regard to security-based swaps is substantially similar to that in the FMI Report.[177] As security-based swap products with different characteristics are proposed for clearing over time, the Commission would evaluate risk profiles of such products to consider how they would be treated under the "cover two" standard.

The Commission also is not persuaded that the "cover two" standard reflects an implausible occurrence that therefore should not be embedded into the Commission's rules. The financial crisis of 2008 demonstrated the plausibility of the default of two large participants in a clearing agency over a brief period. One large investment bank was saved from the brink of default in March 2008.[178] In September 2008, two large financial institutions failed and another large financial institution was rescued from insolvency by the Federal Reserve.[179] Throughout the course of these events, the U.S. and world financial markets were affected by a systemic crisis of confidence that stifled the ability of market participants to obtain financing and avoid

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177 The Commission has previously estimated that single-name CDS will constitute roughly 95% of the market, as measured on a notional basis, for instruments that fall within the definition of security-based swap. See Securities Exchange Act Release No. 34-66868 (Apr. 27, 2012), 77 FR 30596 (May 23, 2012), at 30636, n.476.

178 See Board of Governors of the Federal Reserve System, Bear Stearns, JPMorgan Chase, and Maiden Lane LLC, http://www.federalreserve.gov/newsevents/reform_bearstearns.htm (last visited June 25, 2012).

179 LaBonte and Norden Berg, Dodd-Frank Act, Congressional Research Services, Title VIII: Supervision of Payment, Clearing and Settlement Activities (Dec. 10, 2010), at 1, available at http://www.llsdc.org/attachments/files/279/CRS-R41529.pdf (noting the failures of Lehman Brothers Holdings, Inc. and Washington Mutual, Inc. in 2008 and the subsequent rescue of American International Group, Inc.).

default.[180] The Commission believes therefore that it is plausible to assume that a systemic market disruption like that which was experienced in 2008 could affect the two largest participants of a security-based swap CCP.

One clearing agency commented that since its modeling assumptions for simultaneous default of two participants assume significant market volatility but its modeling assumptions for the default of the largest participant assume low volatility, it is possible that a requirement for financial resources to cover the default of the largest two participants may result in only a slightly higher or even a lower requirement than one for financial resources to cover the default of the largest participant.[181] However, the Commission is not persuaded by this comment and the assumption regarding low volatility. All registered clearing agencies are expected to ensure that the assumptions underlying their models are reasonably designed to meet the requirements of the Exchange Act and related regulations at all times, and the Commission staff reviews the practices of clearing agencies in this area through its established supervisory process. To the extent Commission staff identifies shortcomings in an individual registered clearing agency's practices relevant to its maintenance of the "cover one" or "cover two" requirements, further action may be taken to address such concerns, as may be necessary or appropriate. For example, in connection with an examination, the Commission can request corrective action as part of its examination findings. Where there are shortcomings that violate the clearing agency's rules or Rule 17Ad-22(b)(3), the Commission may take enforcement action.[182]

Finally, the Commission does not believe that Rule 17Ad-22(b)(3) will require major

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180 See, e.g., Trustee's Preliminary Investigation Report and Recommendations of the Attorneys for James W. Giddens for the SIPA Liquidation of Lehman Brothers, Inc. (Aug. 25, 2010), available at http://dm.epiq11.com/LBI/Project/default.aspx.

181 See supra note 150.

182 See Section 17A discussion supra Section I.A.2 and accompanying text.

changes to the practices that have been developed to measure the sufficiency of financial resources at registered CCPs. The Commission understands that all CCPs currently registered with the Commission maintain enough financial resources to withstand the default of their largest participant under extreme but plausible market conditions.[183] All of the security-based swap transactions that are centrally cleared in the United States are handled by a security-based swap CCP that maintains enough financial resources to be able to withstand the default of its two largest participants.[184]

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[183] See, e.g., International Monetary Fund, Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of the National Securities Clearing Corporation's Observance of the CPSS-IOSCO Recommendations for Central Counterparties (2010), at 10, available at http://www.imf.org/external/pubs/ft/scr/2010/cr10129.pdf (assessing NSCC's observance of Recommendation 5 from the RCCP that a CCP should maintain sufficient financial resources to withstand, at a minimum, the default of a participant to which it has the largest exposure in extreme but plausible market conditions and noting that NSCC began evaluating itself against this standard in 2009 and has back-testing results to support that during the period from January through April 2009 there was sufficient liquidity to cover the needs of the failure of the largest affiliated family 99.98% of the time); International Monetary Fund, Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of the Fixed Income Clearing Corporation – Government Securities Division's Observance of the CPSS-IOSCO Recommendations for Central Counterparties (2010), at 9-10, available at http://www.imf.org/external/pubs/ft/scr/2010/cr10130.pdf (finding that Fixed Income Clearing Corporation's Government Securities Division "observed" the requirement to maintain enough financial resources to meet the default of its largest participant in extreme but plausible market conditions).

[184] See supra note 168 (reflecting that ICE Clear Credit "looks at two simultaneous defaults of the two biggest losers upon extreme conditions…."). Most centrally cleared CDS transactions have cleared at ICE Clear Credit or ICE Clear Europe Limited. As of April 19, 2012, ICE Clear Credit had cleared approximately $15.6 trillion notional amount of CDS contracts based on indices of securities and approximately $1.5 trillion notional amount of CDS contracts based on individual reference entities or securities. As of April 19, 2012, ICE Clear Europe had cleared approximately €7.2 trillion notional amount of CDS contracts based on indices of securities and approximately €1.2 trillion notional amount of CDS contracts based on individual reference entities or securities. See https://www.theice.com/marketdata/reports/ReportCenter.shtml. As of April 19, 2012, CME had cleared approximately $522 billion notional amount of CDS contracts based on indices of securities.

The Commission agrees with the commenter who suggested that it is important for the Commission to provide concrete guidance regarding the meaning of "extreme but plausible market conditions" to assure consistent treatment of that term across clearing CCPs. In general, "extreme but plausible market conditions" are tail event conditions in which the price movement of a cleared security results in losses exceeding expectations at a 99% confidence interval, causing a clearing agency's exposures to its participants to breach margin requirements or other risk controls (i.e., a one out of 100 days scenario). For example, "extreme but plausible market conditions" may include or exceed the worst historical price movement for a particular financial instrument over a specified time horizon. However, the Commission also agrees with commenters that argued that industry professionals, including but not limited to personnel at the clearing agencies themselves, are likely to be equipped with the relevant expertise that can contribute to developing a well-informed standard of "extreme but plausible market conditions." To ensure that the standard is consistently applied across CCPs and that it accurately captures the market understanding of the terminology, the Commission expects to review and publish for public comment rule proposals from clearing agencies adopting a definition for "extreme but plausible market conditions" that is appropriate for the market they serve.

4. Rule 17Ad-22(b)(4): Model Validation

a. Proposed Rule

Rule 17Ad-22(b)(4), as proposed, would require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for an annual model validation process consisting of evaluating the performance of the CCP's margin models and the related parameters and assumptions associated with such models by a qualified person who does not perform functions associated with the clearing agency's margin models (except as part of the

annual model validation) and does not report to a person who performs these functions.[185] The Commission is adopting Rule 17Ad-22(b)(4) to ensure that a registered CCP's models are validated by qualified persons free from influence from the persons responsible for development or operation of the systems and models being validated, with sufficient frequency to assure that the models perform in a manner that facilitates prompt and accurate clearance and settlement of transactions.

b. Comments Received

Commenters generally supported proposed Rule 17Ad-22(b)(4)[186] but they also provided several suggested modifications regarding the required frequency of the model validation and how best to achieve the proper level of scrutiny and testing of the model's adequacy. One commenter stated that the rule should not require the model to be validated on an annual basis. Instead, the commenter suggested that the frequency should be left to the discretion of the clearing agency because it is in the best position to determine the appropriate timing,[187] and in

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185 Any person responsible for supervising the operation of the clearing agency's margin model would be viewed as performing the functions associated with the clearing agency's margin model and could not therefore have supervisory authority over the person conducting the model validation.

186 See The DTCC (April) Letter at 13 (supporting Rule 17Ad-22(b)(4) and recommending certain clarifications); see also Barnard Letter at 1 (supporting generally the thrust of the Commission's proposals in the Proposing Release, particularly proposed Rule 17Ad-22 concerning standards for clearing agencies); BlackRock Letter at 2 (supporting Rules 17Ad-22(b)(1)–(7) because these rules will benefit the markets by reducing concentration risk, increasing the diversity of market participants involved in governance, enhancing competition and lowering costs for customers of clearing members); LCH Letter at 3 (generally supporting the Commission's proposed rules under 17Ad-22(b)); MFA (Kaswell) Letter at 2 (generally supporting the Commission's proposed rules under 17Ad-22(b)).

187 See The DTCC (April) Letter at 13.

the absence of a material change (either to the model itself or in the market environment that affects the model), requiring an annual validation may be unnecessary and overly burdensome.[188]

Commenters also argued that the CCP is in the best position to determine how to conduct a candid assessment free from outside influence concerning its margin models and that qualified internal personnel at the CCP are capable of validating the models if reasonable steps are taken to ensure objectivity (i.e., the reviewers are not the same individuals who are or who were involved in designing the models or who are otherwise biased due to their involvement in implementation of the models).[189] Commenters argued that Rule 17Ad-22(b)(4) should not prescribe a particular method for a clearing agency to achieve that outcome.[190]

One commenter recommended that the Commission should replace the text in proposed Rule 17Ad-22(b)(4) that addresses independence with language from the Proposing Release that "the person validating the clearing agency's model should be sufficiently free from outside influences so that he or she can be completely candid in their [sic] assessment of the model."[191] The commenter stated that this construction is more consistent with RCCP 4: Financial Resources[192] and with Principle 6: Margin from the Consultative version of the FMI Report[193] because it does not prescribe a model validation frequency or a specific way to achieve integrity

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188 See id.

189 See The DTCC (April) Letter at 13; The OCC Letter at 11.

190 See The DTCC (April) Letter at 13.

191 See The DTCC (April) Letter at 14.

192 See RCCP, supra note 33, at 19.

193 See Principles for Financial Market Infrastructures Consultative Report (Mar. 2011), at 40, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD350.pdf; but see supra note 32, at 56 (stating in the finalized FMI Report that a CCP should have its margin model validated at least annually).

in the validation process.[194] Another commenter stated that proposed Rule 17Ad-22(b)(4) should be strengthened to require the model validation to be performed by an outside, independent expert and that the CCP must adjust and revalidate the model at any time it has reason to believe the model is no longer adequate.[195]

Another commenter stated that requiring a CCP to bring independence to the model review process by detaching it from the model development process would effectively require maintenance of two quantitative teams.[196] According to this commenter, that result would impose costs on the CCP to staff both teams as well as create potential staffing problems because talented personnel with the requisite quantitative skills often view the review process as non-creative.[197] That structure, the commenter argued, may create adversarial relationships within the CCP and could require senior management to resolve highly-technical disputes between the model development team and model review team.[198]

The same commenter suggested that proposed Rule 17Ad-22(b)(4) should be revised to require a CCP to do the following: (1) maintain a culture of commitment to quality where correcting and improving models is career-enhancing; (2) adopt sound policies and procedures that create a transparent and auditable model review process; and (3) require that reporting lines must come together at a person who is well-versed in technical quantitative matters.[199] Commenters also cited to the recently released Supervisory Guidance on Model Risk Management, in which the Federal Reserve and the Office of the Comptroller of the Currency

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194 See The DTCC (April) Letter at 15.

195 See Better Markets Letter at 6.

196 See The OCC Letter at 11.

197 See id.

198 See id.

199 See id.

stated that "corporate culture plays a role [in providing appropriate incentives for proper model review] if it establishes support for objective thinking and encourages questioning and challenging of decisions" and that "independence may be supported by separation of reporting lines, [but] it should be judged by actions and outcomes because there may be additional ways to ensure objectivity and prevent bias."[200]

c. Final Rule

The Commission is adopting Rule 17Ad-22(b)(4) with certain modifications to address concerns raised by commenters, including the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. In light of comments asking the Commission to clarify the standard of independence of the qualified person who performs the model validation, the Commission is revising the text of Rule 17Ad-22(b)(4) so that the annual model validation must be performed by a qualified person who is free from influence from the persons responsible for development or operation of the systems and models being validated. Generally, the Commission would consider that a person was free from influence when that person does not, including but not limited to, perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs these functions. The Commission believes that the change from the proposal addresses the concerns raised by commenters.[201] Specifically, the Commission

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200 See id.; see also The DTCC (April) Letter at 14 (citing Supervisory Guidance on Model Risk Management (Apr. 4, 2011)), available at http://www.occ.treas.gov/news-issuances/bulletins/2011/bulletin-2011-12a.pdf.

201 See, e.g., The OCC Letter at 11-12 (stating that "[w]e think that a clearing agency is capable of validating its own models through the use of qualified internal personnel, provided that appropriate steps are taken to ensure objectivity, such as ensuring that the reviewers are not the same individuals as those who are or were involved in *designing* such models or are *otherwise biased* due to their involvement in implementation of the models. Many employees who perform functions associated with margin models may

agrees that who will be the reviewer of the model is best left to the discretion of the CCP, so long as the goals of the model validation process are achieved.[202]

As proposed, Rule 17Ad-22(b)(4) would not have permitted the model validation to be performed by a person performing functions associated with the CCP's margin models (except as part of the annual model validation), or who reports to a person who performs those functions.[203] The Commission reasoned in the Proposing Release that a person involved with the functions related to the model's operation, or someone who reports to such a person, may be less likely to evaluate critically the margin models.[204] After considering the comments, the Commission agrees that instead of requiring a particular method or reporting structure, the less-prescriptive language from the Proposing Release, namely, that a person may perform the model validation as long as that person is free from influence from the persons responsible for development or operation of the systems and models being validated so that he or she can be candid in his or her assessment of the model, would be appropriate to achieve the intended purpose.

The Commission also notes that the "sufficiently free from influence" standard is consistent with the FMI Report, which does not prescribe a specific method to assure the effectiveness of the validation process,[205] and is consistent with the recent guidance from the Federal Reserve and the Office of the Comptroller of the Currency in Supervisory Guidance on

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have no particular conflict or bias that would prevent them from conducting objective model validations and, in fact, many such employees may have a strong interest in ensuring that margin models are as well-designed as possible.").

202 See The DTCC (April) Letter at 14 ("The DTCC model risk policy provides that all models must be certified as valid by a qualified independent reviewer, defined as 'a qualified reviewer that did not develop and does not currently own the model.' The reviewer may be an individual or unit within the organization or an outside consultant.").

203 See supra note 185 and accompanying text.

204 See supra note 35.

205 See FMI Report, supra note 32.

Model Risk Management.[206] The revised standard adopted by the Commission herein would not require the clearing agency to detach model review from model development or to maintain two separate quantitative teams and thus would not lead to potential increased costs.

The Commission is not persuaded that the model validation must be performed by an outside independent expert.[207] As noted above, the Commission believes that objectivity can be preserved where the person performing the model validation is an employee of the CCP as long as the clearing agency strictly adheres to the standard the Commission is adopting herein. Because the Commission has not previously required CCPs to perform an annual model validation, we understand that the implementation of this requirement may require the exercise of substantial judgment by such clearing agencies in the adoption and implementation of written policies and procedures. The Commission intends to review the development of compliance practices and to issue interpretive guidance as appropriate.

The Commission is not persuaded that the frequency of the model validation should be left to the discretion of the CCP. Current model validation practices vary among CCPs. Some CCPs conduct annual validations, while other conduct them on an ad hoc basis. Because of the role margin plays in a default, a CCP needs assurance of its value in the event of liquidation, as well as the capacity to draw upon its margin promptly. The Commission believes, especially considering its statutory responsibilities and the importance of model validation in limiting systemic risk, that it is important to create a consistent and uniformly applied minimum standard

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206 Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency, Supervisory Guidance on Model Risk Management (Apr. 4, 2011), at 9, available at http://occ.gov/news-issuances/bulletins/2011/bulletin-2011-12a.pdf (stating that independence for model review "should be judged by actions and outcomes, since there may be [many] ways to ensure objectivity and prevent bias").

207 See supra note 195.

across all clearing CCPs. The Commission believes that requiring model validation at least annually is appropriate because model performance is not ordinarily expected to vary significantly over short periods but should be reevaluated as market conditions change. Furthermore, the Commission does not think the standard of an annual model validation is too burdensome, particularly given the fact that the Commission is not prescribing any specific qualifications or credentials of the person performing the model validation and is not requiring the person performing the model validation to be independent of the clearing agency and given how important understanding of the margin methodology is to the risk management framework.

The requirement for an annual model validation does not preclude the CCP from adjusting its model any time it has reason to believe that the model is no longer adequate. In fact, as noted above, Rule 17Ad-22(b)(2) requires a CCP to review its risk-based models to set margin requirements at least monthly.

The Commission continues to believe that clearing agencies that provide CCP services must have a qualified person conduct a review of models that are used to set margin levels, along with related parameters and assumptions, to assure that the models perform in a manner that facilitates prompt and accurate clearance and settlement of transactions. In determining whether a person is qualified to conduct the model validation, registered CCPs may consider several factors, including the person's experience in validating margin models, expertise in risk management generally, and understanding of the clearing agency's particular operations and procedures.

While the Commission agrees with the commenter who suggested that CCPs should strive to create a culture of commitment to quality where improving models is career-enhancing and to adopt sound policies and procedures to create a transparent and auditable model review

process,[208] the Commission believes that this result can be achieved by requiring that a model validation review occur annually and that the reviewer be qualified and free from influence from the persons responsible for development or operation of the systems and models being validated.

D. Participant Access Standards for Central Counterparties: Rules 17Ad-22(b)(5)–(7)

Section 17A of the Exchange Act requires that a clearing agency shall not be registered unless the Commission determines, among other things, that the clearing agency's rules do not impose burdens on competition that are unnecessary or inappropriate to promote the purposes of the Exchange Act[209] and that the rules are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the CCP.[210] Therefore, when evaluating the participation standards at a CCP, the Commission must strike an appropriate balance between affording CCPs the necessary discretion to select clearing members that do not jeopardize the CCP's ability to facilitate prompt and accurate clearance and settlement while also not impeding access to central clearing among a range of market participants.

Rules 17Ad-22(b)(5), (6) and (7) introduce certain requirements regarding access to registered CCPs. Respectively, the rules would require a registered CCP to do the following: (1) provide the opportunity for a person who does not perform any dealer or security-based swap dealer services to obtain membership; (2) refrain from using minimum portfolio size and minimum volume transaction thresholds as conditions to membership; and (3) provide the ability to obtain membership to persons who maintain net capital equal to or greater than $50 million.

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208 See supra note 199 and accompanying text.

209 15 U.S.C. 78q-1(b)(3)(F).

210 15 U.S.C. 78q-1(b)(3)(G).

Rules 17Ad-22(b)(5), (6) and (7) each address the common topic of access to and participation in CCPs. Several commenters provided general comments on that shared focus. Those comments represent a wide range of views and are reflected immediately below.

Some commenters expressed their general support for the ways that Rules 17Ad-22(b)(5), (6), and (7) would promote fair and open access to CCP services through CCP participation requirements that are risk appropriate without being unnecessarily restrictive.[211] One of these commenters expressed support for the design of the rules but also made a request for the rules to offer more flexibility and latitude for CCPs to establish participation requirements that ensure integrity of operation and risk management."[212]

Two commenters urged the Commission not to adopt proposed Rules 17Ad-22(b)(5), (6) and (7).[213] The first commenter concluded that the proposed rules, while well-intentioned, "are unnecessary and counterproductive to the goal of fair and open access within a framework of the safe and sound operation of clearing agencies."[214] In particular, this commenter stated its belief that proposed Rules 17Ad-22(b)(5), (6) and (7) are overly prescriptive and that the Commission already has ample and alternative authority under which to monitor membership practices.[215] Specifically, the commenter pointed to the existing requirement in Section 17A(b)(3)(F) of the Exchange Act that a clearing agency shall not be registered unless the Commission determines

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211 See LCH Letter at 3 (upholding the Commission's intent of "ensuring broad participation in and open access to clearing agencies"); MFA (Kaswell) Letter at 2, 3 (generally supporting the Commission's proposed rules under 17Ad-22(b)); CME Letter at 3 (generally supporting "the regulatory objective of participation requirements that are risk appropriate without being unnecessarily restrictive, in order to promote fair and open access to clearing services.").

212 See LCH Letter at 3.

213 See The DTCC (April) Letter at 9; The OCC Letter at 12.

214 See The DTCC (April) Letter at 18.

215 See id.

that the clearing agency's rules are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency. The commenter also stated that if proposed Rule 17Ad-22(d)(2) is adopted, that rule would already require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to have participation requirements that are objective, publicly disclosed, and that permit fair and open access.[216] Finally, this commenter argued that proposed Rules 17Ad-22(b)(5), (6) and (7) do not conform to current or proposed global standards related to participation in CCPs. In contrast, the commenter stated its belief that Section 17A(b)(3) of the Exchange Act and proposed Rule 17Ad-22(d)(2) are consistent with RCCP Recommendation 2: Participation requirements[217] as well as FMI Principle 18: Access and participation requirements.[218]

The second commenter, while not opposed to the substance of proposed Rules 17Ad-22(b)(5), (6) and (7), generally questioned the need to hard wire these requirements into the Commission's rules.[219] Specifically, this commenter argued that the Commission already has authority under Section 17A(b)(3)(F) of the Securities Exchange Act to deny registration to a clearing agency if the clearing agency's rules are designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency.[220] In addition, this commenter stated that under proposed Rule 17Ad-22(d)(2) the Commission would gain less

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216 See id.

217 RCCP Recommendation 2 provides that "[a] CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access."

218 Principle 18 from the FMI Report provides that "[a]n FMI should have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access."

219 See The OCC Letter at 12.

220 See id.

prescriptive but broader and coextensive rule-based authority without imposing "one size fits all" access requirements.[221]

In the "Final Rule and Guidance" sections for Rules 17Ad-22(b)(5), (6) and (7) below, we address these more general comments in the context of a discussion of the more specific comments the Commission received on the proposed rules.

1. Rule 17Ad-22(b)(5): Non-Dealer Member Access

a. Proposed Rule

Rule 17Ad-22(b)(5), as proposed, would require a registered CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide the opportunity for a person that does not perform any dealer[222] or security-based swap dealer[223] services to obtain membership on fair and reasonable terms at the CCP in order to clear securities for itself or on behalf of other persons.

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221 See id.

222 The term "dealer" is defined in Section 3(a)(5) of the Exchange Act and means any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise. The definition contains an exception for a person that buys or sells securities for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business. There is also an exception for banks engaging in certain specified activities. See 15 U.S.C. 78c(a)(5) for the complete definition.

223 Pursuant to Section 761 of the Dodd-Frank Act, the term "security-based swap dealer" is added as Section 3(a)(71) of the Exchange Act, 15 U.S.C 78c(a), and generally means any person who (A) holds itself out as a dealer in security-based swaps; (B) makes a market in security-based swaps; (C) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or (D) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps. The Commission and the CFTC jointly adopted rules to further define the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and eligible contract participant." See supra note 12 (Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", Securities Exchange Act Release No. 34-66868 (Apr. 27, 2012), 77 FR 30596 (May 23, 2012)).

b. Comments Received

Some commenters generally supported the goals of Rule 17Ad-22(b)(5),[224] while other commenters expressed several concerns.[225] Specifically, one commenter stated that "any regulatory mandate to admit specific entities as members of a CCP could undermine the impartial development and application of risk-based standards for membership."[226] This commenter acknowledged the discussion in the Proposing Release explaining that proposed Rule 17Ad-22(b)(5) would not prohibit a clearing agency from using factors aside from a potential clearing member's dealer or security-based swap dealer status to make an admissions decision, but nevertheless urged the Commission to forgo adoption of the rule altogether because it believes clearing agencies should be permitted, under Commission oversight, to determine how best to promote correspondent clearing[227] and to design membership standards.[228] The commenter suggested that if the rule is adopted, it should be modified to reflect the more permissive process for evaluation described in the body of the Proposing Release, namely by

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224 See supra note 211 (citing LCH Letter, MFA (Kaswell) Letter, and CME Letter); see also Barnard Letter at 1 (supporting generally the thrust of the Commission's proposals in the Proposing Release, particularly proposed Rule 17Ad-22 concerning standards for clearing agencies); BlackRock Letter at 2 (supporting Rules 17Ad-22(b)(1)–(7) because these rules will benefit the markets by reducing concentration risk, increasing the diversity of market participants involved in governance, enhancing competition and lowering costs for customers of clearing members).

225 See The DTCC (April) Letter at 18–19; The OCC Letter at 12.

226 See The DTCC (April) Letter at 18.

227 Correspondent clearing is an arrangement between a current participant of a clearing agency and a non-participant that desires to use the clearing agency for clearance and settlement services.

228 See The DTCC (April) Letter at 18–19. The commenter also stated its belief that "financial resources" and "creditworthiness" should be expressly added to the factors that may be considered. Moreover, the commenter suggested that the term "otherwise qualified" be clarified as it was not precise enough standard to meaningfully inform clearing agencies of what criteria may be considered when evaluating potential members.

clarifying that the clearing agency may take other factors into account in making membership decisions.[229]

c. Final Rule

The Commission is adopting Rule 17Ad-22(b)(5) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies.

While the Commission understands concerns raised by commenters, the Commission ultimately believes that the benefits of Rule 17Ad-22(b)(5) are critical to maintaining fairness and open access to central clearing for all market participants, including security-based swaps participants. The Commission believes that no registered CCP should deny membership solely because a person does not perform any dealer or security-based swap dealer services and that such a requirement unfairly discriminates against certain market participants and should be prohibited. The Commission does not believe that performing dealer or security-based swap dealer services is, by itself, a sufficient indicator of whether an applicant should be admitted to a clearing agency.

Dealer and security-based swap dealer services generally involve services designed to facilitate securities transactions by buying and selling securities for a person's own account.[230] The Commission continues to believe that requiring registered CCPs to allow persons who are not dealers or security-based swap dealers to become members of the clearing agency will promote more competition by allowing more firms to clear, thereby increasing competition among clearing members on both price and service which should, in turn, reduce costs to market participants. The enhanced access to central clearing should engender more correspondent

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229 See The DTCC (April) Letter at 19.

230 See supra note 222.

clearing in the security-based swap market. Because of the relationship between security-based swaps and traditional securities (e.g., market participants using security-based swaps to hedge positions in traditional securities), the Commission believes that applying these rules to all CCPs will help ensure that market participants have access to central clearing in all instruments that are centrally cleared.

In situations where direct access to clearing agencies is limited by reasonable participation standards, firms that do not meet these standards may still be able to access clearing agencies through correspondent clearing arrangements with direct participants.[231] Such a process involves the non-participant entering a correspondent clearing arrangement with a participant so that the transaction may be submitted by the participant to the clearing agency. Thus, the success of correspondent clearing arrangements depends on the willingness of participants to enter such arrangements with non-participant firms that may act as direct competitors to the participants in the participants' capacity as dealers or security-based swap dealers in the market for the relevant securities. Given that the existing CCP participants that are dealers or security-based swap dealers may therefore have incentives to restrict competitors in the securities execution markets from accessing a CCP, correspondent clearing arrangements may be inhibited unless participants that do not provide dealer or security-based swap dealer services are provided with the ability to become direct members of a clearing agency.

Also, the Commission is not persuaded by the comment that Rule 17Ad-22(b)(5) is likely to undermine the impartial development and application of risk-based standards for

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[231] See Exchange Act Release Nos. 63107 (Oct. 14, 2010), 75 FR 65882 (Oct. 26, 2010) and 64018 (Mar. 3, 2011), 76 FR 12645 (Mar. 8, 2011) (Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC).

membership.[232] Simply stated, Rule 17Ad-22(b)(5) is designed to prohibit registered CCPs from denying membership on fair and reasonable terms to otherwise qualified persons solely by virtue of the fact that they do not perform any dealer or security-based swap dealer services.[233] The Commission fully recognizes that persons who are not dealers or security-based swap dealers may fail to meet other standards for membership at a clearing agency, such as the operational capabilities required for direct participation. While non-dealer status cannot serve as the sole reason for denying membership, Rule 17Ad-22(b)(5) does not prohibit a registered CCP from taking other standards of membership into account when establishing membership criteria for non-dealers.

Because the factors that each CCP considers when establishing membership criteria differ based on the particular characteristics of the relevant clearing agency and the markets it serves, the Commission believes that it would be counterproductive to modify Rule 17Ad-22(b)(5) to make it more specific and therefore more constraining. One commenter, however, requested that the Commission provide additional clarity in terms of what is required to be considered "otherwise qualified" for membership at a CCP.[234] In response to this comment, the Commission notes that, for purposes of Rule 17Ad-22(b)(5), the term "otherwise qualified" means that the clearing agency's sole reason for denying membership to a prospective participant would be the prospective participant's status as a non-dealer or non security-based swap dealer and that it otherwise maintains the financial resources, creditworthiness, operational capacity, and any other additional characteristics necessary to meet the obligations of participation. As CCPs shape practices to come into compliance with Rule 17Ad-22(b)(3), the Commission will

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232 See supra note 228.

233 See Proposing Release, supra note 35, at Section II.A.

234 See supra note 229.

consider whether further guidance is appropriate.

The Commission believes that the incentives of persons who do not perform dealer or security-based swap dealer services to promote access at a CCP in general would tend to be consistent with increased competition in the market for the relevant securities. These persons do not execute securities trades for their own account. Instead, they provide correspondent clearing services for market participants.[235] As a result, their ability to provide correspondent clearing services would tend to increase as competition and transaction volumes increased. Accordingly, the Commission believes that Rule 17Ad-22(b)(5) will foster the development of correspondent clearing arrangements that will allow market participants who are not dealers or security-based swap dealers to obtain access to a registered CCP and that such access will have the beneficial result of greater competition in and access to central clearing. Moreover, because entities must meet all of the standards for membership, the Commission does not believe that it will undermine the development or application of risk management standards.

2. Rule 17Ad-22(b)(6): Portfolio Size and Transaction Volume Thresholds Restrictions

a. Proposed Rule

Rule 17Ad-22(b)(6), as proposed, would prohibit a CCP from having membership standards that require participants to maintain a portfolio of any minimum size or to maintain a minimum transaction volume.

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[235] For a description of correspondent clearing activity, see generally The Role and Regulation of Clearing Brokers, 48 Bus. Law 841 (May 1993).

b. Comments Received

Some commenters expressed general support for the goals of proposed Rule 17Ad-22(b)(6).[236] At the same time, one commenter opposed adoption of the rule because of concern that "any regulatory mandate on portfolio size and transaction volume thresholds could undermine the impartial development and application of risk-based standards for membership" in a CCP.[237] This commenter also questioned why certain language in the discussion section of the Proposing Release (explaining that the proposed rule "would not prohibit a central counterparty from considering portfolio size and transaction volume as one of several factors when reviewing a potential participant's operations") was not included in the text of the proposed rule.[238] In addition, the commenter stated that even if a CCP has the discretion to consider portfolio size and transaction volume when making a membership decision, it is unclear how much weight the clearing agency actually may give to this factor without running afoul of Rule 17Ad-22(b)(6).[239] Finally, this commenter noted that it ultimately would prefer to see the Commission not adopt Rule 17Ad-22(b)(6) and instead continue to oversee determinations made by clearing agencies concerning membership standards and the weight, if any, to be given to portfolio size and transaction volume.[240]

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236 See supra note 211 (citing LCH Letter, MFA (Kaswell) Letter, and CME Letter); see also Barnard Letter at 1 (supporting generally the thrust of the Commission's proposals in the Proposing Release, particularly proposed Rule 17Ad-22 concerning standards for clearing agencies); BlackRock Letter at 2 (supporting Rules 17Ad-22(b)(1)–(7) because these rules will benefit the markets by reducing concentration risk, increasing the diversity of market participants involved in governance, enhancing competition and lowering costs for customers of clearing members).

237 See The DTCC (April) Letter at 19.

238 See id.

239 See The DTCC (April) Letter at 19–20.

240 See The DTCC (April) Letter at 20.

c. Final Rule

The Commission is adopting Rule 17Ad-22(b)(6) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies.

We believe that imposing minimum thresholds on the size or transaction volume of a participant's portfolio would not function as a good indicator of whether the participant is able to meet its obligations to a CCP.[241] The Commission believes that trading volume and portfolio size alone are poor grounds for limiting participant access to central clearing, and that sole use of these criteria could indicate unfair discrimination against certain market participants and thus should be prohibited as the sole basis for determining membership.

New participants to a CCP that do not, at least initially, intend to transact in substantial size or volume may nevertheless have the operational and financial capacity to perform the activities that other participants are able to perform. Therefore, the Commission believes that Rule 17Ad-22(b)(6) will help facilitate compliance with the requirement in Section 17A of the Exchange Act that the rules of a CCP must permit fair and open access.[242]

For the same reasons discussed in connection with Rule 17Ad-22(b)(5), the Commission is not persuaded by the comment that Rule 17Ad-22(b)(6) is likely to undermine the impartial development and application of risk-based standards for membership.[243] Specifically, the rule does not prohibit a CCP from considering portfolio size and transaction volume as one of several factors when reviewing a potential participant's operations. Rather, the rule prohibits the

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241 Rule 17Ad-22(b)(6) would not prohibit a clearing agency from imposing maximum portfolio sizes or transaction volume amounts.

242 See supra note 210.

243 See supra note 237.

establishment of minimum portfolio sizes or transaction volumes that by themselves would act as barriers to participation by new participants in clearing. Rule 17Ad-22(b)(6) is an absolute bar to the sole use of these criteria for determining membership. The Commission also does not believe that it would be prudent to modify the rule text to make it more specific and potentially more constraining because the factors that each CCP considers when establishing appropriate membership criteria differ to some degree based on the particular characteristics of the relevant clearing agency and the markets it serves. As noted more generally in Section II.B above, the Commission will consider whether to issue further guidance to facilitate compliance as clearing agencies establish, implement, maintain and enforce policies and procedures responsive to Rule 17Ad-22(b)(6).

3. Rule 17Ad-22(b)(7): Net Capital Restrictions

a. Proposed Rule

Proposed Rule 17Ad-22(b)(7) would require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide a person that maintains net capital[244] equal to or greater than $50 million with the opportunity to obtain membership at the CCP, with any net capital requirements being scalable so that they are proportional to the risks posed by the participant's activities to the CCP.

b. Comments Received

Some commenters supported proposed Rule 17Ad-22(b)(7).[245] Several commenters expressed support for the rule because it would require access to a CCP to be scaled in a risk-

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244 Proposed Rule 17Ad-22(a)(5) would define "net capital" for the limited purposes of proposed Rule 17Ad-22(b)(7) to have the same meaning as set forth in Rule 15c3-1 under the Exchange Act for broker-dealers or any similar risk adjusted capital calculation for all other prospective clearing members.

245 See MFA (Kaswell) Letter at 3; ISDA Letter at 4; BlackRock Letter at 1.

based way.[246] One of these commenters expressed the hope that the CFTC would adopt a similar requirement and urged the Commission to work together with the CFTC to harmonize their respective rules in this area.[247]

Another commenter supportive of Rule 17Ad-22(b)(7) urged the Commission to modify the rule to eliminate the ability of a CCP to raise its minimum net capital threshold above $50 million.[248] This commenter stressed that if the Commission declined to take such action when adopting a final rule, then the Commission should (i) require the clearing agency's rationale to meet a higher burden of proof than currently proposed; (ii) require the clearing agency to demonstrate not only that it could not effectively manage the risk using other measures but also that raising the minimum capital requirement is the least restrictive means by which to address the risk posed to the clearing agency; and (iii) review the clearing agency's showing and make an express determination that no other, less- competitively-restrictive measures are available to the clearing agency to manage the risk effectively.[249]

One commenter stated that net capital, without regard to other risk factors, does not conclusively establish creditworthiness or any of the other generally accepted qualifications for becoming a member of a CCP.[250] Another commenter agreed with this assertion, but cited it as support for Rule 17Ad-22(b)(7) on the basis that clearing members with net capital closer to $50

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246 See ISDA Letter at 4; MFA (Kaswell) Letter at 3; BlackRock Letter at 1.

247 See ISDA Letter at 4. See also Derivatives Clearing Organization General Provisions and Core Principles, supra note 38 (in which the CFTC adopted Rule 39.12(a)(2)(iii) to require that a DCO shall not set a minimum capital requirement of more than $50 million for any person that seeks to become a clearing member in order to clear swaps).

248 See MFA (Kaswell) Letter at 4–5 (noting that the CFTC in the DCO Release adopted rule 39.12(a)(2)(iii) in a form that does not permit adjustment of the $50 million net capital requirement for membership).

249 See MFA (Kaswell) Letter at 4–5.

250 See The DTCC (April) Letter at 20.

million may have other characteristics that make their risk profile less risky than clearing members with greater amounts of net capital.[251]

Several commenters expressed concern over proposed Rule 17Ad-22(b)(7).[252] One commenter stated that the proposed $50 million net capital standard could create conditions where a clearing member at that net capital level might use its $50 million of net capital to access multiple clearing agencies.[253] Commenters suggested that this standard would increase the likelihood that the clearing member would not be able to meet capital calls close in time from multiple clearing agencies.[254] To address this concern about margin call risk, the commenter suggested that the rule should be modified to require: (i) daily reporting from each clearing member of its capital cover for the potentially numerous assessments that it could be subject to from each clearing agency where it is a member; (ii) the clearing member to conduct regular stress tests at an "extreme but plausible" market level in relation to the potentially numerous clearing agency assessments that it could be subject to, and to provide the results to each clearing agency where it is a member; and (iii) each clearing agency to monitor and assess, on a daily basis, the ability of a clearing member and its related affiliates to meet these potential assessment exposures and share this daily analysis with other CCPs and any relevant prudential regulator.[255] The commenter stated that unless regulators and clearing agencies are able and willing to commit

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251 See MFA (Kaswell) Letter at 3.

252 See The OCC Letter at 12; The DTCC (April) Letter at 9.

253 See ISDA Letter at 3.

254 See id.

255 See id.

to these actions, then it believes that a far larger minimum net capital requirement, such as $1 billion, is appropriate.[256]

Another commenter expressed concern that because not all market participants use a net capital computation, the proposed rule could give unfair advantages to some market participants over others in terms of gaining and retaining membership at a CCP.[257] The commenter concluded that proposed Rule 17Ad-22(b)(7) should not be adopted, and instead CCPs should continue to determine membership standards subject to Commission oversight (including capital requirements and other measures of creditworthiness) as well as how best to ensure that access to the clearing agency is fair and open.[258]

One commenter noted the Commission's reference in the Proposing Release to the tiered membership standards of the FICC as an example of capital-related requirements that differentiate between types of participants.[259] The commenter stated its opposition to "tiers" in the membership structure of CCPs on the basis that they can have discriminatory or anti-competitive effects.[260] Finally, another commenter stated it generally does not see the need for the approach proposed in Rule 17Ad-22(b)(7) because it believes the Commission has other tools at its disposal to review membership standards on a case-by-case basis that account for the nature of a particular clearing agency's activities and the risks associated with those activities.[261]

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256 See id.

257 See The DTCC (April) Letter at 20.

258 See id.

259 See MFA (Kaswell) Letter at 4.

260 See id.

261 See The OCC Letter at 12.

c. Final Rule

The Commission is adopting Rule 17Ad-22(b)(7) with certain modifications, including the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. As noted by the commenters expressing support for the rule,[262] we believe that persons that maintain a net capital level of equal to or greater than $50 million, as well as an appropriate level of financial expertise, should not be denied participation in a CCP based solely on their net capital levels, provided that such persons are able to comply with other reasonable membership standards. In the Proposing Release, we cited recent broker-dealer reporting data available to the Commission reflecting that the $50 million threshold for net capital is a standard that provides the potential for approximately 4% of the total number of broker-dealers or approximately 201 firms could be eligible to gain clearing membership at one of the registered clearing agencies.[263] According to this data, raising the net capital requirement to $100 million would have reduced the community of eligible broker-dealers by 73 firms or 35% to 128 eligible firms, while reducing the net capital threshold to as low as $25 million would increase the number of broker-dealer potentially eligible for membership by 86 firms or 43% to 287 firms (approximately 6% of broker-dealers). The Commission believes that firms that maintain a net capital level of equal to or greater than $50 million have sufficient financial resources to participate at some level in a CCP provided that they are able to comply with other reasonable membership standards and is concerned that some firms with less than $50 million of net capital may not have sufficient financial resources to fulfill membership obligations. The rule also ensures that each

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262 See supra note 245.

263 Even if proposed Rule 17Ad-22(b)(7) is successful in encouraging the broadening of membership in CCPs that clear CDS, the Commission believes the number of broker-dealers newly eligible for clearing membership that become clearing members as a result of this change is likely to be substantially less than 201.

clearing agency will have the flexibility to develop scalable policies and procedures to limit the activities of participants based on their level of net capital.[264] For example, a CCP can place limits on its potential exposure to participants operating at certain net capital thresholds by restricting the maximum size of the portfolio such participants are permitted to maintain at the clearing agency. Accordingly, the Commission believes the $50 million minimum standard strikes the proper balance between promoting open access to central clearing among participants that have the capacity to participate without posing undue risk to CCPs. The Commission also believes that Rule 17Ad-22(b)(7) would facilitate sound risk management practices by the clearing agencies. The CCPs that seek Commission permission to employ a higher net capital requirement as a condition for membership at the clearing agency must demonstrate to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures. The CCPs seeking to implement such requirements should examine and articulate the benefits of higher net capital requirements and link the nature and degree of participation with the potential risks posed by the participant.

The Commission also does not believe that $50 million net capital standard contained in Rule 17Ad-22(b)(7) would give an advantage to some prospective members at a CCP over others. Further, the rule explicitly is not intended in any way to create an "entitlement" to membership for firms with more than $50 million in capital. Upon adoption of Rule 17Ad-22, a registered CCP cannot restrict access because a participant does not have a net capital level of

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[264] The Commission notes that some clearing agencies currently utilize capital-related requirements that differentiate among types of participants. For instance, the FICC has maintained a $50 million net worth requirement and $10 million excess net capital requirement for its Category 1 Dealer Netting Members and a $25 million net worth requirement and $10 million excess net capital requirement for its Category 2 Dealer Netting Members. This type of arrangement would continue to be acceptable under Rule 17Ad-22(b)(7).

$50 million or more; however, the CCP's policies and procedures can prescribe other reasonable membership standards and can be reasonably designed to limit the activities of the participant in comparison to the activities of other participants that maintain a higher net capital level. For example, as a way to help make its requirements scalable, a registered CCP may elect to place limits on its potential exposure to participants operating at certain net capital thresholds by restricting the maximum size of the portfolio such participants are permitted to maintain at the CCP.

Rule 17Ad-22(b)(7) also permits a registered CCP to provide for a higher net capital requirement (i.e., higher than $50 million) as a condition for membership at the clearing agency if the clearing agency demonstrates to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures, such as scalable limitations on the transactions that the participants may clear through the CCP, and the Commission approves the higher net capital requirement as part of a rule filing or clearing agency registration application. While the Commission is sympathetic to commenters who asked the Commission to eliminate the ability in Rule 17Ad-22(b)(7) of a clearing agency to impose a higher net capital requirement and argued for a heightened burden of proof in such cases,[265] the Commission has decided not to modify this part of the rule. Specifically, the Commission recognizes the benefit of maintaining flexibility to allow a CCP to impose higher net capital requirements in circumstances where that is necessary to mitigate risks that could not otherwise be effectively managed by other measures. For the same reason, the Commission is declining to modify the rule to prohibit a CCP from having tiered membership standards. The Commission is not persuaded by commenters who stated that use of tiered membership standards by clearing

[265] See supra notes 248–249 and accompanying text.

agencies is by itself anti-competitive because the Commission believes the approach taken by the rule permits well capitalized mid-tier firms to compete directly with large dealers and notes that Section 17A of the Exchange Act expressly requires that the rules of a clearing agency not be designed in a way that the rules discriminate among participants in their use of clearing agency services.[266] It is the Commission's view that tailoring participant membership standards based on participant risk profile is neither discriminatory nor anti-competitive. In addition, the use of scalable limitations on the transactions that the participants may clear and settle through the clearing agency is likely to be a key tool for allowing a clearing agency to comply with Rule 17Ad-22(b)(7) without encountering the delay and operational difficulties of having to request Commission approval to impose a net capital requirement that exceeds $50 million and without compromising the clearing agency's risk management standards.[267]

Finally, the Commission did not make any changes to Rule 17Ad-22(b)(7) in response to suggestions that the rule could create margin call risk because a participant with the minimum net capital level might access multiple clearing agencies.[268] The Commission does not believe that the rule will increase margin call risk. While the Commission understands the concerns raised by this commenter, the Commission believes that the clearing agencies themselves are best positioned to address this issue due to their expertise in this area, as well as their other regulatory obligations related to their risk management and financial well-being. Rule 17Ad-22(d)(2) requires clearing agencies to establish, implement, maintain and enforce written policies

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266 See id.

267 Compare with note 258 and accompanying text (the Commission is not persuaded by the position that Rule 17Ad-22(b)(7) should not be adopted, but agrees with the commenters premise that clearing agencies should retain some discretion to allow their expertise to inform participation standards within the requirements of the rule).

268 See supra notes 253–256 and accompanying text.

and procedures reasonably designed to require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP and have procedures in place to monitor that participation requirements are met on an ongoing basis. Accordingly, a small clearing member should not be able to expose a clearing agency to significant risk even if it is able to clear at multiple CCPs.[269] The Commission also will be able to monitor the financial strength of clearing members that are registrants pursuant to other financial reporting requirements. Accordingly, we believe that it is important to allow CCPs enough flexibility to determine the most effective approach for mitigating any potential call risk. In addition, the Commission will continue to monitor this issue and will consider whether any regulatory changes are necessary based on experience with the $50 million capital standard. The Commission will also consider any further action responsive to this issue after receiving input from interested parties through the outreach described in Section II.B.

E. Record of Financial Resources and Annual Audited Financial Statements: Rules 17Ad-22(c)(1)–(2)

1. Rule 17Ad-22(c)(1): Record of Financial Resources for Central Counterparties

a. Proposed Rule

Proposed Rule 17Ad-22(c)(1) would provide that each fiscal quarter (based on calculations made as of the last business day of the clearing agency's fiscal quarter), or at any

[269] For example, CCPs that participate in the Shared Market Information System (SHAMIS) will be able to see a clearing member's risk and financial information across participating CCPs, and a CCP also could on its own initiative require clearing members to directly report their clearing activity at other clearing agencies. Other similar systems may develop in the future.

time upon Commission request, a CCP shall calculate and maintain a record[270] of the financial resources necessary to meet its requirement in proposed Rule 17Ad-22(b)(3) and sufficient documentation to explain the methodology it uses to compute such financial resource requirement.

b. Comments Received

Commenters generally supported proposed rule 17Ad-22(c)(1).[271]

c. Final Rule

We are adopting Rule 17Ad-22(c)(1) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. The Commission believes that it is appropriate to require registered clearing agencies to make these calculations quarterly or at any time based on the request of the Commission because it provides a periodic update of the financial resources that are needed by the clearing agencies as market conditions change. The structure of Rule 17Ad-22(c)(1) also provides flexibility for the Commission to request such calculations on a real-time basis, which we believe to be useful during periods of market stress or other circumstances where more timely information is desired. The Commission believes that these calculations and related documentation will also help our oversight of compliance by clearing agencies with Rule 17Ad-

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270 See Exchange Act Rule 17a-1 (17 CFR 240.17a-1). Clearing agencies may destroy or otherwise dispose of records at the end of five years consistent with Exchange Act Rule 17a-6 (17 CFR 240.17a-6).

271 See The DTCC (April) Letter at 7; see also Barnard Letter at 1 (supporting generally the thrust of the Commission's proposals in the Proposing Release, particularly proposed rule 17Ad-22 concerning standards for clearing agencies); LCH Letter at 1 (stating its general belief that the rules in the Proposing Release "will help establish a comprehensive regulatory framework to reduce risk, increase transparency and promote market integrity within the financial system.").

22(b)(3) by providing a clear record of the method used by the clearing agency to maintain sufficient financial resources.

2. Rule 17Ad-22(c)(2): Clearing Agency Annual Audited Financial Statements

a. Proposed Rule

Rule 17Ad-22(c)(2), as proposed, would require a clearing agency to post on its website an annual audited financial report. Each financial report would be required to: (i) be a complete set of financial statements of the clearing agency for the most recent two fiscal years of the clearing agency and be prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP"), except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country, the financial statements may be prepared according to U.S. GAAP or International Financial Reporting Standards as issued by the International Accounting Standards Board ("IFRS"); (ii) be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with Rule 2-01 of Regulation S-X (17 CFR 210.2-01); and (iii) include a report of the registered public accounting firm that complies with paragraphs (a) through (d) of Rule 2-02 of Regulation S-X (17 CFR 210.2-02).

b. Comments Received

Commenters generally supported proposed Rule 17Ad-22(c)(2).[272] In response to a question asked by the Commission in the Proposing Release, one commenter stated that it does not believe the Commission should require a reconciliation to U.S. GAAP for reports prepared using IFRS because it believes that IFRS is a high-quality set of accounting standards that is

[272] See The DTCC (April) Letter at 7; ENY Letter at 2.

widely recognized, understood and used by investors when evaluating investment opportunities.[273] The commenter also asked the Commission to consider allowing non-U.S. based clearing agencies to prepare their financial statements in accordance with accounting standards generally accepted in the clearing agency's particular jurisdiction so long as the financial statements are accompanied by a reconciliation to U.S. GAAP.[274] The commenter suggested that not allowing this flexibility could force non-U.S. based clearing agencies to post financial statements on their website that do not conform to the clearing agency's local accounting and financial reporting requirements.[275]

c. Final Rule

We are adopting Rule 17Ad-22(c)(2) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. We have also changed references to "annual audited financial report" to "annual audited financial statements" to be consistent with the term used in Regulation S-X. Furthermore, we have clarified that a registered clearing agency will be required to post its financial statements of income, changes in stockholders' equity and other comprehensive income and cash flows[276] within 60 days after the end of its fiscal year, which is consistent with the staff guidance on meeting the requirements of Section 17A in its Announcement of Standards for the

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273 See ENY Letter at 1.

274 See id. at 2.

275 See id.

276 The added language, "changes in stockholders' equity and other comprehensive income," does not change the substance of the rule as provided in the Proposing Release. This language has been added in the final rule to clarify the scope of what is meant by a complete set of financial statements consistent with customary industry accounting practices.

Registration of Clearing Agencies.[277] The Commission believes that requiring the disclosure of the clearing agency's annual audited financial statements to be an additional layer of information about the activities and financial strength of the clearing agency that market participants may find useful in assessing their use of the clearing agency's services.[278]

Consistent with recommendations from commenters, we are adopting Rule 17Ad-22(c)(2) in a form that does not require a reconciliation to U.S. GAAP for clearing agency reports that are prepared using IFRS.[279] We appreciate the request made by commenters for the Commission to consider allowing non-U.S. based clearing agencies to prepare their financial statements in accordance with accounting standards generally accepted in their home jurisdiction so long as the financial statements are accompanied by a reconciliation to U.S. GAAP.[280] However, we also recognize the advantages of financial statement disclosure that are limited to more widely applied bases of accounting and may offer more utility to market participants, regulators and other stakeholders of clearing agencies. Therefore, we have limited the different bases of accounting upon which the annual audited financial statements may be prepared to IFRS and U.S. GAAP.

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277 See Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (June 23, 1980) ("Accordingly, a clearing agency should undertake in its rules to furnish to participants, within 60 days following the close of the clearing agency's fiscal year, unconsolidated audited comparative financial statements which are prepared in accordance with generally accepted accounting principles and are covered by a report prepared by its independent public accountant.").

278 The requirements of proposed Rule 17Ad-22(c)(2) concerning the audited annual financial statements would apply individually to each respective clearing agency.

279 See supra note 273.

280 See supra notes 274-275 and accompanying text.

F. Minimum Standards for Registered Clearing Agencies: Rules 17Ad-22(d)(1)–(15)

Rule 17Ad-22(d) sets forth certain minimum standards regarding the operations of registered clearing agencies providing CCP or CSD services. The standards established in Rule 17Ad-22 address areas including: (1) transparent and enforceable rules and procedures; (2) participation requirements; (3) custody of assets and investment risk; (4) operational risk; (5) money settlement risk; (6) cost-effectiveness; (7) links; (8) governance; (9) information on services; (10) immobilization and dematerialization of securities certificates; (11) default procedures; (12) timing of settlement finality; (13) delivery versus payment; (14) risk controls to address participants' failures to settle; and (15) physical delivery risks.

Like Rules 17Ad-22(b) and (c), Rule 17Ad-22(d) is designed to work in tandem with the Commission's existing mandate under Section 17A of the Exchange Act by establishing minimum standards for clearing agency operations. In particular, Congress directed the Commission to facilitate the establishment of (1) a national system for the prompt and accurate clearance and settlement of transactions in securities (other than exempt securities) and (2) linked or coordinated facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options.[281] In using its authority, the Commission must consider the public interest, the protection of investors, the safeguarding of securities and funds, and the maintenance of fair competition among brokers and dealers, clearing agencies, and transfer agents.[282] When Congress established this system for the regulation of clearing agencies in 1975, Congress found that:

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[281] See 15 U.S.C. 78q-1(a)(2)(A).

[282] See 15 U.S.C. 78q-1(b)(3)(A)–(I).

- The prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto, are necessary for the protection of investors and persons facilitating transactions by and acting on behalf of investors.
- Inefficient procedures for clearance and settlement impose unnecessary costs on investors and persons facilitating transactions by and acting on behalf of investors.
- New data processing and communications techniques create the opportunity for more efficient, effective, and safe procedures for clearance and settlement.
- The linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement will reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors. [283]

These findings serve as objectives in the Commission's ongoing efforts to enhance efficiency and reduce risk in the operation of the U.S. clearance and settlement system. Over the years, the Commission's view of the actions by a clearing agency that are necessary to meet these objectives as well as the other requirements in Section 17A has changed with prevailing market conditions and as new technologies are developed. For example, in the years after the October 1987 market break, the Commission worked to implement a number of changes in the securities markets, including the reduction of the standard settlement time frame for a securities transaction to the third day after the securities trade date (i.e., T+3) and the conversion to a same-day funds settlement system.[284] In 2004, in a concept release titled Securities Transaction

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[283] See 15 U.S.C. 78q-1(a)(1).

[284] See 17 CFR 240.15c6-1; Exchange Act Release No. 34-26051 (Aug. 31, 1988), 53 FR 34852 (Sept. 8, 1988).

Settlement, the Commission noted at that time that (1) size and growth of the securities markets; (2) tighter linkages among markets and market participants; and (3) a possible wide-scale regional disruption prompted the Commission to consider shortening the standard T+3 securities settlement cycle even further to mitigate the possibility of systemic disruptions and to facilitate a more efficient clearance and settlement system.[285]

Over time, changes to the U.S. legal framework have also led to enhancements in the operation of the U.S. clearance and settlement system. For example, the adoption of Revised Article 8 of the Uniform Commercial Code in 1995 strengthened the laws governing the holding and transfer of securities.[286] In response, clearing agencies changed their rules to provide greater legal certainty to their direct investors and provide greater protection to investors.[287] Amendments to the U.S. bankruptcy code in 2005 similarly provided an opportunity for enhanced legal protections for clearing agencies and clearing agency participants.[288]

Consistent with these examples of how the Commission's approach to administrative oversight and practices by clearing agencies have changed over time to meet the objectives of Section 17A, the Commission believes that Rule 17Ad-22(d) creates standards for various aspects of the payment, clearance and settlement process and that to meet these standards clearing agencies will likely need to update their rules and procedures as market conditions evolve (e.g., through new products and trading strategies), to keep pace with relevant changes in

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285 See Concept Release: Securities Transaction Settlement, Release No. 34-49405 (Mar. 11, 2004).

286 See generally James S. Rogers, Policy Perspectives on Revised U.C.C. Article 8 (1996), Boston College Law School Faculty Papers, Paper 343, available at http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1346&context=lsfp.

287 Securities and Exchange Act Release Nos. 39924 (Apr. 27, 1998), 63 FR 24584 (May 4, 1998) and 36781 (Jan. 26, 1996), 61 FR 3958 (Feb. 2, 1996).

288 Bankruptcy Abuse Prevention and Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23.

technology, and appropriately respond to other conditions.[289] The discussion below provides greater detail regarding each respective standard covered in Rules 17Ad-22(d)(1)–(15). As indicated in Section II.B the Commission intends to observe clearing agency practices as they are developed to establish, implement, maintain and enforce policies and procedures that are intended to achieve compliance with Rules 17Ad-22(d)(1)–(15). Monitoring those practices and through cognizance of changes in other relevant areas that affect a clearing agency's operation and governance, such as market conditions, technology, or international standards, the Commission may modify Rules 17Ad-22(d)(1)–(15) over time or adopt additional rules as appropriate. The Commission may also choose to issue further guidance concerning its rules for clearing agencies.

1. Rule 17Ad-22(d)(1): Transparent and Enforceable Rules and Procedures

a. Proposed Rule

Rule 17Ad-22(d)(1), as proposed, would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for a well-founded, transparent and enforceable structure for each aspect of their activities in all relevant jurisdictions.[290]

b. Comments Received

Commenters generally supported Rule 17Ad-22(d)(1).[291]

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289 See supra note 71.

290 A relevant jurisdiction would include, among others, activities (1) in the United States, (2) involving any means of interstate commerce, or (3) in respect to providing clearing services to any U.S. person. For clearing agencies that operate in multiple jurisdictions, this also could include resolving possible conflicts of laws issues that the clearing agency may encounter.

291 See The DTCC (April) Letter at 7 (noting its support for proposed Rule 17Ad-22(d)(1) as drafted); see also Better Markets Letter at 2 (stating generally that"[i]n fashioning the

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(1) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. We believe that well-founded, transparent and enforceable policies and procedures established to underpin a clearing agency's operational and business activities are essential to reduce legal risks and enhance a clearing agency's ability to facilitate the prompt and accurate clearance and settlement of securities transactions and safeguard securities and funds as required for the protection of investors by Section 17A of the Exchange Act.[292]

To achieve compliance with Rule 17Ad-22(d)(1), a clearing agency must have written policies and procedures[293] in place that, at a minimum, address the significant aspects of a clearing agency's operations and risk management to provide a well-founded legal framework and must be clear, internally consistent, and readily accessible by the public in order to provide a transparent legal framework. In addition, the clearing agency must be able to enforce its policies and procedures that contemplate enforcement by the clearing agency. Moreover, policies and

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rules, and in accordance with the Dodd-Frank Act, the Commission has appropriately taken into account international standards governing clearance and settlement"); Barnard Letter at 1 (supporting generally the thrust of the Commission's proposals in the Proposing Release, particularly proposed Rule 17Ad-22 concerning standards for clearing agencies); The OCC Letter at 7 (applauding the Commission generally for choosing to incorporate many aspects of the current CPSS-IOSCO Recommendations in the Proposing Release); LCH Letter at 1 (stating its general belief that the rules in the Proposing Release "will help establish a comprehensive regulatory framework to reduce risk, increase transparency and promote market integrity within the financial system").

[292] 15 U.S.C. 78q-1(a)(1)(A).

[293] Clearing agencies are SROs as defined in Section 3(a)(26) of the Exchange Act. A stated policy, practice, or interpretation of an SRO, such as a clearing agency's written policies and procedures, would generally be deemed to be a proposed rule change, unless (1) it is reasonably and fairly implied by an existing rule of the self-regulatory organization or (2) it is concerned solely with the administration of the self-regulatory organization and is not a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of a SRO's existing rule. See 17 CFR 240.19b-4.

procedures that govern or create remedial measures that a party other than the clearing agency (such as a clearing member) can undertake to seek redress or to promote compliance with applicable rules must be enforceable.[294] Examples of legal risk in the operation of a clearing agency include, among other things, the likelihood that the policies and procedures of a clearing agency are incomplete, opaque, or not enforceable and will therefore adversely affect the functioning of the clearing agency.[295] The Commission believes that it is helpful for a clearing agency to bear these risk factors in mind and that it should also consider the extent to which changes in the legal framework affecting the clearing agency may require changes to its organization and practices to ensure that the establishment, implementation, maintenance and enforcement of its policies and procedures continues to provide for a well-founded, transparent and enforceable structure that protects the interests of the clearing agency and its participants.

2. Rule 17Ad-22(d)(2): Participation Requirements

a. Proposed Rule

Rule 17Ad-22(d)(2), as proposed, would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency; have procedures in place to monitor that participation requirements are met on an ongoing basis; and have participation requirements that are objective, publicly disclosed, and permit fair and open access.

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294 The Commission believes that Rule 17Ad-22(d)(1) would augment the Exchange Act requirement that the rules of the clearing agency must provide that its participants shall be appropriately disciplined for any violation of any provision of the rules of the clearing agency. See 15 U.S.C. 78q-1(b)(3)(G).

295 See generally RSSS Recommendation 1, Legal Framework and RCCP Recommendation 1, Legal Risk, supra note 33.

b. Comments Received

Some commenters supported proposed Rule 17Ad-22(d)(2).[296]

One commenter stated its specific preference for proposed Rule 17Ad-22(d)(2) to facilitate the Commission's regulation of access at clearing agencies compared to Rules 17Ad-22(b)(5), (6) and (7) for CCPs.[297] The commenter suggested that adoption of Rule 17Ad-22(d)(2), though not a prescriptive rule, would give the Commission a broad level of plenary authority over participant access to clearing agencies.[298]

One commenter recommended that the Commission should take an expansive, prescriptive approach to its rule requirements for clearing agency participation and participant monitoring.[299] The commenter asked that the Commission to be more detailed in the requirements of its proposed rules that address participation standards, like Rule 17Ad-22(d)(2).[300] The commenter suggested that the Commission should apply this approach within several categories of clearing agency operation that it believes comprise risk management.[301]

One commenter supported the requirement in Rule 17Ad-22(d)(2) for clearing members to have written policies and procedures for risk management but also emphasized the importance

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296 See The DTCC (April) Letter at 7; see also Better Markets Letter at 2; Barnard Letter at 1; The OCC Letter at 7; LCH Letter at 1.

297 See The OCC Letter at 12.

298 See id.

299 See Barnard Letter at 1; ISDA Letter at 3–4.

300 See ISDA Letter at 3–4.

301 See id. (citing the following areas as components of a clearing agency's risk management framework: (1) board and senior management oversight; (2) an organizational structure that conforms to the overall strategy and risk policy set by the board; (3) that individuals permitted to take risk on behalf of the clearing member have a strong understanding of the organization's risk profile, the products it trades, and approved trading limits; (4) risk management that is independent and reports directly to senior management or the board; and (5) strong systems and procedures for controlling, monitoring, and reporting risk (including for transactions with affiliates)) (emphasis added).

of placing emphasis on practical experience in risk management.[302] The commenter urged the Commission to require that participants in a clearing agency must be able to participate in its default management process, which includes the ability to bid for the portfolios of other clearing members.[303] The commenter also stated that if a clearing agency admitted a clearing member that was unable to participate in default management, it would reduce available resources and liquidity, place heightened burdens on other clearing members, and reduce the likelihood that the clearing agency's risk management process would operate effectively.[304]

One commenter encouraged the Commission to prohibit clearing agencies from imposing rules or engaging in conduct that is prejudicial to indirect clearing participants compared to direct clearing participants (e.g., with respect to eligibility or the timing of clearing or processing of trades), and stated that if a transaction satisfies a clearing agency's rules then the clearing process for that trade should be the same regardless of whether it involves direct or indirect clearing participants.[305]

Some commenters expressed concern that clearing agency participants may rely on the resources and services of a third party to meet the requirements developed by clearing agencies pursuant to Rule 17Ad-22(d)(2).[306] One commenter expressed that it does not believe that a

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302 See ISDA Letter at 4.

303 See ISDA Letter at 5.

304 See id.

305 See MFA (Kaswell) Letter at 7 (further stating that this includes "barriers to competitive price provision by a liquidity provider that is an indirect clearing participant versus a direct clearing participant" because "when an indirect clearing participant trades with another indirect clearing participant, the clearing process should be identical and as prompt as when one of the parties is a direct clearing participant so long as the transaction satisfies the relevant clearing agency's rules, requirements and standards otherwise applicable to such trades."); MFA (Baker) Letter Attachment 1, at 1.

306 See ISDA Letter at 4–5.

clearing member should be able to use a credit facility funding arrangement from an unaffiliated entity to satisfy financial resource requirements developed by a clearing agency pursuant to Rule 17Ad-22(d)(2).[307] The commenter noted that in this case the clearing member receives only a contractual right to funds, may need to attempt to enforce that right at a time of stressed liquidity, and does not have rights to monitor the financial resources of the liquidity facility.[308] The same commenter stated that participants should not be permitted to outsource default management.[309] It argued that preventing the outsourcing of default management arrangements is critical to mitigate risks associated with outsourcing.[310]

Several commenters argued that Rule 17Ad-22(d)(2) is only appropriate for CCPs.[311] As noted below, Rule 17Ad-22(d)(2) only applies to these entities.

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(2) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies.

Rule 17Ad-22(d)(2) is intended to reduce the likelihood of defaults by participants, while also providing flexibility for clearing agencies to tailor standards that are linked to the obligations of the participant. The Commission believes the rule fosters compliance with the

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307 See ISDA Letter at 4.

308 See id.

309 See ISDA Letter at 5.

310 See id. (noting (1) the fact that the third-party does not "have skin in the game" and (2) the third party service provider could inappropriately bind a clearing member to accept positions from a defaulting clearing member that it is not equipped to handle. The commenter also pointed out that conflicts of interest could exacerbate these risks if the third party service provider is operated by a competing clearing member).

311 See Omgeo Letter at 10; TriOptima Letter at 6–7.

requirement under Section 17A of the Exchange Act that the rules of a clearing agency must not be designed to permit unfair discrimination in the admission of participants by requiring standards that are designed to be measurable, open and fair.[312]

We agree with those commenters who supported Rule 17Ad-22(d)(2) as a mechanism to help ensure that clearing agencies meet the Exchange Act requirements in their participation standard practices.[313] However, we are not persuaded by the position that Rule 17Ad-22(d)(2) is so coextensive with the requirements of Rules 17Ad-22(b)(5), (6) and (7) that it renders the adoption of those rules unnecessary.[314] As discussed above, Rules 17Ad-22(b)(5), (6) and (7) are responsive to specific concerns about access to CCPs that have been brought to the attention of the Commission in connection with efforts to promote central clearing of security-based swaps by the financial services industry, government regulators and legislators in response to the recent financial crisis.[315] We believe that Rule 17Ad-22 promotes the compliance of all clearing agencies with the requirement in Section 17A of the Exchange Act that a clearing agency's rules may not be designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency. We also believe this complements the design of Rules 17Ad-22(b)(5), (6) and (7) to specifically promote compliance with the fair access requirement by CCPs.

We agree with commenters that comprehensive and explicit requirements are an appropriate part of a clearing agency's risk management framework, including participation

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312 15 U.S.C. 78q-1(b)(3)(F).

313 See supra note 296.

314 See supra note 297.

315 See discussion supra Section II.B.

standards.[316] We also agree with commenters who stated that it is important for the Commission to promote clearing agencies' use of practical experience in establishing, implementing, maintaining and enforcing their policies and procedures concerning participation standards and that the inability of a clearing member to participate in the default management process during a default would be problematic.[317] Accordingly, we believe that it is important to allow clearing agencies enough flexibility to use their market experience to shape the rules, policies and procedures addressing participation standards and for the Commission to oversee the suitability of those standards through its oversight, including the SRO rule filing process, periodic inspections and examinations, and day-to-day monitoring of the activities of clearing agencies. Because of the importance of clearing agency flexibility and the existing oversight mechanisms, the Commission declines to adopt more prescriptive requirements under Rule 17Ad-22(d)(2) at this time.

We agree with commenters that credit facility arrangements represent a contractual right to funds and that enforcement of that contractual right may become more difficult during stressed market conditions.[318] However, we do not believe that the rule should completely prohibit participants from using credit facility arrangements with an unaffiliated entity to satisfy financial resource requirements to a clearing agency because such credit facility arrangements can be an important tool that allows clearing agencies to access liquidity quickly in times of stress avoiding an immediate need to liquidate assets. Instead, we expect clearing agencies to use their expertise to establish rules, policies and procedures that properly reflect the extent to which credit facility arrangements are appropriate for participants at the particular clearing agency

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316 See supra notes 299-300.

317 See supra note 302 and accompanying text.

318 See supra notes 306–308 and accompanying text.

based on the particular clearance and settlement services it provides.

We agree with commenters who stated that clearing agencies should not process trades differently on the sole basis of whether the trade is between direct clearing members or involves participants that access the clearing agency through those clearing members, and so the Commission does not find it necessary to create disparate standards for the treatment of direct and indirect participants.[319]

3. Rule 17Ad-22(d)(3): Custody of Assets and Investment Risk

a. Proposed Rule

Proposed Rule 17Ad-22(d)(3) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to hold assets in a manner whereby risk of loss or of delay in access to them is minimized, and invest in instruments with minimal credit, market and liquidity risks. Compliance with the requirement is intended to improve the ability of the clearing agency to meet its settlement obligations by reducing the likelihood that assets securing participant obligations to the clearing agency would be unavailable or insufficient when the clearing agency needs to draw on them.

b. Comments Received

Some commenters expressed concerns about the application and scope of proposed Rule 17Ad-22(d)(3). One commenter stated that proposed Rule 17Ad-22(d)(3) is not sufficiently clear in its scope.[320] The commenter urged the Commission to make clear that Rule 17Ad-22(d)(3) applies only to the assets of the clearing agency that are available to facilitate

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319 See supra note 305 and accompanying text.

320 See The DTCC (April) Letter at 21.

settlement in the event of a participant default and not those assets that are held in custody by the clearing agency.[321]

However, another commenter asked the Commission to clarify that proposed Rule 17Ad-22(d)(3) applies to customer assets only and not to the assets of the clearing agency (or its sponsor).[322] The commenter noted that by defining the scope of Rule 17Ad-22(d)(3) that way the rule would not apply to clearing agencies that perform post-trade processing services (e.g., compression or collateral management) and do not take in or retain any assets of their users.[323] An additional commenter agreed that Rule 17Ad-22(d)(3) should not apply to clearing agencies that do not hold assets on behalf of participants.[324]

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(3) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. The Commission believes that Rule 17Ad-22(d)(3) strengthens the requirement in Section 17A(b)(3)(F) of the Exchange Act that the rules of a clearing agency must be designed to ensure the safeguarding of securities and funds in the custody or control of

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321 See The DTCC (April) Letter at 21–22 (remarking that it believes this ambiguity is also contained in RCCP 7: Custody and investment risks on which Rule 17Ad-22(d)(3) is modeled but noting that proposed language for FMI Principle 16: Custody and investment risk would resolve that ambiguity and asking the Commission to revise Rule 17Ad-22(d)(3) as follows to make clear that the requirements of the rule do not apply to assets of participants held in custody: "(d) Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable: (3) Hold its assets in a manner whereby risk of loss or of delay in its access to them is minimized; and invest such assets in instruments with minimal credit, market and liquidity risks").

322 See TriOptima Letter at 7.

323 See id.

324 See Omgeo Letter at 10.

the clearing agency or for which the clearing agency is responsible.[325] Because the purpose of Rule 17Ad-22(d)(3) is to help ensure assets are available in the event of a participant default, Rule 17Ad-22(d)(3) would apply to all assets held by a clearing agency that may be used for that purpose. However, the Commission notes that Rule 17Ad-22(d)(3) may not apply to the assets of a participant's customer depending on how a clearing agency's operations are structured. The Commission does not expect that registered clearing agencies would need to rely on their physical assets, such as computers, furniture and buildings, to cover a participant default under the rule.

We appreciate the concerns expressed by commenters who asked the Commission to clarify how Rule 17Ad-22(d)(3) applies in the context of the different services that a clearing agency may perform, and note that Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities that are exempt from registration as a clearing agency.

4. Rule 17Ad-22(d)(4): Identification and Mitigation of Operational Risk

a. Proposed Rule

Rule 17Ad-22(d)(4), as proposed, would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify sources of operational risk and minimize these risks through the development of appropriate systems, controls, and procedures; implement systems that are reliable, resilient and secure and have adequate scalable capacity; and have business continuity plans that allow for timely recovery of operations and ensure the fulfillment of a clearing agency's obligations.

Rule 17Ad-22(d)(4) should help to ensure that clearing agencies are able to operate with minimal disruptions, even during times of market stress when there may be greater demands on

[325] 15 U.S.C. 78q-1(b)(3)(F).

their systems due to higher volume. In addition, the rule would require that clearing agencies have business continuity plans that allow for timely recovery of operations and ensure the fulfillment of a clearing agency's obligations. This requirement would be relevant in the event of, among other things, deficiencies in information systems or internal controls, human errors, management failures, unauthorized intrusions into corporate or production systems, or disruptions from external events such as natural disasters.

b. Comments Received

Several commenters recommended that the rule should not apply to the activities of clearing agencies that perform post trade processing services. For example, one commenter reasoned that the application of proposed Rule 17Ad-22(d)(4) to a clearing agency that performs post-trade comparison services is unnecessary if that clearing agency is operating pursuant to a conditional exemptive order from the Commission.[326] The commenter stated that the conditions of an exemptive order can be tailored to provide the Commission with sufficient regulatory oversight of a clearing agency's operational risks.[327]

Another commenter expressed its view that operational risk management and disaster recovery systems are critical to any well-founded compression service or collateral management service.[328] However, the commenter argued that a clearing agency that performs those services

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326 See Omgeo Letter at 10.

327 See id. (identifying such measures as making the clearing agency subject to: (1) the Commission's Automation Review Program, (2) regular audits by Commission staff, (3) annual reports to the Commission, (4) a duty to report systems outages to the Commission, and (4) on-site inspections by Commission staff of the clearing agency's facilities).

328 See TriOptima Letter at 7–8.

should be free to implement and amend such procedures as it considers necessary to operate its business without undue regulatory delay or oversight.[329]

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(4) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. We believe that Rule 17Ad-22(d)(4) complements the existing guidance provided by the Commission in its Automation Review Policy Statements[330] and the Interagency White Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System.[331] We also believe that Rule 17Ad-22(d)(4) helps to address risks posed by potential operational

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329 See id. (supporting its position through assertions that: (1) the robustness of a compression service's systems will be a competitive issue that will be determinant of the commercial viability of the compression service; (2) compression services do not represent a systemic risk to the viability of the market because collateral management providers merely run a set of calculations for collateral management purposes; (3) systems integrity is a central feature of the provider's contractual framework and system design and, ultimately, its ability to attract users; and (4) the risk of data loss is, in practice, very small).

330 See Automated Systems of Self-Regulatory Organizations, Exchange Act Release No. 34-27445 (Nov. 16, 1989), 54 FR 48703 (Nov. 24, 1989); Automated Systems of Self-Regulatory Organizations (II), Release No. 34-29815 (May 9, 1991), 56 FR 22489 (May 15, 1991) ("Automation Review Policy Statements"). Generally, the guidance in the Automation Review Policy Statements provides for the following activities by clearing agencies: (1) performing periodic risk assessments of its automated data processing ("ADP") systems and facilities; (2) providing for the selection of the clearing agency's independent auditors by non-management directors and authorizing such non-management directors to review the nature, scope, and results of all audit work performed; (3) having an adequately staffed and competent internal audit department; (4) furnishing annually to participants audited financial statements and an opinion from an independent public accountant as to the clearing agency's system of internal control – including unaudited quarterly financial statements also should be provided to participants upon request; and (5) developing and maintaining plans to assure the safeguarding of securities and funds, the integrity of the ADP system, and recovery of securities, funds, or data under a variety of loss or destruction scenarios.

331 See Exchange Act Release No. 47638 (Apr. 7, 2003), 68 FR 17809 (Apr. 11, 2003), available at http://www.sec.gov/news/studies/34-47638.htm.

deficiencies to a clearing agency and its participants and therefore supports the requirement in Section 17A of the Exchange Act that a clearing agency must be so organized and have the capacity to be able to facilitate prompt and accurate clearance and settlement. Finally, Rule 17Ad-22(d)(4) does not require clearing agencies to eliminate all operational risks. Instead, the rule provides registered clearing agencies with the ability to consider the relevant trade-offs between cost and risk reduction. The rule provides this ability by allowing registered clearing agencies, subject to Commission oversight, to develop systems, controls, and procedures that are "appropriate" in response to the identified risks.[332]

As discussed above, Rule 17Ad-22 applies only to registered clearing agencies. It does not apply to entities that perform post-trade processing services or that are exempt from registration as a clearing agency. As discussed above, entities that perform certain post trade processing services, and that fall within the definition of clearing agency, may be subject to different rulemaking by the Commission at a later time.[333]

5. Rule 17Ad-22(d)(5): Money Settlement Risks

a. Proposed Rule

Proposed Rule 17Ad-22(d)(5) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants, and require funds transfers to the clearing agency to be final when effected. Money settlement arrangements, among other things, are meant to reduce the risk that financial obligations related to the activities of the clearing agency are not timely settled or discharged

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332 See discussion supra Section I.A.2.

333 See discussion supra Section II.B.4 and Section III.A.

with finality. Generally, money settlement by a clearing agency and its participants involves the use of a settlement bank[334] as an intermediary. Failure by the settlement bank to effectuate timely and final settlement adversely affects the clearing agency by exposing it to credit and liquidity pressures that in turn can destabilize the clearing agency's ability to facilitate prompt and accurate clearance and settlement.

The Commission is providing clearing agencies with flexibility to implement arrangements in a manner fit for them to meet the requirement of the rule. The Commission notes that there are a number of arrangements that clearing agencies could establish to comply with the rule, including criteria for use of settlement banks that address the banks' creditworthiness, access to liquidity, and operational reliability, and legal agreements with settlement banks to ensure that funds transfers to the clearing agency are final when affected.

b. Comments Received

One commenter stressed that if the Commission adopts Rule 17Ad-22(d)(5) as proposed then the Commission should clarify that a clearing agency cannot eliminate all exposure to settlement bank risk.[335] The commenter pointed out that even if a clearing agency uses an account at a U.S. Federal Reserve bank to make settlement with participants, the clearing agency is still exposed to the settlement risk of the commercial banks that are used by clearing agency participants.[336]

The same commenter stressed that the Commission should not mandate a minimum number of settlement banks and that the requirements of Rule 17Ad-22(d)(5) should focus on

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334 A settlement bank is a bank that is used to effect money settlements between a central counterparty and its participants.

335 See The OCC Letter at 14.

336 See id.

providing clearing agencies with discretion to select settlement banks with care, diversifying risk among those settlement banks to the extent practicable, and monitoring their financial status.[337]

Two commenters argued that proposed Rule 17Ad-22(d)(5) should be applicable only to clearing agencies that take in or process securities or funds from users.[338]

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(5) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. We believe Rule 17Ad-22(d)(5) limits the potential that a clearing agency's money settlement arrangements will cause the clearing agency to face higher levels of credit and liquidity risks. In addition, the Commission believes that the rule is consistent with the requirement of Section 17A(b)(3)(F) of the Exchange Act, which requires the rules of a clearing agency to be designed to assure the safeguarding of securities and funds that are in the custody or control of the clearing agency or for which it is responsible.[339]

As noted, some commenters pointed out that a clearing agency may not be positioned to eliminate all exposure to credit and liquidity risks from the use of banks to effect money settlements.[340] For example, we agree that even if a clearing agency elects to use an account at a U.S. Federal Reserve bank to make settlement with participants, the clearing agency is still exposed to the settlement risk of the banks chosen by clearing agency participants. The Commission notes however that Rule 17Ad-22(d)(5) does not require a clearing agency to

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337 See id.

338 See Omgeo Letter at 11; TriOptima Letter at 8 (stating that the proposed rule should not apply to compression services and collateral management providers that do not hold or process any of their users' assets).

339 15 U.S.C. 78q-1(b)(3)(F).

340 See supra notes 335–336 and accompanying text.

completely eliminate settlement bank risks. Instead, the clearing agency must establish, implement, maintain and enforce written policies and procedures reasonably designed to employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks. We believe clearing agencies have the authority through their rules to shape the settlement bank practices in order to achieve that outcome. We also agree with commenters that clearing agencies should retain discretion, subject to Commission oversight, to establish rules governing settlement bank practices with participants that are tailored to the operations of the clearing agency.[341]

As discussed above, Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities that are exempt from registration as a clearing agency except to the extent specifically contemplated by the terms of a future exemption.

6. Rule 17Ad-22(d)(6): Cost-Effectiveness

a. Proposed Rule

Rule 17Ad-22(d)(6), as proposed, would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to be cost-effective in meeting the requirements of participants while maintaining safe and secure operations.

Having clearing agencies be mindful of the costs that are incurred by their participants, while maintaining such compliance, should help to reduce inefficiencies in the provision of clearing agency services. This point is particularly important in circumstances where clearing agencies may not be subject to strong competitive forces (such as when there is only one clearing agency for an asset class) for the provision of their services and therefore may have less of an

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[341] See supra note 337 and accompanying text.

incentive to be cost-effective in meeting the requirements of participants. Accordingly, the Commission believes the rule should potentially help reduce the costs incurred for clearing agency services while also maintaining appropriate standards for a clearing agency's operations.

b. Comments Received

Two commenters expressed reservations about the rule.[342] One commenter stated that it is unnecessary to apply proposed Rule 17Ad-22(d)(6) to a clearing agency if the Commission already regulates the cost-effectiveness of that clearing agency through conditions in an exemptive order.[343]

Another commenter stressed that unless a provider of compression or collateral management services is systemically important, or market participants are obliged to purchase its services, then it should be free to set fees in a fair and commercial manner that encourages broad participation while permitting sufficient flexibility to offer favorable rates to high-volume users, early adopters, magnet clients and other key participants.[344] The commenter added that portfolio compression and collateral management are service areas in which cost effectiveness is a dominant part of commercial viability and that those services today do not represent a systemic risk to the viability of the markets.[345]

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342 See Omgeo Letter at 11; TriOptima Letter at 8.

343 See Omgeo Letter at 11 ("[P]ursuant to Omgeo's Exemptive Order, Omgeo may not charge its customers more for use of its central matching services than Omgeo charges its customers when all counterparties are customers of Omgeo. Moreover, because DTCC, which is industry-owned, is the majority owner of Omgeo's Class A Interests, which controls the U.S. regulated aspects of Omgeo's business, DTCC can influence the prices Omgeo charges for its U.S. regulated services. This system has worked well, and therefore application of Proposed Rule 17Ad-22(d)(6) to Omgeo is unnecessary").

344 See TriOptima Letter at 8.

345 See id.

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(6) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. As discussed above, the Commission believes Rule 17Ad-22(d)(6) is appropriate and serves to advance the statutory goals of prompt and accurate clearance and settlement.[346] Specifically, the rule should help reduce the costs incurred for clearing agency services by requiring registered clearing agencies to be mindful of costs incurred by their participants, which may include keeping fees lower for participants, while also requiring that registered clearing agencies maintain safe and secure operations.

With regard to suggestions that Rule 17Ad-22(d)(6) should not apply to entities that perform certain post-trade services (i.e., comparison of trade data, collateral management and compression/tear-up services),[347] or a clearing agency through the conditions of an exemptive order rather than the requirements of Rule 17Ad-22(d)(6),[348] we note that Rule 17Ad-22 only applies to CCPs and CSDs and does not apply to entities exempt from registration as clearing agency except to the extent specifically contemplated by the terms of a future exemption.

7. Rule 17Ad-22(d)(7): Links

a. Proposed Rule

Rule 17Ad-22(d)(7), as proposed, would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to evaluate the potential sources of risks that can arise when the clearing agency establishes links either cross-border or domestically to clear or settle trades, and to ensure that these risks are managed

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346 See supra note 1.

347 See supra notes 344–345 and accompanying text.

348 See supra note 343 and accompanying text.

prudently on an ongoing basis. Tying the operations of different clearing agencies together by link arrangements potentially exposes a clearing agency and its members to the risk that the other entity may experience a financial loss or is otherwise unable to meet its settlement obligations that causes the clearing agency or its members to fail to meet their obligations.[349] Although the design and operation of each link will present a unique risk profile, clearing agencies potentially face legal, operational, credit and liquidity risks from link arrangements. In addition, because links can create interdependencies, clearing agencies may be affected by systemic risk if there are deficiencies in these arrangements. The Commission believes that requiring clearing agencies to evaluate and monitor any link arrangements they maintain is essential to protect the marketplaces that clearing agencies serve because the requirement would reduce the likelihood that such arrangements perpetuate risks that could create disruptions in the operations of clearing agencies.

b. Comments Received

Three commenters expressed concerns about the rule.[350] One commenter expressed concern that proposed Rule 17Ad-22(d)(7) is not sufficiently clear in scope.[351] Specifically, the commenter stated that it is not entirely clear whether the rule applies only to links between clearing agencies or may also apply to other "links" and any other entities that may be involved in the process of clearing and settling trades.[352] Accordingly, the commenter asked the

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349 A clearing agency may be required to enter into a participant agreement with the other clearing organization as part of the link arrangement, which includes sharing in the loss allocations of that clearing organization. See RCCP 4.10.6, supra note 33.

350 See The DTCC (April) Letter at 22; TriOptima Letter at 9; Omgeo Letter at 12.

351 See The DTCC (April) Letter at 22.

352 See id. (providing examples of these other types of links such as those that a clearing agency may establish with a data processor, pricing service, custodian bank, transfer agent or liquidity provider).

Commission to revise the proposed rule text for 17Ad-22(d)(7).[353] An additional commenter suggested that proposed Rule 17Ad-22(d)(7) should be modified to encourage prudent portfolio compression and collateral management services globally.[354] One commenter argued that it should not be subject to Rule 17Ad-22(d)(7) because it is already subject to the conditions of an exemptive order from clearing agency registration by the Commission.[355]

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(7) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. We believe the rule is consistent with and furthers the purposes of the Exchange Act. Section 17A(a)(1)(D) of the Exchange Act states that the linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance

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353 See The DTCC (April) Letter at 23 (requesting that Rule 17Ad-22(d)(7) be revised as follows: "Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable, evaluate the potential sources of risks that can arise when the clearing agency establishes links with other central counterparties or central securities depositories either cross-border or domestically to clear trades, and ensure that the risks are managed prudently on an ongoing basis.").

354 See TriOptima Letter at 9 (noting its belief that regulations that restrict the global availability of compression services and collateral management services will necessarily reduce the effectiveness of the risk-management service, by reducing the geographic scope of counterparties to which domestic users can connect). The commenter expressed its views on modifying Rule 17Ad-22(d)(7) in the larger context of its belief "that the registration requirement with respect to [portfolio compression services and] . . . collateral management services is inappropriate and would place unnecessary burdens on entities providing swap market participants useful back-office tools that are intended to improve the efficiency of collateral management systems in a manner that reduces systemic risk." See TriOptima Letter at 1.

355 See Omgeo Letter at 12 (suggesting that its exemptive order is the oversight mechanism that strikes the appropriate balance to govern its link arrangements because its link arrangements (1) do not involve the handling of securities or funds; (2) provide for standardization and processing of information in a uniform and efficient manner; and (3) disruptions to its link arrangements are of a different type and are far less significant than disruptions in the linkages of registered clearing agencies).

and settlement will reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors.[356] Further, Section 17A(b)(3)(F) of the Exchange Act requires that the rules of a clearing agency foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions.[357]

The Commission agrees with the suggestion from some commenters that the specific type of link arrangements contemplated by Rule 17Ad-22(d)(7) is link arrangements between clearing agencies.[358] The Commission notes however that under Section 17A(b)(3)(F) of the Exchange Act, a clearing agency is charged with responsibility to coordinate with persons engaged in the clearance and settlement of securities transactions, not just other clearing agencies.[359] Accordingly, we have not amended the text of Rule 17Ad-22(d)(7) from the proposal. Further, the Commission notes that during the clearance and settlement process, a registered clearing agency is confronted with a variety of risks that must be identified and understood if they are to be effectively controlled.[360] To the extent that these risks arise as a result of a registered clearing agency's links with another entity involved in the clearance and settlement process, Rule 17Ad-22(d)(7) should help ensure that clearing agencies have policies and procedures designed to identify those risks.

Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities that are exempt from registration as a clearing agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

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356 15 U.S.C. 78q-1(a)(1)(D).

357 15 U.S.C. 78q-1(b)(3)(F).

358 See supra note 352.

359 15 U.S.C. 78q-1(b)(3)(F).

360 See RCCP, supra note 33, at 39.

8. Rule 17Ad-22(d)(8): Governance

a. Proposed Rule

Proposed Rule 17Ad-22(d)(8) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to have governance arrangements that are clear and transparent to fulfill the public interest requirements in Section 17A of the Exchange Act applicable to clearing agencies,[361] to support the objectives of owners and participants, and to promote the effectiveness of the clearing agency's risk management procedures.[362]

b. Comments Received

Two commenters registered their preference for what they regard as the principles-based approach in proposed Rule 17Ad-22(d)(8) to regulation of clearing agency governance rather than the prescriptive rules set forth in the Commission's proposed Regulation MC applicable to the security-based swap clearing agencies.[363] One commenter urged the Commission not to adopt hard and fast standards that will be costly to implement and maintain and yield little or no apparent corresponding regulatory benefits.[364]

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361 Section 17A(b)(3)(F) of the Exchange Act requires that the rules of a clearing agency be designed to protect investors and the public interest. 15 U.S.C. 78q-1(b)(3)(F).

362 Rule 17Ad-22(d)(8) would complement other applicable requirements concerning governance at clearing agencies that may also separately apply. These other requirements include the existing regulatory framework of Section 17A of the Exchange Act and the related requirements contemplated by proposed Rule 17Ad-25, as well as Section 765 of the Dodd-Frank Act with respect to security-based swap clearing agencies. See supra Section III.F (stating that clearing agencies be required to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify and address existing or potential conflicts of interest). See also Exchange Act Release No. 63107 (Oct. 14, 2010), 75 FR 65882 (Oct. 26, 2010), supra note 231.

363 See CME Letter at 3; The OCC Letter at 14 (referencing the Commission's proposed requirements for clearing agencies in Regulation MC).

364 See CME Letter at 4.

One commenter urged the Commission to ensure that Rule 17Ad-22(d)(8) as well as any requirements adopted from the Commission's proposed Regulation MC pertaining to the mitigation of conflicts of interest are designed to ensure that buy-side market participants have a meaningful voice in the operating committees of clearing agencies because that representation is critical to promoting robust governance arrangements at clearing agencies and serving the best interests of the U.S. financial system.[365] Another commenter stated that proposed Rules 17Ad-22(d)(8), 17Ad-25, and 17Ad-26 reflect a better approach to governance, conflicts of interest, and board and committee composition than the Commission's proposed requirements for clearing agencies under Regulation MC.[366]

One commenter urged the Commission to consider complementing proposed Rule 17Ad-22(d)(8) with a minimum board independence requirement so that at least two-thirds of all board directors would be required to be independent.[367]

Several commenters made recommendations to the Commission concerning the application of Rule 17Ad-22(d)(8) to clearing agencies that perform post-trade processing services.[368] One commenter stated that if the Commission interprets proposed Rule 17Ad-22(d)(8) to be applicable to clearing agencies that perform post-trade processing services for security-based swaps (e.g., comparison of data, portfolio compression and collateral management) then the governance requirements should be commensurate with the low risk presented by those service providers because requirements that are unduly onerous would impose

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365 See BlackRock Letter at 2.

366 See The DTCC (April) Letter at 8.

367 See CII Letter at 1.

368 See TriOptima Letter at 9; Omgeo Letter at 12.

unnecessary burdens and costs.[369] Another commenter argued that application of proposed Rule 17Ad-22(b)(8) to a clearing agency is unnecessary in cases when an industry utility has such a significant influence over a clearing agency's management and operation that the clearing agency's governance is already appropriately transparent to fulfill the public interest.[370]

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(8) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. Rule 17Ad-22(d)(8) is designed to promote these types of arrangements and the ability of a clearing agency to serve the interests of its various constituents and the interests of the general public while maintaining prudent risk management processes to promote prompt and accurate clearance and settlement.

Governance arrangements have the potential to play an important role in making sure that clearing agencies fulfill the Exchange Act requirements that the rules of a clearing agency be designed to protect investors and the public interest and to support the objectives of owners and participants. Similarly, governance arrangements may promote the effectiveness of a clearing agency's risk management procedures by creating an oversight framework that fosters a focus on the critical role that risk management plays in promoting prompt and accurate clearance and settlement.[371]

We appreciate the perspective of commenters who prefer the more general policies and

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369 See TriOptima Letter at 9.

370 See Omgeo Letter at 12.

371 The role of governance arrangements in promoting effective risk management has also been a focus of rules recently proposed by the Commission to mitigate conflicts of interest at security-based swap clearing agencies. See Exchange Act Release No. 63107 (Oct. 14, 2010), 75 FR 65882 (Oct. 26, 2010).

procedures design of Rule 17Ad-22(d)(8) to any more prescriptive rulemaking by the Commission in the area of clearing agency governance.[372] We agree that Rule 17Ad-22(d)(8) provides an important element of discretion to a clearing agency to be able to use its experience and expertise to hone policies and procedures for governance arrangements that support the clearing agency's particular operations. Even so, we are not persuaded by the assertions that more prescriptive Commission rules to address clearing agency governance practices would necessarily be disproportionately costly to implement and maintain when compared to potential countervailing benefits.[373] We continue to perform a careful review and evaluation of the comments that the Commission received on proposed Rules 17Ad-25, 17Ad-26 and Regulation MC, which commenters rightly observed represent separate, and in some cases more prescriptive, proposed requirements related to clearing agency governance and mitigation of conflicts of interest.

At this time, the Commission also is not acting on the recommendation of some commenters to structure Rule 17Ad-22(d)(8) so that it would require at least two-thirds of a clearing agency's board of directors to be independent.[374] Proposed Rule 17Ad-26 and Regulation MC address whether and how to require some degree of independent representation on the board of a clearing agency. We believe it is more appropriate to consider those issues in connection with the Commission's ongoing consideration of those rules.

With regard to suggestions that Rule 17Ad-22(d)(8) should not apply to entities that perform certain post-trade services (i.e., comparison of trade data, collateral management and

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372 See supra note 364.

373 See id.

374 See supra note 367.

compression/tear-up services),[375] we note that Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities exempt from registration as a clearing agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

We are not persuaded by the argument that the operation of a clearing agency through a utility model negates the need for Rule 17Ad-22(d)(8) because regardless of the business model adopted, the board should reflect the interests of the full range of stakeholders in order to effective. [376] In response to comments that the rule should apply to a clearing agency in a way that is commensurate with the risk of its services,[377] the Commission expects that not all policies and procedures established by clearing agencies to satisfy Rule 17Ad-22(d)(8) will be the same. Instead, to be useful to a clearing agency and its interested parties, the policies and procedures should necessarily reflect the unique relationships at that clearing agency between the scope of its operations and its governance and risk management needs.

9. Rule 17Ad-22(d)(9): Information on Services

a. Proposed Rule

Proposed Rule 17Ad-22(d)(9) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide market participants with sufficient information for them to identify and evaluate the risks and costs associated with using the clearing agency's services.

The Commission believes that requiring a clearing agency to disclose information sufficient for participants to identify risks and costs associated with using the clearing agency will allow participants to make informed decisions about the use of the clearing agency and take

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375 See supra notes 368–370.

376 See supra note 370 and accompanying text.

377 See supra note 369 and accompanying text.

appropriate actions to mitigate their risks and costs associated with the use of the clearing agency.

b. Comments Received

One commenter stated that it does not believe that the proposed rule is necessary because among other things a clearing agency's fees, collateral deposits, and operational requirements are already included in the clearing agency's rules and its published procedures and are already required to be sufficiently available to market participants and the public at large.[378]

Two commenters expressed that application of proposed Rule 17Ad-22(d)(9) to clearing agencies that do not handle securities or funds is unnecessary.[379]

c. Final Rule

We are adopting Rule 17Ad-22(d)(9) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies We believe that requiring a clearing agency to have policies and procedures that require a clearing agency to disclose sufficient information so that participants can identify risks and costs associated with using the clearing agency will allow participants to make informed decisions about the use of the clearing agency and take appropriate actions to mitigate their risks and costs associated with the use of the clearing agency. While the rule provides clearing agencies flexibility to determine how to adequately disclose information so participants can identify and evaluate risks and costs associated with participation, the Commission believes that disclosure of the clearing agency rulebook, the costs of its services, a description of netting and

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378 See The OCC Letter at 15.

379 See Omgeo Letter at 12; see also TriOptima Letter at 9 (noting that compression services and collateral management services operate on the basis of clear, standardized documentation and present few risks to users. If a compression cycle or collateral management service fails, the users' pre-existing transactions remain in effect and the risks can be disclosed in user documentation).

settlement activities it provides, participants' rights and obligations, information regarding its margin methodology, and information regarding the extreme but plausible scenarios that the clearing agency uses to stress test its margin requirements are among the categories of information that participants could use to identify and evaluate risks and costs associated with use of the clearing agency. The Commission also believes that it is reasonable to expect that the type of information and level of detail that market participants will consider to be sufficient will evolve over time and therefore clearing agencies should seek to establish regular channels of communication with market participants and processes for continuously improving their disclosure practices as the marketplace changes over time.

Because clearing agencies are SROs, their rules are published by Commission and are generally available on each clearing agency's website. Nevertheless, discrete rule proposals do not necessarily provide a complete picture of a clearing agency's operations and the risk mitigation procedures. Accordingly, the rule is intended to promote a better understanding among market participants of a clearing agency's operations. A better understanding should foster confidence in the clearing agency's ability to manage those risks and costs, including, but not limited to, any margin requirements, restrictions or limitations of the clearing agency's obligations, and conditions used by the clearing agency to test the adequacy of its financial resources.

We acknowledge that existing requirements address the need for clearing agencies to incorporate matters such as the clearing agency's fees, collateral deposits, and operational requirements in its rules and procedures, which are already made available to market participants and the public.[380] The Commission is also aware that under Rule 17Ad-22(d)(9), the nature of

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[380] See supra note 378.

the information that clearing agencies must provide, how frequently it must be provided, and who is entitled to receive it are all aspects of compliance with Rule 17Ad-22(d)(9) that implicate concerns by clearing agencies about protection of their proprietary information.[381] We believe that the nature and extent of information that is required to be provided under Rule 17Ad-22(d)(9) should be tailored to the needs of market participants based on the risks and costs to which they are exposed. Clearing agencies are expected to establish such tailored approaches in their policies and procedures designed to achieve compliance with Rule 17Ad-22(d)(9).

We agree with commenters who recommended that Rule 17Ad-22(d)(9) should only apply categorically to clearing agencies that take in or process securities or funds. Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities exempt from registration as a clearing agency except to the extent specifically contemplated by a future exemption.

10. Rule 17Ad-22(d)(10): Immobilization and Dematerialization of Securities Certificates

a. Proposed Rule

Proposed Rule 17Ad-22(d)(10) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to immobilize[382] or

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381 See id.

382 Immobilization refers to any circumstance where an investor does not receive a physical certificate upon the purchase of securities or is required to physically deliver a certificate upon the sale of securities.

dematerialize[383] securities certificates and transfer them by book entry to the greatest extent possible when the clearing agency provides CSD services.[384]

The Commission believes that the immobilization and dematerialization of securities and their transfer by book entry results in reduced costs and risks associated with securities settlements and custody by removing the need to hold and transfer many, if not most, physical certificates.[385] The Commission also believes that the proposed rule strengthens the requirement in Section 17A(b)(3)(F) of the Exchange Act for the rules of a clearing agency to assure the safeguarding of securities and funds that are in the custody or control of the clearing agency or for which it is responsible.[386]

b. Comments Received

One commenter expressed concern that proposed Rule 17Ad-22(d)(10) places responsibilities on clearing agencies that perform CSD services to immobilize or dematerialize securities that are beyond the clearing agency's control. Therefore, the commenter requested

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383 Dematerialization is the process of eliminating physical certificates as a record of security ownership.

384 See proposed Rule 17Ad-22(a)(2) for definition of "central securities depository services." DTC is currently the only registered clearing agency that provides central securities depository services.

385 By concentrating the location of physical securities in a single central securities depository, clearing agencies are able to centralize the operations associated with custody and transfer and reduce costs through economies of scale. Virtually all mutual fund securities, government securities, options, and municipal bonds in the United States are dematerialized and most of the equity and corporate bonds in the U.S. market are either immobilized or dematerialized. While the U.S. markets have made great strides in achieving immobilization and dematerialization for institutional and broker-to-broker transactions, many industry representatives believe that the small percentage of securities held in certificated form impose unnecessary risk and expense to the industry and to investors. See Exchange Act Release No. 8398 (Mar. 11, 2004), 69 FR 12921 (Mar. 18, 2004).

386 15 U.S.C. 78q-1(b)(3)(F).

that the rule be revised to reflect the need for cooperation from market participants and regulators.[387]

Another commenter stated its belief that the proposed Rule 17Ad-22(d)(10) should not apply to portfolio compression and collateral management services for security-based swaps.[388]

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(10) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. Rule 17Ad-22(d)(10) does not require a clearing agency to take any actions that are beyond the scope of its rules, procedures and operations. We agree that collaboration between regulators, market participants, and clearing agencies is necessary to achieve total immobilization or dematerialization of securities certificates; but this result is not required by Rule 17Ad-22(d)(10). The Commission also understands that some clearing agencies already have taken steps in furtherance of full dematerialization in the U.S. financial markets and that such efforts are ongoing.[389]

In response to comments about the application of the rule to portfolio compression and collateral management services, the Commission notes that Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities exempt from registration as a clearing

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387 See The DTCC (April) Letter at 23–24 (asking the Commission to reformulate Rule 17Ad-22(d)(10) as follows: "Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable, promote the immobilization or dematerialization of securities certificates and transfer them by book entry to the greatest extent possible when the clearing agency provides central securities depository services.").

388 See TriOptima Letter at 11.

389 See DTCC White Paper, Strengthening the U.S. Financial Markets: A Proposal to Fully Dematerialize Physical Securities, Eliminating the Costs and Risks They Incur (July 2012).

agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

11. Rule 17Ad-22(d)(11): Default Procedures

a. Proposed Rule

Proposed Rule 17Ad-22(d)(11) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to make key aspects of their default procedures publicly available and establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default.

The Commission believes that the rule would provide certainty and predictability to market participants about the measures a clearing agency will take in the event of a participant default because default procedures, among other things, are meant to reduce the likelihood that a default by a participant, or multiple participants, will disrupt the clearing agency's operations. By creating a framework of default procedures that are designed to permit a clearing agency to take actions to contain losses and liquidity pressures it faces while continuing to meet its obligations, the clearing agency should be in a better position to continue providing its services in a manner that promotes accurate clearance and settlement during times of market stress.

The Commission also believes that the requirements in Rule 17Ad-22(d)(11) would increase the possibility that defaults by participants, should they occur, would proceed in an orderly and transparent manner. In particular, the rule would help to ensure that all participants are aware of the default process and are able to plan accordingly and that clearing agencies would have sufficient time to take corrective actions to mitigate potential losses.

b. Comments Received

One commenter urged the Commission to place additional requirements on clearing agencies to conduct and document a test of their default management plans.[390] The commenter stated its belief that default management tests should be undertaken at least on a semi-annual basis.[391]

One commenter responded to a question asked by the Commission in the Proposing Release about how much flexibility clearing agencies should have in the amount of time they are permitted to manage a default and perform a liquidation of positions. The commenter recommended that in the context of security-based swaps the time permitted should be the time necessary for the clearing agency to actually liquidate a security-based swap portfolio rather than establishing a predetermined period by rule.[392] The commenter noted that the time necessary depends on facts and circumstances and is likely to be tied to the characteristics of the security-based swaps involved and the particular markets it in which they trade--as well as the liquidation times derived from the default management plan and practice testing by the clearing agency.[393] The commenter stated that the Commission should have a view of and sign-off authority over the clearing agency's default management plan.[394] The commenter also noted that clearing agencies should continually monitor the risk associated with concentration in participants' positions, and if that concentration could not be liquidated within the time required by the default

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390 See ISDA Letter at 5.

391 See id.

392 See ISDA Letter at 6.

393 See id.

394 See id.

management plan, the clearing agency should have discretion to include extra charges in initial margin to reflect that risk.[395]

Two commenters argued that proposed Rule 17Ad-22(d)(11) should not apply to entities that perform post-trade processing services such as comparison of data,[396] collateral management and portfolio compression.[397]

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(11) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. The Commission believes that the requirements in Rule 17Ad-22(d)(11) increase the possibility that defaults by participants, should they occur, will proceed in an orderly and transparent manner because Rule 17Ad-22(d)(11) helps to ensure that all participants are able to plan for the default process and that clearing agencies will have sufficient time to take corrective action to mitigate potential losses.

As an initial matter, we believe that how frequently a clearing agency conducts default management tests should be determined by each individual clearing agency, in consultation with, and subject to oversight by, the Commission.[398] We agree that it is important for clearing agencies to conduct default management tests, but clearing agencies overseen by the Commission already largely perform these types of exercises as part of their compliance with the requirements of Section 17A of the Exchange Act. Unless additional circumstances clarify that a prescriptive course of action by the Commission is appropriate to bring more standardized scope

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395 See id.

396 See Omgeo Letter at 13.

397 See TriOptima Letter at 10.

398 See supra notes 390–391 and accompanying text.

and frequency to these exercises, we believe that it is appropriate, subject to Commission oversight, to continue to allow clearing agencies discretion to design and perform default management tests that are suited to their particular clearance and settlement activities.

With respect to the commenter who advised the Commission not to establish a particular period in Rule 17Ad-22(d)(11) during which a clearing agency would be required to manage and complete a default liquidation process for security-based swaps, we are not adopting specifically bounded timing requirements in Rule 17Ad-22(d)(11) for a clearing agency to achieve compliance with the rule. Instead, our current belief is that the more general approach we are adopting in Rule 17Ad-22(d)(11) allows clearing agencies to establish, implement, maintain and enforce policies and procedures that comply with Rule 17Ad-22(d)(11) and take into account the particular characteristics of the financial instruments and market dynamics involved in a default at a particular clearing agency. We believe this is the best approach to allow clearing agencies to contain losses and the liquidity pressures that they face while continuing to meet their obligations

We also agree with commenters who suggested that it is appropriate for clearing agencies to consider concentration risk in margin practices and that if certain concentrations indicate that liquidation of the concentrated positions could not be performed within the parameters of the clearing agency's default management plan, then the clearing agency should consider extra initial margin charges to account for that occurrence.[399] We believe that these issues are appropriately addressed by individual clearing agencies through the submission of proposed rule changes to the Commission for review and public comment.

With regard to suggestions that Rule 17Ad-22(d)(11) categorically should not apply to entities that perform certain post-trade services (i.e., comparison of trade data, collateral

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[399] See supra note 395 and accompanying text.

management and compression/tear-up services),[400] we note that Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities exempt from registration as a clearing agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

12. Rule 17Ad-22(d)(12): Timing of Settlement Finality

a. Proposed Rule

Proposed Rule 17Ad-22(d)(12) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to ensure that final settlement occurs no later than the end of the settlement day and that intraday or real-time finality is provided where necessary to reduce risks. The Commission believes that settlement finality should occur not later than the end of the settlement day because it will help to limit the volume of outstanding obligations that are subject to settlement at any one time and thereby reduce the settlement risk exposure of participants and the clearing agency.

b. Comments Received

One commenter that operates several clearing agencies expressed concern that the second clause of proposed Rule 17Ad-22(d)(12), which reads "and require that intraday or real-time finality be provided where necessary to reduce risks" could be interpreted to require intraday or real-time settlement finality beyond what its clearing agencies currently provide and are capable of providing without significant systems and process changes.[401] The commenter asked the Commission to clarify that the rule is not intended to impose an obligation on the clearing agencies it operates to provide intraday or real-time finality beyond their current practices or any obligation to build additional capability unless and until there is industry and

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400 See supra notes 396–397 and accompanying text.

401 See The DTCC (April) Letter at 25.

regulatory consensus on whether and what additional capability to build and how to allocate the cost.[402]

One commenter expressed general support for proposed Rule 17Ad-22(d)(12) but requested that the Commission provide clarification regarding how the rule is compatible with correction of errors and also clarify that "title transfer" of initial margin may not occur when it is posted to a clearing agency.[403] Another commenter stated that although it generally supports the proposed requirement to ensure that final settlement occurs no later than the end of the settlement day, it also believes that this requirement must be interpreted reasonably.[404] The commenter asked the Commission to expressly state in the adopting release that circumstances may arise that make same-date settlement impossible, such as natural disasters, terrorist acts, and major communications breakdowns.[405] The commenter added that it currently has the ability to make margin calls on an intraday basis as necessary and its agreements with settlement banks expressly provide when payments in satisfaction of such calls become irrevocable.[406] The commenter asked the Commission to specifically state whether this structure satisfies the requirements of proposed Rule 17Ad-22(d)(12).[407]

One commenter expressed concern that proposed Rule 17Ad-22(d)(12) fails to provide clear standards for real-time trade processing and therefore does not provide a workable framework for trade processing and clearing of security-based swaps.[408] To address its concern,

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402 See id.

403 See ISDA Letter at 7.

404 See The OCC Letter at 15.

405 See id.

406 See id.

407 See id.

408 See SDMA Letter at 6.

the commenter requested that the Commission adopt rules equivalent to CFTC Rules 37.6(b) and 39.12(B)(7) to require swaps to be immediately confirmed and accepted for clearing upon execution.[409]

Two commenters argued that proposed Rule 17Ad-22(d)(11) should not apply to entities that perform post-trade processing services such as comparison of data,[410] collateral management and portfolio compression,[411] because those services do not involve settlement of transactions.

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(12) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. Rule 17Ad-22(d)(12) does not require a clearing agency that has policies and procedures in place to facilitate final settlement by the end of the settlement day to alter its rules and procedures. As stated in the Proposing Release, "intraday or real-time finality may be necessary to reduce risk in circumstances where the lack of intraday or real-time finality may impede the clearing agency's ability to facilitate prompt and accurate clearance and settlement, cause the clearing agency's participants to fail to meet their obligations, or cause significant disruptions in the securities markets."[412] The Commission agrees with the commenter that a decision to revise the settlement process to implement intraday settlement

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409 See id.

410 See Omgeo Letter at 13.

411 See TriOptima Letter at 10.

412 See Proposing Release, supra note 35, at 14490.

should involve consultation with all stakeholders.[413] The Commission is not proposing a rule at this time, but plans to study the issue further. Furthermore, the need to correct errors would not be a violation of Rule 17Ad-22(d)(12). We agree that Rule 17Ad-22(d)(12) must be reasonably construed to provide that in extreme circumstances same-date settlement may be impossible to achieve (i.e., due to natural disasters, terrorist acts, and major communications breakdowns).[414] The Commission however notes that the duty of a clearing agency to address these situations is governed by Rule 17Ad-22(d) (4), which requires a clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify sources of operational risk and minimize these risks through the development of appropriate systems, controls, and procedures; implement systems that are reliable, resilient and secure and have adequate scalable capacity; and have business continuity plans that allow for timely recovery of operations and ensure the fulfillment of a clearing agency's obligations.

We agree with commenters that the timing of the effective transfer of initial margin is an important consideration related to achieving settlement finality in an event of default.[415] In general, the validity of the clearing agency's liens and interest in collateral, including initial margin posted by participants, likely could be ascertained by referring to the clearing agency membership agreements, its rules and procedures and Articles 8 and 9 of the Uniform Commercial Code.

With respect to the commenter who said that that the rules in 17Ad-22(d)(12): "fail to provide clear standards for real time trade processing," the Commission does not intend for the

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413 We note that one clearing agency has made efforts to create a dialogue with the industry on the issue of shortening the settlement cycle. See DTCC White Paper, Proposal to Launch a New Cost-Benefit Analysis on Shortening the Settlement Cycle (Dec. 2011).

414 See supra note 404 and accompanying text.

415 See supra note 403 and accompanying text.

rule to provide standards for security-based swaps that are centrally cleared to be confirmed, accepted for clearing and guaranteed by a clearing agency at the point of trade execution.[416] Instead, Rule 17Ad-22(d)(12) focuses on achieving settlement on the particular settlement date associated with the securities transaction or on an intraday or real-time basis (i.e., delivery versus payment) where those additional steps are necessary to reduce risks. The Commission continues to consider the appropriateness of proposing more specific rules that would require transactions to be immediately confirmed and accepted for clearing upon execution.

We agree with commenters that Rule 17Ad-22(d)(12) should not apply if a clearing agency's services do not involve the handling of securities or funds to facilitate settlement of obligations. As discussed above, Rule 17Ad-22 applies only to registered clearing agencies and does not apply to entities exempt from registration as a clearing agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

13. Rule 17Ad-22(d)(13): Delivery versus Payment

a. Proposed Rule

Proposed Rule 17Ad-22(d)(13) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to eliminate principal risk by linking securities transfers to funds transfers to achieve delivery versus payment ("DVP").

DVP eliminates the risk that a party would lose some or its entire principal because payment is made only if securities are delivered. The Commission believes that clearing agencies should be required to use this payment method to reduce the potential that delivery of

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416 See supra notes 408–409 and accompanying text.

the security is not appropriately matched with payment for a security, thereby impeding the clearing agency's ability to facilitate prompt and accurate clearance and settlement.

b. Comments Received

One commenter pointed out that the Commission previously approved an SRO rule change which eliminated the commenter's right to reject matched trades that are reported to it by an exchange even if the purchasing clearing member eventually fails to pay the purchase price of the option.[417] This approach was adopted because of a preference by the clearing agency and its participants to mutualize the risk of such defaults rather than bear the risk that a completed trade would be rejected on the following day because of the default of the counterparty.[418] The commenter asked the Commission to confirm that it would not consider this policy to violate Rule 17Ad-22(d)(13).[419]

Two commenters argued that proposed Rule 17Ad-22(d)(13) should not apply to entities that perform post-trade processing services such as comparison of data,[420] collateral management and tear-up/compression,[421] because those services do not involve settlement of transactions.

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(13) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. As described in the Proposing Release, DVP is achieved in the settlement process when the mechanisms facilitating settlement ensure that delivery occurs if and

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417 See The OCC Letter at 15.

418 See id.

419 See id.

420 See Omgeo Letter at 13.

421 See TriOptima Letter at 10.

only if payment occurs.[422] The Commission believes that clearing agencies should be required to link securities transfers to funds transfers in a way that achieves DVP to reduce the potential that delivery of the security is not appropriately matched with payment for a security, thereby impeding the clearing agency's ability to facilitate prompt and accurate clearance and settlement.

The elimination by a clearing agency of its right to reject matched trades and subsequently relying on mutualization of resources to make settlement if necessary does not violate Rule 17Ad-22(d)(13), as mutualization of risk by participants is an acceptable means of eliminating principal risk that would otherwise exist for a clearing agency. The rule requires a clearing agency to establish policies and procedures to link the transfer of securities and funds in a manner that mitigates principal risk in the event of a participant default. The rule does not govern when a clearing agency guarantees a transaction or the clearing agency's loss allocation procedures in the event of a default.

We agree with commenters who suggested that Rule 17Ad-22(d)(13) is not applicable to clearing agencies that do not handle securities or funds to perform settlement. As discussed above, Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities exempt from registration as a clearing agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

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422 See Bank for International Settlements, Delivery Versus Payment in Securities Settlement Systems (1992), available at http://www.bis.org/publ/cpss06.pdf. Three different DVP models can be differentiated according to whether the securities and/or funds transfers are settled on a gross (trade-by-trade) basis or on a net basis.

14. Rule 17Ad-22(d)(14): Risk Controls to Address Participants' Failure to Settle

a. Proposed Rule

Proposed Rule 17Ad-22(d)(14) requires clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant exposure fully, that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle when the clearing agency provides CSD services[423] and extends intraday credit to participants.

The Commission believes it is important for clearing agencies that provide CSD services to institute risk controls, including collateral requirements and limits, to cover the clearing agency's credit exposure to each participant exposure fully, that ensure timely settlement in these circumstances to address the risk that the participant may fail to settle after credit has been extended. The Commission also believes that requiring the controls to be designed to withstand the inability of the participant with the largest payment obligation to settle, in such circumstances, would reduce the likelihood of disruptions at the clearing agency by having controls in place to account for the largest possible loss from any individual participant and thereby help the clearing agency to provide prompt and accurate clearance and settlement during times of market stress.

b. Comments Received

One commenter asked the Commission to revise Rule 17Ad-22(d)(14) to expressly state that the rule applies to a clearing agency that provides CSD services and extends intraday credit

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423 See proposed Rule 17Ad-22(a)(2) for definition of "central securities depository services."

through the operation of a net settlement system.[424] The commenter emphasized that it is important to acknowledge a distinction in the rule between central securities depositories that operate gross settlement systems and those that operate net settlement systems because gross settlement systems amount to a direct intraday extension of credit while a net settlement system places the clearing agency in the position of being a legal agent that extends intraday credits on behalf of other participants that are then settled only at one or more discrete, prescribed times during the process day.[425]

Responding to a question posed by the Commission in the Proposing Release, the same commenter stated its belief that clearing agencies that provide CSD services should not be required to maintain enough financial resources to be able to withstand a settlement failure by the two participant families with the largest settlement obligations to the clearing agency that performs central depository services.[426] The commenter argued that no empirical or historical case has been made to support such a change in how clearing agencies that perform CSD services currently operate their risk management controls.[427]

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424 See The DTCC (April) Letter at 25–26 (noting that the standard in RSSS 9, on which Rule 17Ad-22(d)(14) is modeled, specifically identifies central securities depositories that operate net settlement systems).

425 See The DTCC (April) Letter at 26 (suggesting the following language to revise the proposed rule: "each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable, institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant family fully, that ensure timely settlement in the event that the participant family with the largest payment obligation is unable to settle when the clearing agency provides central securities depository services and operates a net settlement system or extends intraday credit to participants").

426 See The DTCC (April) Letter at 26–27.

427 See id.

One commenter stated that the requirements of proposed Rule 17Ad-22(d)(14) should not apply to portfolio compression or collateral management service providers for security-based swaps.[428]

c. Final Rule

We are adopting Rule 17Ad-22(d)(14) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. The Commission believes it is important for clearing agencies that provide CSD services to institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant exposure fully, that ensure timely settlement in these circumstances to address the risk that the participant may fail to settle after credit has been extended. The Commission also believes that requiring the controls that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle, in such circumstances, reduces the likelihood of disruptions at the clearing agency.

The Commission considered the concerns of commenters who asked the Commission to abstain from any action that would modify Rule 17Ad-22(d)(14) to require a clearing agency that performs CSD services and extends intraday credit to participants to maintain enough financial resources to be able to withstand a settlement failure by the two participant families with the largest settlement obligations to the clearing agency.[429] Rule 17Ad-22(d)(14) does not apply to clearing agencies that provide CCP services.

We understand the request for clarification from some commenters who asked the Commission to revise Rule 17Ad-22(d)(14) to apply solely to a clearing agency that performs

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428 See TriOptima Letter at 10.

429 See supra notes 426-427 and accompanying text.

CSD services and extends intraday credit to participants through a net settlement system.[430] We agree that the requirements of Rule 17Ad-22(d)(14) apply in full in the context of the operation of a net settlement system. Nevertheless, a clearing agency providing CSD services may choose to organize its operations so that it settles transactions on a trade-for-trade or gross basis and may extend credit in the form of intraday loans or repurchase agreements to facilitate settlement. Accordingly, we are not changing the text of Rule 17Ad-22(d)(14), as suggested, in order to continue to address that situation if it occurs.

We agree with commenters who argued that Rule 17Ad-22(d)(14) does not apply to clearing agencies that do not perform CSD services and do not extend intraday credit to participants.[431] As discussed above, Rule 17Ad-22 only applies to entities that perform CCP or CSD services and does not apply to entities exempt from registration as a clearing agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

15. Rule 17Ad-22(d)(15): Physical Delivery Risks

a. Proposed Rule

Proposed Rule 17Ad-22(d)(15) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to disclose to their participants the clearing agency's obligations with respect to physical deliveries.[432]

The Commission believes that such policies and procedures will help to ensure that participants have information that is likely to enhance the participants' understanding of their

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430 See supra notes 424–425 and accompanying text.

431 See supra note 428 and accompanying text.

432 The proposed rule would provide clearing agencies with the flexibility to determine the method by which the clearing agency will state this information to its participants. However, the clearing agencies should take care to develop an approach that provides sufficient notice to its participants regarding the clearing agency's obligations.

rights and responsibilities with respect to using the clearance and settlement services of the clearing agency. The Commission also believes that providing such information to participants would promote a shared understanding regarding physical delivery practices between the clearing agency and its participants that could help reduce the potential for fails and thereby facilitate prompt and accurate clearance and settlement.

The rule also would require clearing agencies to reasonably design their operations to identify and manage the risks that arise in connection with their obligations for physical deliveries. The risks associated with physical deliveries could stem from, among other factors, operational limitations with respect to assuring receipt of physical deliveries and processing of physical deliveries. The Commission believes that requiring clearing agencies to identify and manage these risks would reduce the potential that issues will arise as a result of physical deliveries because the clearing agency will have acted preemptively to deal with potential issues that may disrupt the clearance and settlement process. Accordingly, the Commission believes this requirement would help a clearing agency to facilitate prompt and accurate clearance and settlement consistent with Section 17A of the Exchange Act.[433]

b. Comments Received

One commenter stated that the requirements of proposed Rule 17Ad-22(d)(15) should not apply to portfolio compression or collateral management service providers for security-based swaps.[434]

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(15) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to

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[433] 15 U.S.C. 78q-1(b)(3)(F).

[434] See TriOptima Letter at 11.

registered clearing agencies. The Commission believes that Rule 17Ad-22(d)(15) helps ensure that participants will have information that enhances their understanding of their rights and responsibilities with respect to using the physical delivery services of a clearing agency which will help reduce the potential for fails. Accordingly, the Commission believes this requirement should help facilitate prompt and accurate clearance and settlement consistent with Section 17A of the Exchange Act.[435]

As discussed above, Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities exempt from registration as a clearing agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

IV. Paperwork Reduction Act

A. Overview and Burden Estimate Comparison to Proposing Release

Certain provisions of the final rules contain new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[436] In accordance with 44 U.S.C. 3507 and 5 CFR 1320.11, the Commission has submitted the information to the Office of Management and Budget ("OMB") for review. The title of the new collection of information is "Clearing Agency Standards." An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The control number for Rule 17Ad-22 is OMB Control No. 3235-0695.

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[435] 15 U.S.C. 78q-1(b)(3)(F).

[436] 44 U.S.C. 3501 et seq.

1. Changes in Estimates

As an initial matter, we note that the PRA burden estimates in this adopting release are significantly lower than the PRA burden estimates in the Proposing Release.[437] Several reasons account for the change. The Proposing Release contained five proposed rules with PRA collection of information requirements in addition to Rule 17Ad-22 – proposed Rules 17Aj-1, 17Ad-23, 17Ad-25, 17Ad-26 and 3Cj-1. As described above, these other proposed rules are not being adopted at this time.

Additionally, the Proposing Release estimated that the proposed rules would have applied to seventeen entities. A number of these entities -- in particular those providing post-trade processing services for security-based swap transactions -- would have been completely unfamiliar with the Commission's registration process for clearing agencies. Further, these entities typically do not have written rule books to govern their relationship with their users. As a result, they would have experienced significant initial burdens associated with the proposed rules.

In contrast, the final rules being adopted today apply only to the seven clearing agencies currently registered with the Commission that provide CCP or CSD services, as discussed above in Section II.B.4.[438] These registered clearing agencies already have written rules, policies and

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437 See Proposing Release, supra note 35, at 14521 ("The Commission preliminarily believes that for all respondent clearing agencies the aggregate paperwork burdens contained in proposed Rules 17Ad-22(d)(1), (2), (3), (4), (5), (6), (7), (8), (9), (10), (11), (12), (13), (14), (15), (b)(1), (2), (3), (4), (5), (6), (7), (c)(1) and (2) would impose a one-time burden of 83,343 hours and an ongoing annual burden of 39,658 hours."). In the adopting release, the Commission estimates the total initial burden for Rule 17Ad-22 to be 11,880 hours, with the total ongoing annual burden for Rule 17Ad-22 to be 4,888 hours. See infra Section IV.C.7.

438 The Commission also notes that the Boston Stock Exchange Clearing Corporation ("BSECC") and Stock Clearing Corporation of Philadelphia ("SCCP") are currently registered with the Commission as clearing agencies but conduct no clearance or

procedures addressing significant aspects of Rule 17Ad-22. For purposes of the PRA analysis, the Commission also estimates that three entities may potentially register with the Commission as clearing agencies acting as CCPs, bringing the total number of respondents to ten – nine of which are CCPs and one of which is a CSD.[439] The Commission believes that some of the entities seeking to register with the Commission as clearing agencies may already be providing similar services in other jurisdictions and therefore may already have written rules and procedures similar to those contemplated by Rule 17Ad-22. Accordingly, the Commission believes that the potential PRA burden on this smaller and more established group of respondents will be significantly lower than the estimates provided in the Proposing Release. Further, the Proposing Release treated each subsection of the rule -- and therefore each required policy and procedure -- as a separate PRA burden. However, the Commission believes that registered clearing agencies are more likely to be able to address the changes required by Rule 17Ad-22 in an integrated, not piecemeal, review and drafting process. That is, respondents are likely to group aspects of Rule 17Ad-22 together as they implement policies and procedures responsive to Rule 17Ad-22. Therefore, the revised PRA burden estimates no longer account for each requirement as a separate burden.

Finally, the Commission has revised the PRA burden estimates in recognition that many parts of Rule 17Ad-22 – specifically Rules 17Ad-22(b)(1)–(3) and Rules 17Ad-22(d)(1)–(15) -- reflect usual and customary practices of registered clearing agencies. Since registered clearing agencies already comply with significant aspects of Rule 17Ad-22 in the normal course of their

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settlement operations. See Securities Exchange Act Release Nos. 63629 (Jan. 3, 2011), 76 FR 1473 (Jan. 10, 2011), and 63268 (Nov. 8, 2010), 75 FR 69730 (Nov. 15, 2010), respectively.

439 The burden estimates include the possibility that either BSECC or SCCP, or both, resume operations in the future.

activities, many aspects of Rule 17Ad-22 impose minimal PRA burdens on registered clearing agencies limited to the review of the rule and their existing policies and procedures. As discussed below, because certain rules would involve adjustments to a registered clearing agency's rule book and its policies and procedures rather than the creation of entirely separate policies and procedures to support entirely new operations and practices, the Commission recognizes that some aspects of Rule 17Ad-22 will impose incremental new PRA burdens on registered clearing agencies.

Accordingly, the estimated PRA burdens discussed below reflect these updated assessments of the likely PRA burdens.

2. Organization of PRA Review

The discussion of the PRA burdens and costs associated with Rule 17Ad-22 is organized in the following manner:

1. Rules 17Ad-22(b)(1)–(3) and Rules 17Ad-22(d)(1)–(15)
2. Rule 17Ad-22(b)(4)
3. Rules 17Ad-22(b)(5)–(7)
4. Rule 17Ad-22(c)
5. Rule 17Ad-22(c)(1)
6. Rule 17Ad-22(c)(2)

Rules 17Ad-22(b)(1)–(3) and Rules 17Ad-22(d)(1)–(15) are discussed together because these rules represent usual and customary practices already being implemented by registered clearing agencies. Because Rules 17Ad-22(b)(4), (b)(5)–(7) and (c), respectively establish new minimum practices for registered clearing agencies with regard to model validation, membership practices and certain financial information, the adopting release discusses these rules separately. The burden discussion for Rules 17Ad-22(c)(1) and (2) has been split into sections to account for

the different information collection requirements for varying numbers of respondents.

B. Summary of Collection of Information, Use of Information and Comments Received

As noted earlier, the Commission received 25 comment letters concerning the proposed rules.[440] While the Commission received general comments in support of its approach that is both consistent with current global standards[441] and principles-based[442], thereby making compliance less burdensome for registered clearing agencies, a few commenters discussed the paperwork and compliance burden concerns for some of the rules associated with this adopting release. Some commenters expressed general concerns about the burden of regulation, but such comments focused on rules in the Proposing Release not being adopted today and on areas that go beyond the scope of the adopting release.[443] Commenters expressed concerns about the

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440 See supra note 37.

441 See The DTCC (April) Letter at 4 (stating that "[t]he application of global standards to clearing agencies will also prevent clearing agencies and their participants from incurring unnecessary expense associated with complying with different, and potentially conflicting regulatory standards."); see also The OCC Letter at 3 (encouraging the Commission "to avoid taking final action on the Proposed Rules prior to receiving greater clarity on what clearinghouse regulations are ultimately adopted by European and U.K. legislators and regulators and what approaches to regulation are ultimately embraced by CPSS/IOSCO. Many potential market participants will be able to choose the jurisdiction in which they conduct their clearing activity, and imposing more prescriptive and costly regulatory burdens on U.S. clearing agencies will have a predictably adverse competitive impact on those clearing agencies.").

442 See The DTCC (April) Letter at 6 (stating that "[i]f the Proposed Rules are overly prescriptive, organizations such as DTCC may be subject to conflicting requirements and may be forced to fragment certain enterprise-wide programs in order to comply with such conflicting requirements, which could substantially increase costs and compliance risks within such organizations."); The OCC Letter at 2 (stating that it "support[s] the Commission's approach. . . ."); CME Letter at 3 (stating that "CME Group favors a principles-based approach in these areas, and we urge the Commission not to adopt hard and fast standards that will be costly to implement and maintain and that yield little or no apparent corresponding regulatory benefits.").

443 See, e.g., ICE Letter at 1-2 (stating that "[p]ost-trade processing service providers would be unable to distribute end-of-day settlement prices, as required by the Proposal, and the

burdens associated with parts of Rule 17Ad-22(b), and those comments are addressed below. Commenters did not specifically comment on the burdens associated with Rule 17Ad-22(c)–(d).

1. Rules 17Ad-22(b)(1)–(3) and Rules 17Ad-22(d)(1)–(15)

The rules in the adopting release contain requirements subject to the PRA. Rules 17Ad-22(b)(1)–(3) and (d)(1)–(15) contain "collection of information requirements" within the meaning of the PRA. These rules would require a registered clearing agency to have policies and procedures to adequately document all material aspects of its liquidity risk management processes and its compliance with their requirements. The information collected by virtue of written policies and procedures requirements contained in Rules 17Ad-22(b)(1)–(3) and Rules 17Ad-22(d)(1)–(15) generally codify usual and customary practices at CCPs and registered clearing agencies, and thus the PRA burden would be expected to be minimal. Rules 17Ad-22(b)(1)–(3) require written policies and procedures that address risk management practices by CCPs. Specifically, the rules would create standards with respect to: (1) measurement and management of credit exposures; (2) margin requirements; and (3) financial resources. The Commission did not receive comments on the burdens associated with Rule 17Ad-22(b)(1)–(3).

Rule 17Ad-22(d) sets forth certain minimum standards regarding the operations of registered clearing agencies. The standards established in 17Ad-22(d) address areas including: (1) transparent and enforceable rules and procedures; (2) participation requirements; (3) custody of assets and investment risk; (4) operational risk; (5) money settlement risk; (6) cost-effectiveness; (7) links; (8) governance; (9) information on services; (10) immobilization and dematerialization of securities certificates; (11) default procedures; (12) timing of settlement

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record keeping requirements of the Proposal would prove so burdensome to such providers that the efficiency and alacrity that they provide to the CDS industry would be adversely affected.").

finality; (13) delivery versus payment; (14) risk controls to address participants' failures to settle; and (15) physical delivery risks. Commenters did not comment on the burdens associated with Rule 17Ad-22(d).

2. Rule 17Ad-22(b)(4)

Rule 17Ad-22(b)(4) contains "collection of information requirements" within the meaning of the PRA. Rule 17Ad-22(b)(4) will require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for an annual model validation consisting of evaluating the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who is free from influence so that he can be candid in his assessment of the model.

One commenter stated that "a regulatory requirement of model validation on an annual basis is unnecessary (and may be overly burdensome) . . . . [and] can be achieved in a less directive manner."[444] The commenter did not provide an estimate of the proposed burdens. The commenter suggested that model validation should be conducted on a "periodic" basis by a qualified person who "is sufficiently free from outside influences to perform a candid evaluation."[445] The commenter did not explain how the suggested alternative requirements would achieve the purposes of the rule with a lesser burden.

The Commission is not persuaded by the position that the frequency of the model validation should be left to the discretion of the CCP.[446] The rule requiring that CCPs have policies and procedures in place for model validation at least annually is appropriate because model performance is not ordinarily expected to vary significantly over short periods but should

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444 See The DTCC (April) Letter at 13.

445 See The DTCC (April) Letter at 15.

446 See id.

be reevaluated as market conditions change. Overall, the Commission believes the collection of information related to Rule 17Ad-22(b)(4) is necessary to achieve its purpose, particularly in light of the Congressional mandate under the Dodd-Frank Act.

3. Rules 17Ad-22(b)(5)–(7)

Rules 17Ad-22(b)(5)–(7) contain "collection of information requirements" within the meaning of the PRA. The information collection under the written policies and procedures requirements contained in Rules 17Ad-22(b)(5)–(7) would establish requirements regarding access to CCPs.

One commenter expressed that proposed Rules 17Ad-22(b)(5)–(7) providing for mandatory access to CCPs in certain circumstances goes "beyond anything in current or proposed global standards. . . . [and is, therefore,] unnecessary and counterproductive to the goal of fair and open access within a framework of safe and sound operation."[447] But the commenter did not provide an estimate of these burdens. Nor did the commenter suggest alternative requirements that would achieve the purposes of the rule with a lesser burden.

While the Commission understands the concerns raised, the Commission ultimately believes that the benefits of Rules 17Ad-22(b)(5)–(7) are critical to maintaining fairness and open access to central clearing for all market participants, including security-based swaps participants.[448] In this regard, the Commission believes the collection of information related to

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447 See The DTCC (April) Letter at 5; see also The DTCC (April) Letter at 4 (stating that "[t]he application of global standards to clearing agencies will also prevent clearing agencies and their participants from incurring unnecessary expense associated with complying with different, and potentially conflicting regulatory standards.").

448 See supra Section III.D.1.

the rule is necessary to achieve its purpose, particularly in light of the Congressional mandate under the Dodd-Frank Act.

4. Rules 17Ad-22(c)(1)—(2)

Rule 17Ad-22(c)(1)—(2) contains "collection of information requirements" within the meaning of the PRA. The information collection under the written policies and procedures requirements contained in Rule 17Ad-22(c) establishes a recordkeeping requirement for CCPs regarding their responsibilities under Rule 17Ad-22(b)(3) and for registered clearing agencies with respect to posting on their respective websites annual audited financial statements.

Commenters did not specifically comment on the burdens associated with Rule 17Ad-22(c)(1)—(2).

C. Total Initial and Annual Reporting and Recordkeeping Burdens

1. Standards in Rules 17Ad-22(b)(1)–(3) and Rules 17Ad-22(d)(1)–(15) that Impose a PRA Burden

The requirements to develop written policies and procedures in Rules 17Ad-22(b)(1)–(3) and Rules 17Ad-22(d)(1)–(15) impose a PRA burden. The requirements in Rules 17Ad-22(b)(1)–(3) will apply to CCPs that are registered clearing agencies. The Commission estimates that a total of nine CCPs[449] will be subject to the burdens under Rules 17Ad-22(b)(1)–(3). Currently, six clearing agencies are registered to provide CCP services, and the Commission estimates that three more entities could register as clearing agencies to provide CCP services. The requirements in Rules 17Ad-22(d)(1)–(15) (with the exception of Rules 17Ad-22(d)(10) and (13)–(15), which are applicable only to CSDs), on the other hand, apply to all registered clearing

[449] The Commission believes that there is a potential for new security-based swap clearing agencies to form but does not expect there to be a large number based on the significant level of capital and other financial resources needed for the formation of a clearing agency.

agencies, of which there could potentially be a total of ten entities, including the one registered clearing agency that is a CSD.

As noted above, registered clearing agencies already have written policies and procedures that meet the standards set forth in Rules 17Ad-22(b)(1)–(3) and (d)(1)–(15) as part of their usual and customary business practice. Accordingly, the Commission believes that the registered clearing agencies would not need to build new infrastructure or modify operations to continue to meet Rule 17Ad-22(b)(1)–(3) and (d)(1)–(15). The Commission believes that registered clearing agencies will incur the incremental burdens of reviewing existing policies and procedures for compliance and updating existing policies and procedures where appropriate. The requirements would impose an aggregate one-time burden of approximately 1,750 hours for all registered clearing agencies.[450] The standards contained in Rule 17Ad-22(d) would also impose ongoing burdens on registered clearing agencies. For example, Rules 17Ad-22(b)(1)–(3) and (d)(1)–(15) would require registered clearing agencies to perform certain ongoing monitoring and enforcement activities with respect to the written policies and procedures the registered clearing agency creates in response to the standard. Accordingly, the Commission believes that those ongoing activities would impose an aggregate annual burden of approximately 600 hours for all respondent clearing agencies.[451] Because recent assessments of the registered U.S. clearing

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450 This figure was calculated as follows: ((Assistant General Counsel at 60 hours) + (Compliance Attorney at 85 hours) + (Computer Operations Manager at 15 hours) + (Senior Business Analyst at 15 hours)) = 175 hours x 10 respondent clearing agencies = 1,750 hours.

451 This figure was calculated as follows: Compliance Attorney at 60 hours x 10 respondent clearing agencies = 600 hours.

For each respondent clearing agency, the estimated annualized burden for Rules 17Ad-22(b)(1)—(3) and (d)(1)—(15) is 98 hours (figure calculated as follows: 175 hours (Year 1 burden) + 60 hours (Year 2 burden) + 60 hours (Year 3 burden) = 295 hours (estimated total burden over 3 years) ÷ 3 years = 98 hours).

agencies support the conclusion that clearing agencies and their rule books generally meet or exceed analogous standards of operation and governance to those standards within Rules 17Ad-22(b)(1)–(3) and (d)(1)–(15),[452] the Commission believes that the burden estimate for the aggregate one-time burden should be revised down from the burden estimated in the Proposing Release. The Commission estimates that because these initial compliance efforts will largely comprise a review of existing policies and procedures, the aggregate one-time burden on respondent clearing agencies will be incremental to their current compliance processes. The expected review of current policies and procedures will likely not involve much involvement by the information technology staff at the clearing agency or much involvement by the clearing agency's assistant general counsel because the requirements of these rules have already been written into and have been implemented as part of the policies and procedures of registered clearing agencies. Accordingly, those burden estimates have been reduced and the burden estimate for the compliance attorney, who will most likely perform most of the review of current policies and procedures, has been increased. In order to estimate the one-time burden and annual burden for ongoing activities, we looked to the burdens imposed by similar policies and procedures requirements in Regulation NMS as a guide and adapted those figures for the purposes of this release.[453]

2. Standards in Rule 17Ad-22(b)(4) that Impose a PRA Burden

The requirement to develop written policies and procedures in Rule 17Ad-22(b)(4) imposes a PRA burden. The requirement in Rule 17Ad-22(b)(4) will apply to all CCPs. As

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452 See Proposing Release, supra note 35, at 14509.

453 See Exchange Act Release Nos. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (discussing in Section VIII.A.4 the time needed from legal, compliance, information technology and business operations personnel to create policies and procedures for preventing and monitoring trade-throughs).

discussed above, the Commission estimates that nine CCPs will be subject to the burdens under Rule 17Ad-22(b)(4).

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS, the Commission has preserved the burden estimates from the Proposing Release. The Commission estimates that Rule 17Ad-22(b)(4) would impose a one-time burden on each respondent CCP of 210 hours, corresponding to an aggregate one-time burden on all respondent CCPs of 1,890 hours.[454]

Rule 17Ad-22(b)(4) would require one-time systems adjustments related to the capability to perform an annual model validation. These adjustments would amount to an aggregate one-time burden of approximately 900 hours.[455]

CCPs would be required to collect information relating to their model validation standards required by Rule 17Ad-22(b)(4) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for model validation standards would vary depending on how frequently each CCP may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS, the Commission estimates that the ongoing requirements of this rule would impose an annual burden of 60 hours on each respondent CCP, corresponding to an aggregate annual burden for all respondent CCPs of 540 hours.[456]

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454 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 9 respondent CCPs = 1,890 hours.

455 This figure was calculated as follows: ((Chief Compliance Officer for 40 hours) + (Computer Department Operations Manager for 40 hours) + (Senior Programmer for 20 hours)) = 100 hours x 9 respondent CCPs = 900 hours.

456 This figure was calculated as follows: Compliance Attorney at 60 hours x 9 respondent CCPs = 540 hours for all respondent CCPs.

Based on its oversight of clearing agencies, the Commission estimates that Rule 17Ad-22(b)(4) would impose an annual cost on all respondent CCPs for work on model validation. The Commission believes clearing agencies would hire a consulting firm that dedicates two consultants to the project. Consistent with the Proposing Release,[457] the Commission estimates that should respondent CCPs decide to hire external consultants to develop and implement Rule 17Ad-22(b)(4) through written policies and procedures, the ongoing cost associated with hiring such consultants would be approximately $3.9 million per year.[458]

3. Standards in Rules 17Ad-22(b)(5)–(7) that Impose a PRA Burden

The requirements to develop written policies and procedures in Rules 17Ad-22(b)(5)–(7) impose a PRA burden. These PRA burdens will apply to all CCPs. As discussed above, the Commission estimates that nine CCPs will be subject to the burdens under Rules 17Ad-22(b)(5)–(7). The Commission believes that CCPs are more likely to be able to address the changes required by Rules 17Ad-22(b)(5)–(7) in an integrated, not piecemeal, review and drafting process to implement policies and procedures responsive to these rules. Therefore, the revised PRA burden estimates no longer account for each requirement as a separate burden.

For each respondent CCP, the estimated annualized burden for Rule 17Ad-22(b)(4) is 143 hours (figure calculated as follows: 210 hours + 100 hours (Year 1 burden) + 60 hours (Year 2 burden) + 60 hours (Year 3 burden) = 430 hours (estimated total burden over 3 years) ÷ 3 years = 143 hours).

457 See Proposing Release, supra note 35, at 14529.

458 This figure was calculated as follows: 2 Consultants for 30 hours per week at $600 per hour = $36,000 per week x 12 weeks = $432,000 per clearing agency x 9 respondent CCPs = $3,888,000. The $600 per hour figure for a consultant was calculated using www.payscale.com, modified by Commission staff to account for an 1800 hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS, the Commission has preserved the burden estimates from the Proposing Release. The Commission estimates that Rules 17Ad-22(b)(5)–(7) would impose a one-time burden on each respondent CCP of 210 hours, corresponding to an aggregate one-time burden on all respondent CCPs of 1,890 hours.[459]

CCPs would be required to collect information relating to standards of Rules 17Ad-22(b)(5)–(7) on an ongoing basis. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS, the Commission estimates that the ongoing requirements of this rule would impose an annual burden of 60 hours on each respondent CCP, corresponding to an aggregate annual burden for all respondent CCPs of 540 hours.[460]

4. Standards in Rule 17Ad-22(c) that Impose a PRA Burden

The standards in Rule 17Ad-22(c) impose a PRA burden.[461] The requirements of Rule 17Ad-22(c) will apply to all registered clearing agencies. Based on the analogous policies and

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459 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 9 respondent CCPs = 1,890 hours.

460 This figure was calculated as follows: Compliance Attorney at 60 hours x 9 respondent CCPs = 540 hours for all respondent CCPs.

For each respondent CCP, the estimated annualized burden for Rules 17Ad-22(b)(5)—(7) is 110 hours (figure calculated as follows: 210 hours (Year 1 burden) + 60 hours (Year 2 burden) + 60 hours (Year 3 burden) = 330 hours (estimated total burden over 3 years) ÷ 3 years = 110 hours).

461 The burden discussion for the different information collection requirements of Rule 17Ad-22(c)(1)—(2) has been split into sections to account for the different requirements for varying numbers of respondents. Rule 17Ad-22(c) imposes an overall burden relating to policies and procedures and system adjustments on all registered clearing agencies, while Rule 17Ad-22(c)(1), as discussed below, imposes on CCPs an ongoing burden to generate the required reports concerning their financial resources and Rule 17Ad-22(c)(2), as discussed below, imposes initial and ongoing burdens related to annual

procedures requirements and the corresponding burden estimates in Regulation NMS, the Commission has preserved the burden estimates from the Proposing Release. In contrast to the Proposing Release's burden estimates for proposed Rule 17Ad-22(c)(2), which accounted for 17 clearing agencies, the burden estimate in the adopting release for Rule 17Ad-22(c) reflects a smaller number of clearing agencies. The Commission estimates that Rule 17Ad-22(c) would impose a one-time burden on each respondent clearing agency of 191 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 1,910 hours.[462]

The Commission believes the one-time burden imposed would involve adjustments needed to synthesize and format existing information in a manner sufficient to explain the methodology the clearing agency uses to meet the requirement of Rule 17Ad-22(c). The Commission believes these adjustments would impose a one-time burden of 100 hours on each clearing agency, corresponding to an aggregate one-time burden imposed on all clearing agencies of 1,000 hours.[463]

Clearing agencies would be required to collect information relating to standards of Rule 17Ad-22(c) on an ongoing basis. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS, the Commission estimates that the ongoing requirements of this rule would impose an annual burden of 60 hours on each

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audited financial statements to all registered clearing agencies, some of which are already implementing this requirement as part of their usual and customary practices.

[462] This figure was calculated as follows: ((Assistant General Counsel at 60 hours) + (Compliance Attorney at 85 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 191 hours x 10 respondent clearing agencies = 1,910 hours.

[463] This figure was calculated as follows: ((Chief Compliance Officer at 40 hours) + (Computer Operations Department Manager at 40 hours) + (Senior Programmer at 20 hours)) = 100 hours x 10 respondent clearing agencies = 1,000 hours.

respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 600 hours.[464]

5. Standards in Rule 17Ad-22(c)(1) that Impose a PRA Burden

The standards in Rule 17Ad-22(c)(1) impose a PRA burden. In contrast to the Proposing Release's burden estimates for proposed Rule 17Ad-22(c)(2), which accounted for 17 clearing agencies, the burden estimate in the adopting release for Rule 17Ad-22(c)(1) reflects a smaller number of clearing agencies. The requirements of Rule 17Ad-22(c)(1) will apply to nine CCPs.

On an ongoing basis, the Commission estimates that for a CCP to generate the required reports concerning its financial resources would impose a burden of three hours per respondent CCP per quarter. This amounts to an annual burden of 12 hours for each CCP and corresponds to an aggregate annual burden of 108 hours for all respondent CCP. [465]

6. Standards in Rule 17Ad-22(c)(2) that Impose a PRA Burden

The standards in Rule 17Ad-22(c)(2) impose a PRA burden. In contrast to the Proposing Release's burden estimates for proposed Rule 17Ad-22(c)(2), which accounted for 17 clearing

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464 This figure was calculated as follows: Compliance Attorney at 60 hours x 10 respondent clearing agencies = 600 hours for all respondent clearing agencies.

For each respondent clearing agency, the estimated annualized burden for Rule 17Ad-22(c) is 137 hours (figure calculated as follows: 191 hours + 100 hours (Year 1 burden) + 60 hours (Year 2 burden) + 60 hours (Year 3 burden) = 411 hours (estimated total burden over 3 years) ÷ 3 years = 137 hours).

465 This figure was calculated as follows: ((Compliance Attorney at 1 hour) + (Computer Operations Department Manager at 2 hours)) = 3 hours per quarter x 4 quarters per year = 12 hours per year x 9 respondent clearing CCPs = 108 hours.

For each respondent CCP, the estimated annualized burden for Rule 17Ad-22(c)(1) is 8 hours (figure calculated as follows: 0 hours (Year 1 burden) + 12 hours (Year 2 burden) + 12 hours (Year 3 burden) = 24 hours (estimated total burden over 3 years) ÷ 3 years = 8 hours).

agencies, the burden estimate in the adopting release for Rule 17Ad-22(c)(2) reflects a smaller number of clearing agencies. The requirements of Rule 17Ad-22(c)(2) will apply to all registered clearing agencies, a total of ten respondents.

The Commission expects that the exact burden of collecting information relating to the procedures for facilitating an annual audited financial statement of the clearing agency and posting that annual audited financial statement to the clearing agency's website would vary depending on how frequently each clearing agency may need to update its procedures. Also, the Commission estimates based on its experience with entities of similar size to the respondents to this collection, that the initial burden of generating annual audited financial statements would generally require on average 500 hours per respondent clearing agency.[466] However, as most registered clearing agencies are already implementing this requirement as part of their usual and customary practices, the rule, as an initial burden, would largely affect a total of four entities -- three potential new entrants and one clearing agency that currently does not have two years of annual audited financial statements prepared in accordance with U.S. GAAP or IFRS posted on its website and therefore, would be required to incur the costs of paying for an independent audit for two years of financial statements.[467] The Commission estimates that Rule 17Ad-22(c)(2) would impose a one-time burden on each of these four clearing agencies of 500 hours to prepare and review internal financial statements, corresponding to an aggregate one-time burden on the

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466 An example of the Commission's experience with entities of a similar size to the respondents is that the Commission required entities to post their annual financial statements on their respective websites as conditions to the Commission's authorizing them to provide CCP services for credit default swaps. See supra note 2.

467 BSECC and SCCP currently do not post audited financial statements on their websites and are considered new entrants.

four respondent clearing agencies of 2,000 hours.[468] This requirement would necessitate work hours of compliance personnel and finance personnel at the clearing agency to compile relevant data, organize and analyze that data, and then post it to the clearing agency's website consistent with the rule.

Clearing agencies also would be required to collect information relating to any procedures used to support compliance with Rule 17Ad-22(c)(2) on an ongoing basis. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS, the Commission estimates that the ongoing requirements of this rule would impose an annual burden of 250 hours on each respondent clearing agency for collecting information relating to administering policies and procedures for facilitating an annual audited financial statement of the clearing agency and posting that annual audited financial statement to the clearing agency's website for an aggregate burden of 2,500 hours.[469]

The requirement also would require the services of a registered public accounting firm. The Commission estimates those services would on average cost approximately $500,000 annually.[470] Therefore, to meet the ongoing requirements of Rule 17Ad-22(c)(2) the

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468 This figure was calculated as follows: Senior Accountant at 500 hours x 4 respondent clearing agencies = 2,000 hours.

469 This figure was calculated as follows: Senior Accountant at 250 hours x 10 respondent clearing agencies = 2,500 hours.

Annualized, the estimated burden for Rule 17Ad-22(c)(2) is 333 hours (figure calculated as follows: 500 hours (Year 1 burden) + 250 hours (Year 2 burden) + 250 hours (Year 3 burden) = 1,000 hours (estimated total burden over 3 years) ÷ 3 years = 333 hours). This figure represents a weighted average for 10 respondent clearing agencies. The burden will be higher for clearing agencies that have not yet implemented Rule 17Ad-22(c)(2). The burden will be less for clearing agencies that have already implemented the requirement as part of their usual and customary practices.

470 A precise estimate of audit costs for clearing agencies cannot be made, and therefore, we examined a number of existing surveys, (see, e.g., surveys by CFO.com studying large

Commission estimates a total annual cost of approximately $5,000,000 in the aggregate for all respondent clearing agencies.[471]

7. Total Burden for Rule 17Ad-22

The total initial burden for Rule 17Ad-22 is 11,340 hours.[472] The total ongoing annual burden for Rule 17Ad-22 is 4,888 hours.[473] The ongoing external cost for Rule 17Ad-22 is $8.9 million.[474]

D. Collection of Information is Mandatory

The collection of information relating to Rule 17Ad-22(b) and Rule 17Ad-22(c)(1) will be mandatory for all CCPs. The collection of information relating to Rule 17Ad-22(c)(2) and Rule 17Ad-22(d) will be mandatory for all registered clearing agencies.

E. Confidentiality

The Commission expects that the written policies and procedures that will be generated pursuant to Rules 17Ad-22(b)(1)–(7), Rule 17Ad-22(c)(2), and Rules 17Ad-22(d)(1)–(15) will be communicated to the members, subscribers, and employees (as applicable) of all entities covered by the Rule. To the extent that this information is made available to the Commission, it

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and small public companies). While the costs may vary depending on the circumstances, we are using an estimate of $500,000, which is on the upper range for an average cost.

471 This figure was calculated as follows: $500,000 estimated cost of registered public accounting firm x 10 respondent clearing agencies = $5,000,000.

472 This figure was calculated as follows: 1,750 hours for initial burdens associated with 17Ad-22(b)(1)–(3) and (d)(1)–(15) + 2,790 hours for initial burdens associated with 17Ad- 22(b)(4) + 1,890 hours for initial burdens associated with 17Ad-22(b)(5)–(7) + 4,910 hours for initial burdens associated with 17Ad-22(c) = 11,340 hours.

473 This figure was calculated as follows: 600 hours for annual burdens associated with 17Ad-22(b)(1)–(3) and (d)(1)–(15) + 540 hours for annual burdens associated with 17Ad-22(b)(4) + 540 hours for initial burdens associated with 17Ad-22(b)(5)–(7) + 3,208 hours for annual burdens associated with 17Ad-22(c) = 4,888 hours.

474 This figure was calculated as follows: $3,888,000 (for Rule 17Ad-22(b)(4)) + $5,000,000 (for Rule 17Ad-22(c)(2)).

will not be kept confidential. Any records generated in connection with the requirement of Rules 17Ad-22(b)(1)–(3), Rules 17Ad-22(b)(5)–(7), Rule 17Ad-22(c)(2), and Rules 17Ad-22(d)(1)–(15) to establish written policies and procedures will be required to be preserved in accordance with, and for the periods specified in, Exchange Act Rules 17a-1[475] and 17a-4(e)(7).[476]

The information collected pursuant to Rule 17Ad-22(c)(1) relating to the calculation and maintenance of a record of the financial resources necessary to meet the requirements of Rule 17Ad-22(b)(3) will be retained by the registered clearing agencies that perform CCP services and will be available to the Commission. To the extent that the Commission receives confidential information pursuant to this collection of information, such information would be kept confidential, subject to the provisions of applicable law.[477]

V. Economic Analysis

A. Overview

The rules that we are adopting today are designed to enhance the substantive regulation of securities clearing agencies. The Commission is sensitive to the economic effects of the rules it is adopting today, including their costs and benefits. Some of these costs and benefits stem from statutory mandates, while others are affected by the discretion we exercise in implementing the mandates. We requested comment on all aspects of the costs and benefits of the proposal,

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475 17 CFR 240.17a-1.

476 17 CFR 240.17a-4(e)(7).

477 See, e.g., 5 U.S.C. 552 (Exemption 4 of the Freedom of Information Act provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. 552(b)(4). Exemption 8 of the Freedom of Information Act provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. 552(b)(8)).

including any effect our proposed rules may have on efficiency, competition, and capital formation.

As required by Title VII and Title VIII of the Dodd Frank Act, Rule 17Ad-22 will establish a regulatory framework for CCPs for security-based swap transactions and clearing agencies that are designated as systemically important by the Council. In so doing, Rule 17Ad-22 will help ensure that clearing agencies maintain effective operational and risk management procedures as well as meet the statutory requirements under the Exchange Act on an ongoing basis. Rule 17Ad-22 is consistent with the Dodd-Frank Act and the Congressional findings in the adoption of Section 17A. Specifically, Congress found that:

(A) The prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto, are necessary for the protection of investors and persons facilitating transactions by and acting on behalf of investors.

(B) Inefficient procedures for clearance and settlement impose unnecessary costs on investors and persons facilitating transactions by and acting on behalf of investors.

(C) New data processing and communications techniques create the opportunity for more efficient, effective, and safe procedures for clearance and settlement.

(D) The linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement will reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors.[478]

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[478] See 15 U.S.C. 78q-1(a)(1).

Section 17A of the Exchange Act was adopted in direct response to the paperwork crisis of the late 1960's that nearly brought the securities industry to a standstill and directly or indirectly resulted in the failure of large numbers of broker-dealers[479] because the industry's clearance and settlement procedures were inefficient and lacked automation.

Economic characteristics of FMIs,[480] such as clearing agencies, including economies of scale, barriers to entry, and the particulars of their legal mandates may limit competition and confer market power on FMIs, which could lead to lower levels of service, higher prices, or under-investment in risk-management systems.[481] In addition, the institutional structure of entities that provide clearance and settlement services may not provide strong incentives or mechanisms for safe and efficient design and operation, fair and open access, or the protection of participant and customer assets in some circumstances.[482] Moreover, the participants in a clearing agency may not consider the full impact of their actions on other participants, such as the potential costs of delaying payments or settlements.[483] Overall, a clearing agency and its

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479 This crisis resulted from sharply increased trading volumes and historic industry inattention to securities processing, as demonstrated by inefficient, duplicative and highly manual clearance and settlement system, poor records, insufficient controls over funds and securities, and use of untrained personnel to perform processing functions. See, e.g., Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 231, 92d Cong., 1st Sess. 13 (1971).

480 A "financial market infrastructure" is a multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities, derivatives, or other financial transactions. See id. at 7.

481 See FMI Report, supra note 32, at 11.

482 See id.

483 See id.

participants may generate significant negative externalities for the entire securities market if they do not adequately manage their risks.[484]

While the Commission believes that the U.S. clearance and settlement system currently works well, it is important that the operations of clearing agencies evolve with the securities markets, especially as clearing agencies affect a wider array of market participants. A clearing agency's direct participants, such as broker–dealers, banks and other types of financial intermediaries, use clearing agencies to clear and settle proprietary trading activity. They also use clearing agencies as intermediaries for institutional investors, retail investors, and proprietary trading firms,[485] because clearing and settling a high volume of financial transactions multilaterally through a clearing agency may in many cases allow for greater efficiency and lower costs than settling bilaterally.[486] In addition, clearing agencies are often able to manage risks related to the clearing and settling of financial transactions more effectively for their participants, and, in some cases, reduce certain risks, such as the risk that a purchaser of a security will not receive the security or the risk that a seller of a security will not receive payment for the security.[487]

Because clearing agencies concentrate risk, a disruption in a clearing agency's operations or the failure of a clearing agency to meet its obligations could cause a systemic disruption that can be costly for more than just the clearing agency and its members. For example, a significant

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484 See id.

485 Some clearing agencies permit proprietary trading firms, including high-frequency traders, that meet the clearing agency's participation requirements, to clear trades without intermediation by a broker-dealer or futures commission merchant ("FCM").

486 See Risk Management Supervision of Designated Clearing Entities (July 2011), Report by the Commission, Board and CFTC to the Senate Committees on Banking, Housing, and Urban Affairs and Agriculture in fulfillment of Section 813 of Title VIII of the Dodd-Frank Act.

487 See id.

dollar value of financial transactions pending for clearance or to be cleared in the future through the clearing agency could fail to settle on time or at the original contract terms. If the clearing agency acting as a CCP does not have the funds to cover the fail, members of the clearing agency would suffer losses and liquidity constraints due to their inability to access their clearing fund contributions and the clearing agency's inability to honor its obligations.[488] In addition, the failure has the potential to harm the market as a whole in all financial instruments cleared by that clearing agency and its members, beyond the securities pending for clearance at the time of the original settlement failure.

The standards adopted today as part of Rule 17Ad-22 are intended to help mitigate these risks by requiring measures that would reinforce the safety of clearing agencies. Safe and reliable clearing agencies are essential not only to the stability of the securities markets they serve but often also to payment systems, which may be used by a clearing agency or may themselves use a clearing agency to transfer collateral. The safety of securities settlement arrangements and post-trade custody arrangements is also critical to the goal of protecting the assets of investors from claims by creditors of intermediaries and other entities that perform various functions in the operation of the clearing agency. Investors are more likely to participate in markets when they have confidence in the safety and reliability of clearing agencies; therefore the rule being adopted today should promote capital formation.

In addition, the rule seeks to promote the efficiency of clearing agencies. As described below, the structure of the clearing agency market and the structure of the clearing agencies

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488 See id. at 8. While no clearing agency has ever failed in the United States, such failure is not impossible. See, e.g., Donald MacKenzie, An Engine, Not A Camera: How Financial Models Shape Markets (2009); Ian Hay Davison, Securities Review Committee Report (1989) (discussing the events surrounding the failure of the Hong Kong Futures Exchange Clearing Corporation in 1987).

themselves may not provide the competitive incentives necessary to promote transparency, fair access, and efficient operations. Transparency helps to ensure that clearing members can make more informed decisions and that market participants in general have better information about the stability of the system. In turn, transparency promotes competition by facilitating comparisons across clearing agencies. Fair access ensures that a variety of market participants can gain access to clearing and settlement services and thus promotes competition by lowering barriers to entry for clearing agency participants.[489] Efficient operations can result in higher quality services or lower fees (or both) to clearing agency members and their customers.

The analysis below examines the projected economic effects of the adopted rules. The analysis starts with a baseline discussion of the current regulatory landscape and existing industry practices of clearing agencies relating to their operations and risk management procedures and membership policies. This discussion provides a point of comparison for the second half of the economic analysis, which is a discussion of the benefits and costs of the rules, as well as alternative approaches to the rules that were considered by the Commission.[490]

B. Baseline

Rule 17Ad-22 impacts the market for clearing agency services in securities, with an emphasis on CCP services. There are currently seven clearing agencies registered with the Commission that provide CCP or CSD services. Six of these clearing agencies offer CCP services, and one is a CSD. Together, they processed over $1 quadrillion in financial market

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489 See infra discussion of Rules 17Ad-22(b)(5), (6) and (7) in Section V.C.5.

490 In discussing the current practices of the registered clearing agencies below, we have omitted descriptions of the variations in the practices, policies, and procedures among registered clearing agencies that are, nevertheless, consistent with the requirements of the final rules. However, while these variations are not discussed, notable distinctions in practices, policies, and procedures that significantly impact the economic analysis are addressed, as applicable.

transactions in 2011.[491] Some of these clearing agencies also are regulated by the CFTC, the Federal Reserve, and the New York State Department of Banking.

Central clearing facilitates the management of counterparty credit risk among dealers and other institutions by shifting that risk from individual counterparties to CCPs, thereby helping protect counterparties from each other's potential failures and preventing the buildup of risk in such entities, which could be systemically important. Central clearing generally reduces the counterparty risk of market participants, including market makers and dealers. If market makers and dealers cannot diversify this counterparty risk, they generally pass the costs on to their clients in the form of higher transaction costs. In order for central clearing to reduce risk, mark-to-market pricing and margin requirements need to be applied in a consistent manner.[492] CCPs generally use liquid margin collateral to manage the risk of a CCP member's failure, and rely on the accuracy of their margin calculations and their access to liquid collateral to protect against sudden movements in market prices. A CCP can also reduce systemic risk through netting, by reducing the amount of funds or other assets that must be exchanged at settlement.[493]

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491 This figure was calculated from the following sources: DTCC 2011 Annual Report, available at http://dtcc.com/about/annuals/2011/report.php; OCC 2011 Annual Report, available at http://www.optionsclearing.com/components/docs/about/annual-reports/occ_2011_annual_report.pdf; CME Group 2011 Annual Report, available at http://cmegroup.com/investor-relations/annual-review/2011/downloads/CME_Group_2011_Annual_Report.pdf; InterContinental Exchange 2011 Annual Report, available at http://files.shareholder.com/downloads/ICE/1860307941x0x556734/44EA48C5-CBCB-4468-BF54-048BFEEC8264/ICE_2011AR.pdf.

492 See Christopher Culp, OTC-Cleared Derivatives: Benefits, Costs, and Implications of the "Dodd-Frank Wall Street Reform and Consumer Protection Act (Journal of Applied Finance, No. 2, 2010), available at http://www.rmcsinc.com/articles/OTCCleared.pdf.

493 See, e.g., Darrell Duffie and Haoxiang Zhu, Does a Central Clearing Counterparty Reduce Counterparty Risk?, (Stanford University, Working Paper, 2010), available at http://www.stanford.edu/~duffie/DuffieZhu.pdf; Nout Wellink, Mitigating System Risk in OTC Derivatives Markets, (Banque de France, Financial Stability Review, No. 14 – Derivatives – Financial innovation and stability, July 2010), available at

Nevertheless, a CCP also concentrates risks and responsibility for risk management in the CCP.[494] Consequently the effectiveness of a CCP's risk controls and the adequacy of its financial resources are critical aspects of the infrastructure of the market it serves.[495]

The market for CCP services in the United States tends to be segmented by financial instrument, with clearing agencies often specializing in particular instruments. As such, some market segments may have characteristics of natural monopolies capable of being sustained despite the presence of competitors with the potential to enter the market segment in question.[496] For example, in the United States, following a period of consolidation facilitated by the introduction of Section 17A of the Exchange Act, only one CCP currently processes transactions in U.S.-listed equities and only one CCP processes transactions in exchange-traded options. However, three clearing agencies currently serve as CCPs for swaps and security-based swaps. Although two of the CCPs for security-based swaps are affiliated entities, these affiliated CCPs do not compete with each other; one primarily serves the U.S. market for security-based swaps, and the other primarily serves the European market. Further, the affiliated CCP serving the U.S. market has a dominant market share in the United States, though the Commission believes this may be subject to change over time as a result of competition from the other registered CCPs offering security-based swap services, the entry of new competitors into the U.S. market or other factors.

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http://www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financiere/etude15_rsf_1007.pdf; and Manmohan Singh, Collateral, Netting and System Risk in the OTC Derivatives Market," (International Monetary Fund, Working Paper, 2009), available at http://www.imf.org/external/pubs/ft/wp/2010/wp1099.pdf.

494 See RCCP, supra note 33, at 1.

495 See id.

496 A natural monopoly is one in which the economies of scale make having a single provider more efficient (lower average cost) than having multiple competitors.

The following sections set the baseline for comparison in our analysis of the economic effects. In particular, they describe the legal framework under which registered clearing agencies operate and the current practices of clearing agencies as they relate to the rules being adopted today.

1. Legal Framework

a. Overview of Statutory Framework and the Dodd-Frank Act

In recognition of the risks posed by the concentration of clearance and settlement activity at clearing agencies, the Exchange Act and Titles VII and VIII of the Dodd-Frank Act provide a framework for enhanced regulation and supervision of clearing agencies by the Commission.

i. Exchange Act

Section 17A of the Exchange Act[497] and Rule 17Ab2-1[498] require entities to register with the Commission prior to performing the functions of a clearing agency. Under the statute, the Commission is not permitted to grant registration unless it determines that the rules and operations of the clearing agency meet the standards set forth in Section 17A.[499] If the Commission registers a clearing agency, the Commission oversees the clearing agency to facilitate compliance with the Exchange Act using various tools that include, among other things, the rule filing process for SROs and on-site examinations by Commission staff. Section 17A(d) also gives the Commission authority to adopt rules for clearing agencies as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act and prohibits a registered clearing agency from engaging in

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497 See 15 U.S.C. 78q-1(b). See also Pub. L. No 111-203 § 763(b) (adding subparagraph (g) to Section 17 of the Exchange Act).

498 See 17 CFR 240.17Ab2-1.

499 See supra note 5.

any activity in contravention of these rules and regulations.[500] In 1980, the staff of the Commission provided guidance on meeting the requirements of Section 17A in its Standards for Clearing Agency Regulation.[501]

ii. Title VII of the Dodd-Frank Act

As described in Section I above, the Dodd-Frank Act was enacted to, among other things, mitigate systemic risk and promote the financial stability of the United States by improving accountability and transparency in the financial system and by providing for enhanced regulation and oversight of institutions designated as systemically important.[502] Specifically, Title VII of the Dodd-Frank Act amended the Exchange Act to require that security-based swap transactions must be cleared through a clearing agency that is registered with the Commission (or exempt from registration) if they are of a type that the Commission determines be cleared, unless an exemption from mandatory clearing applies.[503] New Section 17A(i) of the Exchange Act also gives the Commission authority to promulgate rules that establish standards for security-based swap clearing agencies.[504] Compliance with any such rules is a prerequisite to the registration of a clearing agency with the Commission[505] and is also a condition to the maintenance of its continued registration.[506]

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500 See 15 U.S.C. 78q-1(d).

501 See supra note 5.

502 See supra note 20.

503 See 15 U.S.C. 78c-3(a)(1) (as added by Section 763(a) of the Dodd-Frank Act).

504 15 U.S.C. 78q-1(i).

505 Under the Exchange Act, a clearing agency can be registered with the Commission only if the Commission makes a determination that the clearing agency satisfies the requirements set forth in paragraphs (A) through (I) of Section 17A(b)(3) of the Exchange Act. 15 U.S.C. 78q-1(b)(3).

506 See supra Section I.A.3.

iii. Title VIII of the Dodd-Frank Act

In addition to the provisions in Title VII that expand the Commission's authority under the Exchange Act to include security-based swap activities, Title VIII of the Dodd-Frank Act, entitled the Clearing Supervision Act, establishes an enhanced supervisory and risk control system for systemically important clearing agencies and other FMUs.[507] As previously noted, on July 18, 2012, the Council designated DTC, FICC, NSCC and OCC as systemically important, and Section 17A(i) of the Exchange Act provides that the Commission, in establishing clearing agency standards and in its oversight of clearing agencies, may conform such standards and such oversight to reflect evolving international standards.[508] Section 805(a) of the Clearing Supervision Act supplements the Exchange Act requirements by mandating the Commission to take into consideration relevant international standards and existing prudential requirements for clearing agencies that are designated as systemically important FMUs.[509]

In part, the Clearing Supervision Act provides that the Commission, considering relevant international standards and existing prudential requirements, may prescribe regulations that set risk management standards for the operations related to PCS Activities[510] of a Designated Clearing Entity or the conduct of designated activities by a Financial Institution.[511] Creation of any such risk management standards must be done in consultation with the Federal Reserve and the Council.

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507 See supra note 25.

508 15 U.S.C. 78q-1(i).

509 12 U.S.C. 5464(a)(1).

510 Certain post-trade processing activities that are not captured by the Clearing Supervision Act may nevertheless be subject to regulation by the Commission under the Exchange Act. See supra note 100 and accompanying text.

511 See supra note 27.

b. CPSS-IOSCO Standards

As noted above, the final FMI Report was published on April 16, 2012 to replace the earlier CPSS-IOSCO Recommendations and therefore represents a new reference point of international standards contemplated by the Exchange Act and the Clearing Supervision Act relevant for actions taken by the Commission.[512] The FMI Report recognizes that FMIs can differ significantly in design, organization and function and that certain principles are not applicable to certain types of FMIs. The principles are designed therefore to be applied holistically, and the Final Report expressly provides flexibility in terms of how FMIs will apply the principles. The clearing agencies registered with the Commission have generally implemented the CPSS-IOSCO Recommendations. The FMI Report states that financial market infrastructures (including CCPs and CSDs) are expected to observe the principles contained in the FMI Report through "appropriate and swift action" consistent with the national laws of their home jurisdictions.[513]

c. Complementary Regulation by Other Regulators

Rule 17Ad-22 and the rules for DCOs adopted by the CFTC[514] are generally consistent. The CFTC also incorporates some of the CPSS-IOSCO Recommendations by rule to supplement the DCO core principles of the Commodity Exchange Act ("CEA"). Nevertheless, there are some differences between the rules the Commission is adopting today and those of the CFTC.

First, Rule 17Ad-22(b)(1) requires a CCP to measure its credit exposures to its participants at least once a day while the CFTC's DCO rules require that DCOs perform that

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512 See supra note 32.

513 See RSSS and RCCP Reports, supra note 33.

514 See 76 FR 69334 (Nov. 8, 2011).

function periodically throughout the day. Second, consistent with the current practice at registered CCPs providing clearing of security-based swaps, Rule 17Ad-22(b)(3) requires CCPs for security-based swaps to maintain enough financial resources to withstand a default by the two largest participant families.[515] All other CCPs would be required to be able to withstand a default by the single largest participant family, for the reasons discussed in Section V.C below.

The CFTC applies the latter standard to all DCOs. In its October 2010 rule proposal, the CFTC proposed requiring that systemically important DCOs maintain sufficient financial resources to meet their financial obligations to their clearing members notwithstanding a default by the two clearing members creating the largest combined financial exposure for the systemically important DCO in extreme but plausible market conditions.[516] The CFTC did not adopt this proposal as part of its final rules for DCOs. The CFTC stated that it was premature to adopt this rule for the following reasons: (1) the Council had not designated any DCOs as systemically important; (2) the final FMI Report had not been published; and (3) EMIR was not final.[517] The CFTC stated that it would be closely monitoring developments and would be prepared to revisit the issue if the European Union or other foreign regulators move closer to implementation of their respective reforms.[518]

Third, Rule 17Ad-22(b)(4) requires model validations to be performed "annually" by a person who is free from influence from the persons responsible for development or operation of

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515 See supra Section III.C.3.

516 See Financial Resources Requirements for Derivatives Clearing Organizations, 75 FR 63113 (Oct. 14, 2010).

517 See id. at 69352.

518 We note that EMIR requires all CCPs to maintain sufficient financial resources to withstand the default of the two participants with the largest exposures. See supra note 167 at 43. EMIR was adopted in July 2012. See supra note 167.

the systems and models being validated so that he or she can be candid in his or her assessment of the model. The CFTC rule requires an "independent" validation on a "regular basis."

Fourth, Rule 17Ad-22(b)(7) provides for scalability of net capital requirements in proportion to the riskiness of the participants' activities and permits CCPs to seek Commission approval to impose a net capital requirement on participants that is higher than $50 million. In contrast, the CFTC's DCO rules do not provide for scalability and do not allow DCOs the option to seek approval for a higher net capital requirement.

Finally, a DCO is required to publicly disclose its margin-setting methodology and default procedures on its website. Rule 17Ad-22(d)(11) requires a clearing agency to make key aspects of its default procedures publicly available, but nothing in the rules the Commission is adopting today would require publication of the clearing agency's margin methodology.

2. Current Practices

An overview of the risk management practices, operations, policies and procedures of registered clearing agencies is set forth below. The discussions under the headings "Risk Management - Measurement of credit exposures," "--Margin" "--Financial Resources" and under the heading "Other Clearing Services" are based upon public representations[519] made by registered clearing agencies regarding their compliance with the CPSS-IOSCO Recommendations and upon the Commission's observations with regard to registered clearing agencies developed in carrying out its supervisory role. The discussion under the heading "Risk

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519 See, e.g., NSCC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Nov. 14, 2011), available at http://www.dtcc.com/legal/compliance/NSCC_Self_Assessment.pdf; DTC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Dec. 12, 2011), available at http://www.dtcc.com/legal/compliance/DTC_Self-Assessment.pdf; FICC/GSD's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Dec. 15, 2011), available at http://www.dtcc.com/legal/compliance/FICC_Self-Assessment.pdf.

Management -Model Validation" is based upon the Commission's observations with regard to registered clearing agencies in its supervisory role. The Commission notes that the practices observed at registered clearing agencies generally are performed pursuant to stated practices, policies and procedures as described below.[520]

a. Risk Management Practices

i. CCP practices as they relate to Rules 17Ad-22(b)(1)--(4)

CCPs have a range of tools that can be used to manage the financial risks to which they are exposed, and the tools that an individual CCP uses will depend upon the nature of its obligations. Nonetheless, there is a common set of procedures that are implemented by many CCPs to manage counterparty credit and liquidity risks. Broadly, these procedures enable CCPs to manage their risks by limiting the likelihood of defaults, by limiting the potential losses and liquidity pressures if a default should occur, and by ensuring that there are adequate resources to cover losses and meet payment obligations on schedule.

To manage its counterparty credit exposures to its participants effectively, a clearing agency must be able to measure those exposures. A clearing agency can ascertain its current credit exposure to each participant by marking each participant's outstanding contracts to current market prices and (to the extent permitted by a clearing agency's rules and supported by law) netting any gains against any losses. A clearing agency faces the risk that its exposure to a participant can change as a result of a change in prices, in positions, or both.

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[520] Registered clearing agencies are SROs as defined in Section 3(a)(26) of the Exchange Act. A stated policy, practice, or interpretation of an SRO, such as a clearing agency's written policies and procedures, would generally be deemed to be a proposed rule change. See 17 CFR 240.19b-4. See supra note 293.

The current practice of each CCP registered with the Commission includes these procedures: (1) measuring credit exposures at least once a day; (2) setting margin coverage at a 99% confidence level over some set period; (3) using risk-based models; (4) establishing a fund that mutualizes losses of defaults by one or more participants that exceed margin coverage; and (5) maintaining sufficient financial resources to withstand the default of at least the largest participant,[521] and in the case of security-based swap transactions, maintaining enough financial resources to be able to withstand the default of their two largest participants.[522]

1. Measurement of Credit Exposures

Currently, registered clearing agencies measure credit exposures at least once per day. Clearing agencies that guarantee trades on the trade date, such as the FICC/GSD and OCC, measure credit exposures multiple times per day. NSCC does not guarantee trades until midnight of T+1, and it only measures credit exposures daily, though it is considering an accelerated trade guarantee proposal that would potentially revise these practices.[523]

2. Margin

Clearing agencies use risk-based models to set initial and variation margin. Inputs to the margin calculation include, among other things, portfolio size, asset price volatility, current asset values, the likely liquidity of the asset should a particular market maker fail (market-maker domination charges), the likely time it would take to liquidate the assets, potential correlations between the value of assets posted as collateral and the assets being cleared, and the correlation of the prices in the portfolio of assets being cleared by the participant.

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521 See supra note 183.

522 See supra note 168.

523 See NSCC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Nov. 14, 2011), at 24, available at http://www.dtcc.com/legal/compliance/NSCC_Self_Assessment.pdf.

The current practice of many CCPs registered as clearing agencies is to calculate daily margin requirements using risk-based models to ensure coverage at a 99% confidence interval over a designated time horizon. Losses beyond this level are typically covered by the CCP's guaranty fund. This standard is consistent with the RCCP, which has been the internationally accepted minimum standard for CCPs.[524] The RCCP advises that CCPs use margin and other risk control mechanisms to limit exposures to potential losses from defaults by participants in normal market conditions. The generally recognized standard for normal market conditions, as defined in the RCCP, is price movements that produce changes in exposures that are expected to breach margin requirements or other risk controls only 1% of the time (i.e., at a 99% confidence interval).[525]

This standard comports with the international standard for bank capital requirements established by the Bank for International Settlements, which requires banks to measure market risks at a 99% confidence interval when determining regulatory capital requirements.[526] At the time the Basel Committee on Banking Supervision (the "Committee") contemplated this standard, banks measured value-at-risk using a range of confidence intervals from 90-99%.[527]

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524 See supra note 74.

525 See Bank for International Settlements' Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, Recommendations for Central Counterparties, (Nov. 2004), at 21, available at http://www.bis.org/publ/cpss64.pdf; see also infra Section V.B.2 (discussion on current industry baselines and the use of the 99% confidence level).

526 See Bank for International Settlements' Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A Revised Framework (June 2004), available at http://www.bis.org/publ/bcbs107.pdf; see also Darryll Hendricks and Beverly Hirtle, New Capital Rule Signals Supervisory Shift (Sept. 1998), available at http://www.bis.org/bcbs/ca/alrequse98.pdf.

527 See Bank for International Settlements' Basel Committee on Banking Supervision, An internal model-based approach to market risk capital requirements (Apr. 1995), at 12, available at http://www.bis.org/publ/bcbs17.pdf.

When determining the minimum quantitative standards for calculating risk measurements, the Committee noted the importance of specifying "a common and relatively conservative confidence level," choosing the 99% confidence interval over the other, less conservative measures.[528] Since adopted by the Committee in 1998, it has become a generally recognized practice of banks to quantify credit risk as the worst expected loss that a portfolio might incur over an appropriate time horizon at a 99% confidence interval.[529]

3. Financial Resources

All clearing agencies that act as CCPs in the United States collect contributions from their members to guaranty funds or clearing funds for the mutualization of losses under extreme but plausible market scenarios. The guaranty funds or clearing funds consist of liquid assets, the sizes of which vary depending on the products that the CCP clears. In particular, the guaranty funds for CCPs that clear security-based swaps are relatively larger (as measured by the size of the fund as a percentage of the total and largest exposures) than the guaranty funds or clearing funds for other financial instruments. The guaranty funds for security-based swaps are sized to achieve protection against a default by two participant families to whom the clearing agency has the largest exposures and are designed to protect the clearing agency from the extreme jump-to-default risk associated with large protection sellers. Security-based swap CCPs have organized their security-based swap clearing operations either in a separate legal entity or by establishing a separate fund and separate procedures (rules, membership requirements and risk management

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528 See id.

529 See Kenji Nishiguchi, Hiroshi Kawai, and Takanori Sazaki, Capital Allocation and Bank Management Based on the Quantification of Credit Risk, FRBNY Economic Policy Review (Oct. 1998), at 83, available at http://www.newyorkfed.org/research/epr/98v04n3/9810nish.pdf; see also Jeff Aziz and Narat Charupat, Calculating Credit Exposure and Credit Loss: A Case Study (Sept. 1998), at 34, available at http://www.bis.org/bcbs/ca/alrequse98.pdf.

practices) within a single legal entity. The registered clearing agencies clearing products other than security-based swaps maintain the financial resources to withstand the default of the single largest participant family.[530]

4. Model Validation

Clearing agencies registered with the Commission typically have a model validation process in place that evaluates the adequacy of margin models, parameters, and assumptions. Current model validation practices vary among clearing agencies. Some registered clearing agencies conduct annual validations, while others conduct them on an ad hoc basis or perform validations on new models or changes to existing models before implementing them. In addition to validating models, registered clearing agencies typically review models used to calculate margin on a regular basis and back-test them regularly to assess the reliability of the methodology in achieving the desired coverage. Based on our experience in supervising registered CCPs, we understand that registered CCPs' approaches to model validation include model validations conducted by a qualified person who is either an outside third party or is employed by the clearing agency but is free from influence from the persons responsible for the development or operation of the models.

ii. Other Clearing Services (practices as they relate to Rule 17Ad-22(d))

1. Legal Risk

Because registered clearing agencies are SROs, they have written policies and procedures in place that, at a minimum, address the significant aspects of their operations and risk

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530 See, e.g., DTC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Dec. 12, 2011), available at http://www.dtcc.com/legal/compliance/DTC_Self-Assessment.pdf.

management practices.[531] A large portion of these policies and procedures are available to members and participants of clearing agencies, but it is also ordinarily the practice of clearing agencies to limit members' access to certain of their policies and procedures to ensure their integrity, particularly those policies and procedures associated with the oversight of clearing participants. Registered clearing agencies also make their rule books and certain key procedures available to the public to provide a transparent legal framework.[532]

Registered clearing agencies must be able to enforce those policies and procedures and such enforcement powers are specifically contemplated by operative provisions of the Exchange Act, subject to oversight by the Commission.[533] Clearing agency policies and procedures that purport to create remedial measures that a party other than the clearing agency (such as a clearing member) can use to seek redress or to promote compliance with applicable rules must also be enforceable in practice in order to be effective, and the Commission believes that Rule 17Ad-22(d)(1) would augment the Exchange Act requirement that the rules of the clearing agency must provide that its participants shall be appropriately disciplined for any violation of any provision of the rules of the clearing agency.[534]

2. Participation Requirements

Applicants for membership must provide a registered clearing agency with certain financial and operational information prior to being admitted as a member and on an ongoing basis as a condition of continuing membership. The registered clearing agency reviews this information to ensure that the applicant has the operational capability to meet the technical

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531 See supra note 520.

532 Generally, the rules and procedures of registered clearing agencies can be found on their respective websites.

533 See Sections 17A(b)(3)(A), (G), and (H) of the Exchange Act.

534 See 15 U.S.C. 78q-1(b)(3)(G).

demands of interfacing with the clearing agency. In particular, registered clearing agencies require that an applicant demonstrate that it has adequate personnel capable of handling transactions with the clearing agency and adequate physical facilities, books and records and procedures to fulfill its anticipated commitments to, and to meet the operational requirements of, the clearing agency and other participants with necessary promptness and accuracy and to conform to any condition or requirement that the clearing agency reasonably deems necessary for its protection.

Registered clearing agencies use the ongoing monitoring process to ensure they understand relevant changes in the financial condition of their participants and to mitigate credit risk exposure of the clearing agency to its participants. Financial statements filed with the regulatory agencies, information obtained from other SROs and information gathered from various financial publications are analyzed by risk management staff so that the clearing agency may evaluate whether the participant continues to be financially stable.

3. Custody of Assets and Investment Risk

Registered clearing agencies currently seek to minimize the risk of loss or delay in access by holding assets that are highly-liquid (e.g., cash, U.S. Treasury securities or securities issued by a U.S. government agency) and engaging banks to custody the assets and facilitate settlement. Clearing agencies that are designated systemically important by the Council may be provided account services at the appropriate Federal Reserve Bank to the extent such services are not already available as the result of other laws and regulations.[535] The use of account services at the

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535 See Section 806(a) of the Clearing Supervision Act. "The Board of Governors may authorize a Federal Reserve Bank to establish and maintain an account for a designated financial market utility and provide the services listed in section 11A(b) of the Federal Reserve Act (12 U.S.C. 248a(b)) and deposit accounts under the first undesignated paragraph of section 13 of the Federal Reserve Act (12 U.S.C. 342) to the designated

Federal Reserve Bank would reduce custody risk in clearing agencies that are designated systemically important by the Council.

4. Identification and Mitigation of Operational Risk

Registered clearing agencies develop and maintain plans to assure the safeguarding of securities and funds, the integrity of the Automated Data Processing systems, and recovery of securities, funds, or data under a variety of loss or destruction scenarios.[536] In addition, clearing agencies generally maintain an internal audit department to review the adequacy of the clearing agencies' internal controls, procedures, and records with respect to operational risks. Some clearing agencies also engage independent accountants to perform an annual study and evaluation of the internal controls relating to its operations.[537]

5. Money Settlement Risks

Registered clearing agencies use settlement banks to facilitate the cash portion of securities settlements. Because DTC is organized as a limited purpose trust company and is a member of the Federal Reserve System,[538] it has an account at the Federal Reserve Bank of New

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financial market utility that the Federal Reserve Bank is authorized under the Federal Reserve Act to provide to a depository institution, subject to any applicable rules, orders, standards, or guidelines prescribed by the Board of Governors." 12 U.S.C. 5465(a).

536 These practices, among others, have been developed pursuant to Commission guidelines. See Automation Review Policy Statements , supra note 330.

537 See NSCC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Nov. 14, 2011), available at http://www.dtcc.com/legal/compliance/NSCC_Self_Assessment.pdf.

538 See Section 806(a) of the Dodd-Frank Act ("The Board of Governors may authorize a Federal Reserve Bank to establish and maintain an account for a designated financial market utility and provide the services listed in Section 11A(b) of the Federal Reserve Act (12 U.S.C. 248a(b)) and deposit accounts under the first undesignated paragraph of section 13 of the Federal Reserve Act (12 U.S.C. 342) to the designated financial market utility that the Federal Reserve Bank is authorized under the Federal Reserve Act to

York, and uses that account to facilitate end-of-day settlement. NSCC, as an affiliate of DTC, also uses that account.

6. Cost-Effectiveness

Registered clearing agencies have procedures to control costs and to regularly review pricing levels against operating costs. These clearing agencies may use a formal budgeting process to control expenditures, and may review pricing levels against their costs of operation during the annual budget process. Clearing agencies also analyze workflows in order to make recommendations to improve the operating efficiency of the clearing agency.

7. Links

Each registered clearing agency is linked to other clearing organizations, trading platforms, and service providers. An example of such a link is DTC Canadian Link Service, which allows qualifying DTC participants to clear and settle valued securities transactions with participants of a Canadian securities depository. The link is designed to facilitate cross-border transactions by allowing participants to use a single depository interface for U.S. and Canadian dollar transactions and eliminate the need for split inventories.[539]

8. Governance

Each registered clearing agency has a board that governs the operations of the entity and supervises senior management. The key components of a clearing agency's governance arrangements include the clearing agency's ownership structure, the composition and role of its board, the structure and role of board committees, reporting lines between management and the

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provide to a depository institution, subject to any applicable rules, orders, standards, or guidelines prescribed by the Board of Governors.").

539 See infra note 617.

board, and the processes that ensure management is held accountable for the clearing agency's performance.

9. Information on Services

Because registered clearing agencies are SROs, their rules are published by the Commission and are available on each clearing agency's website. In addition, information regarding the operations and services of each clearing agency can be found either on the clearing agency's website or a website maintained by an affiliated entity of the clearing agency.

10. Immobilization and Dematerialization of Securities Certificates

Virtually all mutual fund securities, government securities, options, and municipal bonds in the United States are dematerialized, and most of the equity and corporate bonds in the U.S. market are either immobilized or dematerialized; some securities (e.g., mutual fund shares, U.S. Treasury bills) are issued on a completely dematerialized basis, while most securities issued to the public are issued in the form of one or more physical certificates. Through the end of 2010, over 99% of municipal and corporate debt by par value distributed through DTC was in book-entry-only form.[540] DTC estimates that in excess of 90% of the corporate and municipal securities issued to the public in the United States are distributed through DTC and are represented by one or more physical certificates that are immobilized at the depository.[541]

11. Default Procedures

Each registered clearing agency makes publicly available rules, policies or procedures that set forth the actions the clearing agency may take in the event of a participant default, with the exception of certain of their policies and procedures that are kept non-public to ensure their integrity, such as those associated with the oversight of clearing participants. For example,

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540 See DTCC White Paper, supra note 389.

541 See id.

clearing agency rules typically state what constitutes a default, identify whether the board or a committee of the board may make that determination and describe what steps the clearing agency may take to protect itself and its participants. In this regard, clearing agencies typically attempt, among other things, to close-out, to hedge or to liquidate a defaulting participant's positions.

12. Timing of Settlement Finality

Each registered clearing agency has rules, policies or procedures that provide for the settlement of their respective securities transactions no later than the end of a pre-defined settlement day. For example, DTC provides for final settlement of securities transfers no later than the end of the day and the timing of finality is clearly defined. Final cash settlement occurs at the end of the processing day at DTC. Funds transfers through DTC's account at the Federal Reserve Bank of New York that occur between DTC and a settling bank that is acting on behalf of a DTC participant are final when made.

13. Delivery versus Payment

Rule 17Ad-22(d)(13) would apply to registered clearing agencies that provide CSD services. DTC currently is the only registered clearing agency that is a CSD. DTC operates a Model 2 DVP system that provides for gross settlements of securities transfers during the day followed by an end of day net funds settlement.[542] Under DTC's rules, in a DVP transaction, the delivering party is assured that it will be paid for the securities once they are credited to the receiving party's securities account.[543]

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[542] See DTC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Dec. 12, 2011), available at http://www.dtcc.com/legal/compliance/DTC_Self-Assessment.pdf.

[543] See id.

14. Risk Controls to Address Participant's Failure to Settle

The sole registered clearing agency providing CSD services, DTC, which also extends limited intraday credit to participants, has policies and procedures in place to ensure that timely settlement can be completed in the event of the default of the participant with the largest settlement obligation. DTC has policies and procedures to establish limits (called net debit caps) for each participant. The net debit cap ensures that the amount of cash that a participant owes the clearing agency at any one point in time does not exceed this pre-defined limit or cap. The net debit cap is set in relation to a participant's normal activity with the maximum net debit cap for an individual participant currently set at $1.8 billion. DTC also has implemented other risk management controls to help ensure settlement. For example, DTC monitors the value of the collateral supporting each participant's net debit in its settlement system based on the security's prior business day's closing market price, less a haircut, which is based primarily upon the availability of prices, ratings, and the price volatility of the particular security.

15. Physical Delivery Risks

Each registered clearing agency has rules and procedures that describe its obligations to its participants when it assumes deliveries of physical instruments. For example, under NSCC's rules governing its continuous net settlement ("CNS") system, NSCC becomes the contra-party for settlement purposes at the point NSCC's trade guarantee attaches, thereby assuming the obligation of its members that are receiving securities to receive and pay for those securities, and the obligation of members that are delivering securities to make the delivery. Unless NSCC has invoked its default rules, NSCC is not obligated to make those deliveries until it receives from members with delivery obligations deliveries of such securities; rather, deliveries that come into CNS ordinarily are promptly redelivered to parties that are entitled to receive them through an

allocation algorithm. Members are obligated to take and pay for securities allocated to them in the CNS process. NSCC's rules also provide mechanisms allowing receiving members a right to receive high priority in the allocation of deliveries, and also permit a member to buy-in long positions that have not been delivered to it by the close of business on the scheduled settlement date.

b. Participant Access (practices as they relate to Rules 17Ad-22(b)(5)–(7))

To address credit risk management, clearing agencies establish requirements for participants' financial resources, creditworthiness, and operational capability, and maintain procedures to ensure ongoing compliance with their rules. In its regulatory capacity overseeing clearing agencies, Commission staff has observed that applicants for clearing agency membership must demonstrate standards of financial responsibility, operational capability and character. Specific criteria used by clearing agencies address the extent and nature of the business the applicant intends to conduct through the clearing agency and the applicant's capital resources and financial stability, including factors bearing on its financial capability to meet its projected clearing agency obligations.[544]

As of December 31, 2011, registered CCPs (including those clearing nontraditional securities such as credit default swaps) had the following numbers of members:

- FICC – 302 members

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[544] See, e.g., International Monetary Fund, Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of the NSCC's Observance of the CPSS-IOSCO Recommendations for Central Counterparties (2010), at 6-8, available at http://www.imf.org/external/pubs/ft/scr/2010/cr10129.pdf; IMF's Detailed Assessment of Observance of the Fixed Income Clearing Corporation – Government Securities Division's Observance with the CPSS-IOSCO Recommendations for Central Counterparties, performed in connection with the Financial Sector Assessment Program of the United States in 2010, at 6-8, available at www.imf.org/external/pubs/ft/scr/2010/cr10130.pdf.

- NSCC – 187 full members; 647 limited members
- OCC – 120 members
- CME – 64 members
- ICE Clear Credit – 27 members
- ICE Clear Europe – 60 members

CCPs for traditional securities already have rules regarding access and membership. All CCPs for traditional securities allow non-dealer members, and none of them have minimum portfolio size or trading volume thresholds.[545] In addition, the minimum capital requirements to access these CCPs range from $500,000 to $10,000,000.

Certain clearing agencies that provide CCP services for security-based swap transactions, however, have required members to have significant minimum portfolio sizes or trading volumes, meet significantly higher minimum capital requirements, and require members to operate a dealer business. Such requirements may present challenges to new liquidity providers in the relevant market. The CCPs argue that these requirements are necessary to mitigate the risk exposure of the CCP in the event of default by a clearing member.[546] For example, because markets for credit default swaps are generally less liquid than markets for exchange-traded derivatives, traditional procedures for a CCP to handle a member default may not be effective. The traditional procedures for handling a default, which are used by CCPs for most exchange-traded derivatives, call for the CCP to terminate all of its contracts with the defaulting participant and promptly enter the market and replace the contracts, so as to hedge against further losses on

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545 See infra discussion of Rules 17Ad-22(b)(5), (6) and (7) in Section V.C.5 (benefits and costs of broad access requirements and non-dealer membership).

546 See generally Bank for International Settlements, New Developments in Clearing and Settlement Arrangements for OTC Derivatives (Mar. 2007), at 27-29.

the open positions created by termination of the defaulter's contracts. But if the markets for the contracts cleared by the CCP are illiquid, prompt replacement of the contracts may induce adverse price movements, especially if the defaulting participant's positions are large. Consequently, the application of traditional default procedures to illiquid credit default swaps contracts may entail significant risk to the CCP.

To address this potential risk, these CCPs developed a default management process that requires traders from their clearing members to be seconded to the CCP to manage the defaulter's portfolio. They would be charged with neutralizing the market risk in the portfolio by entering into new OTC derivative contracts with non-defaulting clearing members. Once neutralized as much as possible, the portfolio would be divided and auctioned to non-defaulting members. The CCP would determine a reservation price for the auction, and if a non-defaulting clearing member's bid exceeds that reservation price, the auction would be deemed successful. If not, the auction would fail. In the event of a failed auction, the portfolio would be divided among the non-defaulting clearing members pro rata based on their volumes of business. Under this process, a non-defaulting CCP participant would bear the risk of entering the markets to hedge open positions created by a default only if it is a successful bidder or if one or more auctions fail and it is assigned positions because it has outstanding positions with the CCP.

This process creates a tension between the need for effective default management procedures and the maintenance of fair and open access to a CCP's services. Because of the stringent capital and other requirements imposed by the CCP's membership standards, membership in a CCP clearing security-based swaps generally has been limited to very large dealers, those meeting the outstanding swap portfolio amount and capital requirements. Current members may also have an incentive to exclude new members, either to manage counterparty

risk or to block competitors. Being a member of a CCP may provide a competitive boost to a new member that is a smaller dealer by allowing the CCP's creditworthiness to be substituted for that of the new member. Requirements that prevent smaller dealers from entering as new members may, therefore, undermine competition and the entry of new liquidity providers in the relevant market. Indeed, one committee argues that access criteria in credit default swaps have had the effect of excluding market participants such as mid-tier financial institutions and buy-side firms from direct access to CCPs.[547] While such requirements have to date been adopted only by CCPs that engage in the clearance and settlement of credit default swaps, the Commission believes that preventing the introduction of such requirements also may be an important consideration for other types of instruments.

c. Disclosure of Financial Information (practices as they relate to Rule 17Ad-22(c))

Currently, there is no rule requirement under the Exchange Act or Commission rule that mandates clearing agencies to record and maintain information about their financial resources. Nevertheless, as part of their ordinary risk management procedures developed in consultation with their members, clearing agencies produce at least quarterly internal reports regarding the ability of the CCP to withstand a default by the participant (or two participants) to which the clearing agency has the largest exposure in extreme but plausible market conditions. In addition, as part of the Commission's supervision, oversight and monitoring of clearing agencies, the Commission staff can obtain such information on request. However, clearing agencies do not all currently record and maintain documentation that explains the methodology used to compute their financial resource requirements as required by Rule 17Ad-22(b)(3).

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[547] See Committee on the Global Financial System, The Macrofinancial Implications of Alternative Configurations for Access to Central Counterparties in OTC Derivatives Markets (Nov. 2011), at 9.

Commission staff guidance to clearing agencies provides that clearing agencies should provide, within 60 days following the close of the clearing agency's fiscal year, audited annual financial statements to those participants who have made clearing fund contributions and/or have money and/or securities in the clearing agency's systems.[548] With one exception, the clearing agencies report their accounting information in U.S. GAAP.[549] At present, clearing agencies publish annual audited financial statements on their respective websites and provide unaudited quarterly and annual audited financial statements to their members.[550] All the clearing agencies currently have their financial statements audited in accordance with the standards of the PCAOB by a registered public accounting firm, and when the financial statements are posted on their websites, the clearing agencies include the report of the auditor.

d. Comparison of Current Practices and Rule to CPSS-IOSCO Recommendations as Related to Rules 17Ad-22(b)(1)–(3) and (d)

In 2009, based upon an agreement reached with the U.S. Department of Treasury, the operations of several U.S. clearing agencies were assessed by independent assessors from the

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548 See Exchange Act Release No. 16900 (June 17, 1980). Because BSECC and SCCP do not conduct clearance and settlement operations they do not post audited financial statements. See supra note 438.

549 ICE Clear Europe posts financial statements in UK GAAP.

550 See DTC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Dec. 12, 2011), available at http://www.dtcc.com/legal/compliance/DTC_Self-Assessment.pdf; NSCC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Nov. 14, 2011), available at http://www.dtcc.com/legal/compliance/NSCC_Self_Assessment.pdf; FICC/GSD's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Dec. 15, 2011), available at http://www.dtcc.com/legal/compliance/FICC_Self-Assessment.pdf.

IMF against the CPSS-IOSCO Recommendations.[551] The IMF's assessments supported a finding of full or broad observance of the CPSS-IOSCO Recommendations by each of the clearing agencies registered with the Commission at that time. Further, CME, ICE Clear Credit and ICE Clear Europe represented to the Commission that they met the standards set forth in the RCCP when they sought to obtain an exemption from the Commission to provide CCP services for credit default swaps transactions.[552] Only one CCP, OCC, has not either been subject to an assessment using the RCCP or publicly stated its view on whether it complies with the RCCP.[553] Rules 17Ad-22(b)(1), (2), (3) and (d) are largely modeled on the CPSS-IOSCO Recommendations and therefore are largely consistent with observed practices.

The table below maps the requirements of Rules 17Ad-22(b)(1)–(3) and (d) to the corresponding CPSS-IOSCO Recommendations.

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551 See supra note 183.

552 See generally Securities Exchange Act Release No. 60372 (July 23, 2009), 74 FR 37748 (July 29, 2009) (temporary exemptions in connection with CDS clearing by ICE Clear Europe); Securities Exchange Act Release No. 60373 (July 23, 2009), 74 FR 37740 (July 29, 2009) (temporary exemptions in connection with CDS clearing by Eurex Clearing AG); Securities Exchange Act Release No. 59578 (Mar. 13, 2009), 74 FR 11781 (Mar. 19, 2009) ("March 2009 CME order") and Securities Exchange Act Release No. 61164 (Dec. 14, 2009), 74 FR 67258 (Dec. 18, 2009) ("December 2009 CME order") (temporary exemptions in connection with CDS clearing by CME); Securities Exchange Act Release No. 59527 (Mar. 6, 2009), 74 FR 10791 (Mar. 12, 2009), Securities Exchange Act Release No. 61119 (Dec. 4, 2009), 74 FR 65554 (Dec. 10, 2009), and Securities Exchange Act Release No. 61662 (Mar. 5, 2010), 75 FR 11589 (Mar. 11, 2010) (temporary exemptions in connection with CDS clearing by ICE Trust U.S. LLC).

553 Nevertheless, the Commission has approved a proposed rule change by OCC that revised its clearing fund formula so that it would be the larger of either of the following events: (1) the default of the largest single clearing member group; or (2) an event involving the near-simultaneous default of two randomly-selected clearing member groups. For a more complete description of the proposed rule change, see discussion of the costs of Rule 17Ad-22(b)(3).

Comparison of Rule 17Ad-22 to CPSS-IOSCO RCCP and RSSS Standards		
Rule 17Ad-22	**CPSS-IOSCO RCCP and RSSS**	
17Ad-22 (b)(1): Measurement and management of credit exposures	**RCCP Recommendation 3**	
17Ad-22 (b)(2): Margin requirements	**RCCP Recommendation 4**	
17Ad-22 (b)(3): Financial resources	**RCCP Recommendation 5**[554]	
17Ad-22 (d)(1): Transparent and enforceable rules	**RCCP Recommendation 1 and RSSS Recommendation 1**	
17Ad-22 (d)(2): Participation requirements	**RCCP Recommendation 2 and RSSS Recommendation 2**	
17Ad-22 (d)(3): Custody of assets and investment risk	**RCCP Recommendation 7and RSSS Recommendation 7**	
17Ad-22 (d)(4): Identification and mitigation of operational risk	**RCCP Recommendation 8 and RSSS Recommendation 11**	
17Ad-22 (d)(5): Money settlement risks	**RCCP Recommendation 9 and RSSS Recommendation 10**	
17Ad-22 (d)(6): Cost-effectiveness	**RCCP Recommendation 12 and RSSS Recommendation 15**	
17Ad-22 (d)(7): Links	**RCCP Recommendation 10 and RSSS Recommendation 19**	
17Ad-22 (d)(8): Governance	**RCCP Recommendation 13 and RSSS Recommendation 13**	
17Ad-22 (d)(9): Information on services	**RCCP Recommendation 14 and RSSS Recommendation 17**	
17Ad-22 (d)(10): Immobilization and dematerialization of securities certificates	**RSSS Recommendation 6**	
17Ad-22 (d)(11): Default procedures	**RCCP Recommendation 6**	
17Ad-22 (d)(12): Timing of settlement finality	**RSSS Recommendation 8**	

554 RCCP Recommendation 5: Financial Resources states that "[a] CCP should maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions." The explanatory note states that this should be viewed as a minimum standard and that planning by a CCP should consider the potential for two or more participants to default in a short time frame. Rule 17Ad-22(b)(3) requires that a clearing agency that provides CCP services maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which it has the largest exposure in extreme but plausible market conditions; provided that a security-based swap clearing agency shall maintain sufficient financial resources to withstand, at a minimum, a default by the two participant families to which it has the largest exposures in extreme but plausible market conditions.

17Ad-22 (d)(13): Delivery versus payment	**RSSS Recommendation 7**	
17Ad-22 (d)(14): Controls to address participants' failure to settle	**RSSS Recommendation 9**	
17Ad-22 (d)(15): Physical delivery risks	**RCCP Recommendation 10**	

C. Consideration of Costs, Benefits, and the Effect on Efficiency, Competition and Capital Formation

1. Overview

The purpose of each rule being adopted today is to enhance the regulatory framework for registered clearing agencies. This regulatory framework will facilitate ongoing compliance with the statutory requirements that clearing agencies have rules that facilitate the prompt and accurate clearance and settlement of securities transactions and derivative agreements, contracts and transactions for which they are responsible, and safeguard funds and securities. The rules do so by requiring certain minimum standards. The Commission believes that these requirements will help ensure resilient and cost-effective clearing agency operations as well as promote transparency that would consequently support confidence among market participants in clearing agencies' ability to serve as efficient and financially stable mechanisms for clearance and settlement and to facilitate capital formation.

In addition, the rules relating to membership requirements will help facilitate broad participation and open access to clearing agencies. If the rules enhance market participation by investors, the rules may thereby increase price competition, discovery, and price efficiency in the securities cleared by the clearing agency.

Taken together, the rules are largely consistent with existing industry practices. In particular, Rules 17Ad-22(b)(1)–(3) and (d) are modeled on the CPSS-IOSCO Recommendations, which have been in place since 2004 and are generally observed by all

clearing agencies. Rule 17Ad-22(c)(2) would codify the existing practice of most registered clearing agencies of maintaining certain financial information on their websites. Registered CCPs already disclose their annual audited financial statements on their websites, and all except for one registered CCP prepare such financial statements using U.S. GAAP or IFRS.[555] By codifying existing practices, the rules ensure that these benefits are being achieved with minimal need for change or for disruption to the affected industry, while also providing new entrants with legal certainty and transparency in meeting regulatory standards. At the same time, the rules have been written to accommodate changes in technology and market developments. Lastly, Rules 17Ad-22(b)(4) and (b)(5)–(7) establish new minimum practices for clearing agencies with regard to model validation and membership practices respectively.

In the Proposing Release, the Commission identified potential costs and benefits resulting from Rule 17Ad-22, as proposed, and requested comment on all aspects of the cost-benefit analysis, including the identification and assessment of any costs and benefits that were discussed in the analysis.

The Commission carefully considered all comments received on the Proposing Release. The comments are discussed above in Section III in relation to each part of Rule 17Ad-22. In particular, the Commission carefully considered comments setting forth alternatives to the requirements contained in Rule 17Ad-22. The discussion immediately below takes into account the alternatives proposed by commenters. Several commenters argued that Rule 17Ad-22(d) should not apply to entities that perform certain post-trade processing services (i.e., comparison of trade data, collateral management and tear-up/compression).[556] In response to those

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555 ICE Clear Europe posts financial statements prepared in accordance with UK GAAP.

556 See generally TriOptima Letter; Markit (April) Letter; Markit (July) Letter; MarkitSERV (April) Letter; MarkitSERV (July) Letter; Omgeo Letter.

comments, the Commission has limited the scope of Rule 17Ad-22 to clearing agencies that are registered with the Commission.

As discussed above, many of the provisions in Rule 17Ad-22 are modeled on the CPSS-IOSCO Recommendations. As a general alternative to prescribing its own requirements under Rule 17Ad-22, the Commission considered requiring registered clearing agencies to perform self-assessments using the CPSS-IOSCO Recommendations. This approach would have been similar to the Board's amendment to its Payment System Risk Policy Statement that directed certain systemically important entities to conduct self-assessment using the CPSS-IOSCO Recommendations.[557] The Commission decided against this alternative because the Commission believes that it would be more appropriate for the Commission to require registered clearing agencies to conduct assessments against Commission rules because the Commission's regulatory approach relies on examining and inspecting for compliance with, and, if necessary, enforcing, a clear set of rules. Lastly, the Commission also considered alternatives to each of the individual provisions of Rule 17Ad-22, which are discussed in more detail below.

The Commission believes the resulting revised regulatory framework should enhance confidence in the market and better serve market participants. With the adoption of these rules, clearing agencies will be well-positioned to withstand market volatility and evolve with market developments and technological advancements. Establishing rules that are consistent with current practice minimizes up-front costs and provides a good starting point for promoting appropriate risk management practices. As clearing agency practices evolve over time in response changes in technology, legal requirements and other factors, clearing agencies may need to make appropriate updates and improvements to their operations and risk management

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[557] See supra note 33.

practices, and as a result, actual costs of ongoing compliance with Rule 17Ad-22 may differ from the estimates discussed below.

The following addresses the entire rule and each rule provision being adopted today, its purpose, benefits and costs, and the impact of the rule on efficiency, competition and capital formation.[558]

2. Purpose of Rule 17Ad-22

The adoption by the Commission of Rule 17Ad-22 should benefit the U.S. financial markets in several ways. Because market participants and regulatory authorities are familiar with the CPSS-IOSCO Recommendations upon which Rule 17Ad-22 is based, the provisions being adopted today will increase the consistency among regulatory frameworks worldwide and thus diminish the opportunities for regulatory arbitrage. Since their publication in 2001, and 2004, respectively, the RSSS and RCCP have been used by the World Bank and IMF in numerous technical assistance and FSAP missions.[559] Regulators from multiple jurisdictions also have assessed the operations of clearing organizations using the RSSS and RCCP and

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558 Section 3(f) of the Exchange Act requires the SEC, whenever it engages in rulemaking pursuant to the Exchange Act and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act requires the SEC, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) of the Exchange Act also prohibits the SEC from adopting any such rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

559 Between 2000 and 2009, 35 securities settlement systems were assessed against the RSSS in 22 countries during FSAP and FSAP update missions. See Presentation by Massimo Cirasino, World Bank, and Christine Sampic, IMF, Financial Infrastructure Week, Rio de Janeiro, Brazil (Mar. 15, 2011).

incorporated them into their regulatory frameworks.[560] The CPSS-IOSCO Recommendations have been used as a recognized standard for market participants and regulators to compare the operations of CCPs and CSDs.

The establishment of consistent standards for CCP and CSD operations is an important goal that underpinned the enactment of Section 17A of the Exchange Act. When Congress adopted Section 17A, as part of the 1975 Amendments to the Securities Act ("1975 Amendments"), it determined that the implementation of linked systems for clearance and settlement and uniform standards would reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors. The legislative history noted that when broker-dealers must deal with a dozen or more different clearing and depository systems in their daily securities operations, the result is excessive cost and poorer service to investors.[561] Rule 17Ad-22 establishes minimum standards for the operations and risk management practices for clearing agencies that are consistent with the standards for CCPs and CSDs operating domestically and in other jurisdictions.

Furthermore, Rule 17Ad-22 will have the benefit of serving as a minimum benchmark for the Commission in making its required determinations regarding the rules of registered clearing agencies. For example, for a clearing agency to be registered under Section 17A, the Commission must find that it has the ability to facilitate the prompt and accurate clearance and settlement of transactions, to safeguard investor funds and securities, to remove impediments to and to perfect the mechanism of a national clearance and settlement system, and in general to protect investors and the public interest. Also, the clearing agency's rules must provide adequate

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560 For example, the Board also has proposed a rule that is modeled on the CPSS-IOSCO Recommendations and substantially similar to Rule 17Ad-22. See 76 FR 18452 (Apr. 4, 2011).

561 S. Rep. 94-75, 94th Cong., 1st Sess., at 184 (1975).

access to qualified participants, fair representation of shareholders and participants, equitable pricing, discipline of participants, and must not impose any undue burden on competition.

Rule 17Ad-22 will also have the benefit of augmenting the Commission's ability to regulate clearing agencies. Because clearing agencies are SROs, after a clearing agency has been registered with the Commission, the clearing agency must submit proposed rule changes to the Commission for approval under Exchange Act Rule 19b-4. To approve a clearing agency's proposed rule change, the Commission must find that it complies with Section 17A. The minimum benchmark established by Rule 17Ad-22 will help ensure and demonstrate that the existing operations of clearing agencies and their proposed rule changes meet or exceed international standards while remaining appropriate for the individual clearing agency. As a result, a clearing agency cannot use Rule 17Ad-22 to reduce the strength of its operational standards or adopt a new policy or procedure that the Commission believes does not meet the requirements of Section 17A.

Finally, the Commission believes Rule 17Ad-22 will help market participants be in a position to better compare the operations of U.S. clearing agencies with non-U.S. clearing organizations. In addition, the Commission's adoption of Rule 17Ad-22 will lead to greater confidence, both domestically and internationally, in the resiliency of clearing agencies and their ability to support the U.S. financial markets. The Commission's adoption of Rule 17Ad-22 may also reduce some of the potential regulatory burden for CCPs and CSDs that may be dually-regulated by the SEC and another domestic or foreign regulator because it is modeled on standards already employed by other regulatory authorities.

Below we discuss a number of costs and benefits that are related to the rule being adopted today. Many of these costs and benefits are difficult to quantify with any degree of certainty,

especially as practices at clearing agencies are anticipated to evolve and appropriately adapt to changes in technology and market developments. In addition, the extent to which the increased ability to enforce standards that are incorporated in the rule will help limit future risks is unknown. Moreover, this difficulty is aggravated by the fact that limited public data exists that is related to a clearing agency's risk management practices that could assist in quantifying certain costs. Therefore, much of the discussion is qualitative in nature but where possible, we quantify the costs.

Many, but not all, of the costs of the rule involve a collection of information, and these costs and burdens were discussed in the Paperwork Reduction Act section. When monetized[562] those estimated burdens and costs total $3.7 million[563] in initial costs and $10.1 million[564] in

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562 To monetize the internal costs the Commission staff used data from the SIFMA publications, Management and Professional Earnings in the Security Industry- 2010, and Office Salaries in the Securities Industry – 2010, modified by the Commission staff to account for an 1800 hour work-year and multiplied by 5.35 (professionals) or 2.93 (office) to account for bonuses, firm size, employee benefits and overhead.

563 The total initial cost was calculated as follows: [for Rules 17Ad-22(b)(1)–(3) and (d)(1)–(15) (Assistant General Counsel for 60 hours at $430 per hour) + (Compliance Attorney for 85 hours at $320 per hour) + (Computer Operations Department Manager for 15 hours at $367 per hour) + (Senior Business Analyst for 15 hours at $232 per hour) = $61,985 x 10 respondents = $619,850]; + [for Rule 17Ad-22(b)(4) ((Assistant General Counsel for 87 hours at $430 per hour) + (Compliance Attorney for 77 hours at $320 per hour) + (Computer Operations Department Manager for 23 hours at $367 per hour) + (Senior Business Analyst for 23 hours at $232 per hour) = $75,827 x 9 respondents = $682,443) + ((Chief Compliance Officer for 40 hours at $423 per hour) + (Computer Department Operations Manager for 40 hours at $367 per hour) + (Senior Programmer for 20 hours at $304 per hour) = $37,680 x 9 respondents = $339,120) = $1,021,563]; + [for Rules 17Ad-22(b)(5)–(7) (Assistant General Counsel for 87 hours at $430 per hour) + (Compliance Attorney for 77 hours at $320 per hour) + (Computer Operations Department Manager for 23 hours at $367 per hour) + (Senior Business Analyst for 23 hours at $232 per hour)) = $75,827 x 9 respondents = $682,443]; + [for Rule 17Ad-22(c) ((Assistant General Counsel for 60 hours at $430 per hour) + (Compliance Attorney for 85 hours at $320 per hour) + (Computer Operations Department Manager for 23 hours at $367 per hour) + (Senior Business Analyst for 23 hours at $232 per hour) = $66,777 x 10 respondents = $667,770) + ((Chief Compliance Officer for 40 hours at $423 per hour) + (Computer Department Operations Manager for 40 hours at $367 per hour) + (Senior

annual ongoing costs. A detailed discussion of other economic costs of the rulemaking is provided below.

Many parts of Rule 17Ad-22 are consistent with current practice and therefore should not impose significant costs on registered clearing agencies to comply with those provisions. As noted above, Rule 17Ad-22 also will have the benefit of augmenting the Commission's ability to regulate clearing agencies. Rule 17Ad-22 should improve access to security-based swap clearing agencies. The extent to which security-based swap participants that will be eligible under new access requirements choose to become members is unknown and we are unaware of empirical data on the potential impact that this will have on competition in the security-based swap market. Therefore, the quantification of this benefit is not feasible.

3. Definitions (Rules 17Ad-22(a)(1)–(5))

a. Rule 17Ad-22(a)(1)

Rule 17Ad-22(a)(1) would define "central counterparty" as a clearing agency that interposes itself between counterparties to securities transactions to act functionally as the buyer

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Programmer for 20 hours at $304 per hour) = $37,680 x 10 respondents = $376,800) = $1,044,570] + [for Rule 17Ad-22(c)(2) (Senior Accountant for 500 hours at $198 per hour) x 4 respondents = $396,000] = $3,764,426.

564 The total ongoing cost was calculated as follows: [for Rules 17Ad-22(b)(1)–(3) and (d)(1)–(15) (Compliance Attorney for 60 hours at $320 per hour = $19,200 x 10 respondents = $192,000)]; + [for Rule 17Ad-22(b)(4) ((Compliance Attorney for 60 hours at $320 per hour = $19,200 x 9 respondents = $172,800) + (2 Independent Consultants for 30 hours per week at $600 per hour = $36,000 per week x 12 weeks = $432,000 x 9 respondents = $3,888,000) = $4,060,800]; + [for Rules 17Ad-22(b)(5)–(7) (Compliance Attorney for 60 hours at $320 per hour = $19,200 x 9 respondents = $172,800]; + [for Rule 17Ad-22(c) (Compliance Attorney for 60 hours at $320 per hour = $19,200 x 10 respondents = $192,000)]; [for Rule 17Ad-22(c)(1) (Compliance Attorney for 1 hour at $320 per hour) + (Computer Operations Department Manager for 2 hours at $367) = $1,054 per quarter x 4 quarters per year = $4,216 per year x 9 respondents = $37,944]; [for Rule 17Ad-22(c)(2) (Senior Accountant for 250 hours at $198 per hour) x 10 respondents = $495,000) + (Independent Audit Fee = $500,000 per year x 10 respondents = $5,000,000)] = $10,150,544.

to every seller and as the seller to every buyer. The definition contained in this rule is generally consistent with the common usage and understanding of that term.[565] The costs and benefits associated with the impacts of the definition are incorporated in the discussion below related to the costs and benefits of the provisions where the definition is used.

b. Rules 17Ad-22(a)(2) and (5)

Rule 17Ad-22(a)(2) would define "central securities depository services" to mean services of a clearing agency that is a securities depository as described in Section 3(a)(23) of the Exchange Act.[566] Rule 17Ad-22(a)(5) would define "net capital," for the limited purpose of Rule 17Ad-22(b)(7), to have the same meaning as set forth in Rule 15c3-1 under the Exchange Act for broker-dealers or any similar risk adjusted capital calculation for all other prospective clearing members.[567] The costs and benefits associated with the impacts of the definition are incorporated in the discussion below related to the costs and benefits of the provisions where the definition is used.

c. Rule 17Ad-22(a)(3)

Rule 17Ad-22(a)(3) would define "participant family," for the limited purposes of Rules 17Ad-22(b)(3) and 17Ad-22(d)(14), to mean that if a participant controls another participant, or is under common control with another participant, then the affiliated participants shall be

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565 See RCCP, supra note 33, Annex 5: Glossary.

566 "[Clearing agency] also means any person, such as a securities depository, who (i) acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates, or (ii) otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates." 15 U.S.C. 78c(a)(23).

567 As appropriate, the clearing agency may develop risk adjusted capital calculations for prospective clearing members that are not broker-dealers.

collectively deemed to be a single participant. The Commission is not narrowing the definition of control in this context to mean ownership of 50% or more of the voting securities or other interests in a participant, as requested by one commenter.[568] We believe the more appropriate evaluation of control is based on the relation between the entities and the power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. In conducting this evaluation, clearing agencies should also be guided by the definition of "control" set forth in Rule 405 under the Exchange Act, using the information available to them. The costs and benefits associated with the impacts of the definition are incorporated in the discussion below related to the costs and benefits of the provisions where the definition is used.

d. Rule 17Ad-22(a)(4)

Rule 17Ad-22(a)(4) would define "normal market conditions" for the limited purposes of Rules 17Ad-22(b)(1) and (2), to mean conditions in which the expected movement of the price of cleared securities would produce changes in a clearing agency's exposures to its participants that would be expected to breach margin requirements or other risk control mechanisms only one percent of the time.[569]

The rule conforms to the generally recognized standard of "normal market conditions" as defined in the RCCP and is the benchmark for most CCPs' margin methodologies, many of which use risk-based models to ensure coverage at a 99% confidence interval, at minimum, over

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568 See supra note 107 and accompanying text.

569 The definition of normal market conditions in Rule 17Ad-22(a)(4) is consistent with the corresponding explanation established in the CPSS-IOSCO Recommendations. See RCCP, supra note 33, at 21 (explanatory note number 1).

a designated time horizon.[570] The standard also comports with the international standard for bank capital requirements established by the Bank for International Settlements, which requires banks to measure market risks at a 99% confidence interval when determining regulatory capital requirements.[571] The costs and benefits associated with the impacts of the definition are incorporated in the discussion below related to the costs and benefits of the provisions where the definition is used.

4. Risk Management Requirements for CCPs (Rules 17Ad-22(b)(1)–(4))

Rules 17Ad-22(b)(1)–(4) concern risk management requirements for clearing agencies that perform CCP services. In particular, these rules will require a clearing agency that provides CCP services to have written policies and procedures reasonably designed to: measure its credit exposures at least once a day, use margin requirements to limit its exposures to potential losses from defaults by its participants, use risk-based models and parameters to set margin requirements and to review such requirements at least monthly, maintain sufficient financial resources to withstand a default by the two participant families, if clearing security-based swaps, or one participant family otherwise, to which it has the largest exposure,[572] and provide for an annual model validation process.

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570 See RCCP, supra note 33 , Annex 5: Glossary. See also supra discussion on 99% confidence interval as an accepted standard for measuring market risk in Section II.B.2.b and discussion of current industry baselines in Section V.B.

571 See Bank for International Settlements' Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A Revised Framework (June 2004), available at http://www.bis.org/publ/bcbs107.pdf; see also Darryll Hendricks and Beverly Hirtle, New Capital Rule Signals Supervisory Shift, available at http://www.bis.org/bcbs/ca/alrequse98.pdf. See also supra notes 526-529 and accompanying text.

572 See Rule 17Ad-22(a)(3), supra Section III.B.3 (defining "participant family" for purposes of proposed Rule 17Ad-22(b)(3)).

As described above, these rules are consistent with current practice. Registered clearing agencies already have written policies and procedures designed to meet these risk management requirements, particularly Rules 17Ad-22(b)(1)–(3). While Rules 17Ad-22(b)(1)–(3) reflect the CPSS-IOSCO Recommendations, which are observed by all clearing agencies, Rule 17Ad-22(b)(4) would establish certain new minimum practices for clearing agencies.

- First, Rule 17Ad-22(b)(1) requires that each CCP measure its credit exposures at least once per day. This rule codifies the current minimum baseline adhered to by the two clearing agencies presently registered with the Commission that provide CCP services.
- Second, Rule 17Ad-22(b)(2) requires that each CCP collect margin from its participants to limit exposures resulting from changes in prices or participant positions in current market conditions. This margin can also be used to minimize the CCPs losses in the event of a participant default. This rule is consistent with the current practice of each CCP to calculate daily margin requirements using risk-based models to ensure coverage at a 99% confidence interval (i.e., under "normal market conditions"), at minimum, over a designated time-horizon.
- Third, and consistent with Rule 17Ad-22(b)(3), each CCP currently maintains sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions.[573] In addition, both registered CCPs clearing security-based swap transactions maintain additional financial resources sufficient to withstand the

[573] See, e.g., supra notes 168 and 183.

simultaneous default by the two participant families to which the CCPs have the largest exposures.

- Fourth, Rule 17Ad-22(b)(4) would ensure that all CCPs have annual model validations performed by a qualified person who is free from influence from the persons responsible for development or operation of the models being validated.

While not requiring major changes to existing operational practices and policies and procedures currently in place at most registered clearing agencies, Rules 17Ad-22(b)(1)–(4) provide enforceability to minimum standards regarding how clearing agencies manage counterparty credit and default risks. One of the primary roles of a CCP is to mitigate counterparty credit and default risk. Because of the role margin plays in a default, a CCP must have confidence that the liquidation value of available margin will be sufficient to cover amounts owed by a defaulting participant to the clearing agency, and that the margin will be available for liquidation without delay. As described in the baseline discussion,[574] CCPs have mechanisms and procedures in place to measure credit exposure. To effectively mitigate counterparty credit risk, a CCP must have accurate and timely measurements of its credit exposures to each of its counterparties, and must impose adequate margin requirements determined by risk-based models and parameters. CCPs may be faced with significant and rapid changes in counterparty credit exposures.

Frequent measurement of counterparty credit exposures and the use of validated risk-based modeling are essential to setting adequate margin requirements. A good margin setting methodology will help avoid both under- and over-collateralization. Under-collateralization

[574] See supra Section V.B.2.a.

exposes a CCP to increased credit risk in the event of a participant default, as the CCP may be unable to recover amounts owed to it from the participant on an unsecured basis. Incurring losses on a counterparty default could disrupt the operations of the clearing agency as well as its non-defaulting participants by exposing them to unanticipated liabilities. These disruptions could negatively impact price efficiency and capital formation if distressed liquidations result in prices away from fundamental values for significant periods of time. Over-collateralization imposes unnecessary costs on trading by tying up clearing member assets that could otherwise be used more efficiently, harming allocative efficiency and capital formation. The Commission believes that Rules 17Ad-22(b)(1)–(4) creates standards to mitigate a CCP's risks associated with counterparty credit exposures and defaults.

Rules 17Ad-22(b)(1)–(4) acknowledge that appropriate risk management will vary based on a number of factors relating to the markets and products a CCP serves. Subject to minimum standards, the rules permit each clearing agency the flexibility to develop the most effective and economically efficient risk measurement and risk-based modeling approaches for each of its unique markets and products to achieve an optimal level of risk mitigation. By setting only a minimum standard, the rules also allow each CCP to adapt its risk management strategies as needed in response to dynamic market conditions rather than locking the CCP into a fixed set of risk mitigation rules. The minimum standards also prevent a CCP from establishing risk monitoring procedures below a baseline in an effort to reduce costs and gain a competitive advantage.

The Commission believes that credit exposures should be measured at least once a day because a clearing agency that did not do so would not be able to effectively manage its risk. However, the Commission believes that it cannot reasonably determine the most appropriate

frequency for CCPs to monitor their risk exposures in all circumstances. The minimum standards in Rules 17Ad-22(b)(1)–(4) are intentionally written to comply with CPSS-IOSCO Recommendations and limit systemic risk while not precluding entry to potential new entrant CCPs. Each CCP is exposed to participants in different markets characterized by different trading patterns, volumes, liquidity, transparency and other unique market characteristics. Rules 17Ad-22(b)(1)–(4) provide each CCP the flexibility to tailor its risk management practices to each of its unique markets and products, allowing it to develop the most economically efficient and effective risk mitigation strategies possible.

The Commission considered the range of practices at registered clearing agencies with respect to monitoring risk exposures and recognizes that there is a risk that by setting the minimum standards according to the highest level of current market practice, the standards could be too high for some potential market conditions or future security types. This could result in sub-optimal risk management practices for a period in the future to the extent such factors are not appropriately recognized by the Commission.

The Commission believes it is appropriate that CCPs clearing security-based swaps are held to the higher minimum standard in Rule 17Ad-22(b)(3) than CCPs that do not clear security-based swaps. In particular, the Commission believes that the requirement to maintain at a minimum financial resources capable of withstanding the default of its two largest participant families as opposed to only its largest participant family is at this time appropriate for clearing security-based swaps but not for other securities because of the unique and heightened risks posed by credit default swaps relative to traditional securities. Credit default swaps pose additional risk management challenges in that their value can change by a large amount in an

extremely short time interval (i.e., they are subject to significant jump-to-default risk).[575] Unlike many equity and fixed income securities, but similar to other derivative contracts, a CCP's obligation when clearing credit default swaps does not end when the transaction settles, but at its expiration. In addition, unlike other products that also exhibit these characteristics, credit default swaps are unique in their size relative to their underlying markets. Recent research shows that notional outstanding in credit default swaps are often close to or greater than the outstanding value of the underlying instruments.[576]

Several other factors also complicate risk modeling for credit default swaps. CCPs have only recently introduced clearing for security-based swaps, so the risk models used by CCPs have not yet been stressed by a substantial range of market conditions. In addition, many security-based swaps are relatively illiquid, which complicates the default management process. For example, more than 98% of single-name credit default swap reference entities trade less than 10 times per day.[577] Low liquidity typically leads to wider bid-ask spreads, greater price impact of trades, and potentially higher costs when finding replacements for defaulted positions.

The Commission recognizes that requiring a different standard for CCPs for security-based swaps could discourage new entrants from entering into the market for these instruments because of higher financial resource requirements relative to other types of instruments. In

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575 See supra note 162.

576 See supra note 163.

577 See Memorandum by the Commission's Division of Risk, Strategy, and Financial Innovation, Security-Based Swap Block Trade Definition Analysis (Jan. 13, 2011), available at http://www.sec.gov/comments/s7-34-10/s73410-12.pdf. See also Che Sidanius and Anne Wetherilt, Thoughts on Determining Central Clearing Eligibility of OTC Derivatives, (Bank of England, Financial Stability Paper, No. 14, Mar. 2012), available at http://www.bankofengland.co.uk/publications/Documents/fsr/fs_paper14.pdf. The authors report that in the six months ending February 2012, 90% of their sample of 1,000 single name CDS contracts trade an average of less than 50 times per week.

particular, the higher the financial resource requirements, the higher the costs to establish a new clearing agency, potentially resulting in fewer clearing agencies.

While the Commission is sensitive to the consequences of establishing a different standard for CCPs for security-based swaps, the Commission believes that the financial resources of a CCP must be robust enough to accommodate the risks that are particular to each market served--irrespective of whether such analysis results in different standards. As described above, the Commission believes that Rule 17Ad-22(b)(3) does not represent a change in practice for any CCP that currently clears credit default swaps, and to the extent that it represents an increased financial resources requirement for potential competitors, this increased burden is justified by the greater difficulty of risk-management in credit default swaps as opposed to traditional securities.[578] Furthermore, the Commission believes that the burdens associated with this provision are minimized as the rule permits registered CCPs to comply with the "cover two" requirement by establishing a separate fund and related procedures for their security-based swap operations if they prefer this structure to the application of the "cover two" requirement to the entire legal entity. As security-based swap products with different characteristics are proposed for clearing over time, the Commission would evaluate risk profiles of such products to consider how they would be treated under the "cover two" standard.

The Commission further recognizes the benefits associated with establishing financial resource requirements that are consistent with the international standards, such as the benefit of reduced incentives for regulatory arbitrage. The Commission notes that the "cover two"

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578 See CFTC-SEC Staff Roundtable on Clearing of Credit Default Swaps (Oct. 2010), at 123, available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission7_102210-transcrip.pdf (Stan Ivanov, ICE Clear Credit stating "at ICE we look at two simultaneous defaults of the two biggest losers upon extreme conditions…").

requirement for security-based swaps CCPs is consistent with the financial resource requirements for CCPs contained in the FMI Report[579] and in EMIR.

The Commission believes it is important to codify the practice of obtaining an annual model validation to ensure that a CCP can evaluate the continued appropriateness of its margin models. Rule 17Ad-22(b)(4) also should help CCPs better evaluate their margin models, which should promote greater confidence in clearing agencies' risk management practices.

The Commission is also mindful of the costs associated with the final rule. In particular, the Commission recognizes that though many parts of Rule 17Ad-22 being adopted by the Commission today are a codification of usual and customary practices at CCPs and clearing agencies, they may still impose costs.

As noted above, the standards contained in Rule 17Ad-22(b)(1)–(4) would impose certain burdens and related costs on respondent clearing agencies. As discussed in Section IV.C, based on policies and procedures requirements for Regulation NMS, and based on staff conversations with industry representatives, the Commission has estimated the burdens and related costs of these requirements for clearing agencies.

The clearing agency standards in Rules 17Ad-22(b)(1)–(4) may require respondent clearing agencies to review and amend their policies and procedures. The standards contained in Rule 17Ad-22(b)(4) also would impose one-time costs on clearing agencies to create policies and procedures as well as require one-time systems adjustments related to the capability to perform an annual model validation. The costs of creating these policies are included in the $3.7 million startup cost estimates discussed earlier.

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579 See FMI Report, Principles 4 and 7, supra note 32.

The standards contained in Rules 17Ad-22(b)(1)–(3) also would impose ongoing costs on clearing agencies such as monitoring and enforcement activities with respect to the policies and procedures the registered clearing agency creates in response to the standards. The ongoing costs of these monitoring and enforcement activities are included in the estimated $10.1 million annual costs discussed earlier.[580] These Rules may also impose additional incremental costs related to, for example, employee training, systems testing, and other operational considerations designed to ensure both initial and continued compliance with such policies and procedures.

The standards contained in Rule 17Ad-22(b)(4) would also impose ongoing costs on clearing agencies. For example, the clearing agency standards in Rule 17Ad-22(b)(4) would collectively require respondent CCPs to perform certain ongoing monitoring and enforcement activities with respect to the policies and procedures the clearing agency creates in response to the standard and to provide for an annual model validation. The Commission believes clearing agencies would hire a consulting firm[581] that dedicates two consultants to the project. The costs for the consultants are included in the $10.1 million annual paperwork cost discussed earlier. Rule 17Ad-22(b)(4) may also impose additional incremental costs associated with employee training, systems testing, and other operational considerations designed to ensure initial and continued compliance with the clearing agencies model validation policies and procedures.

Except as noted above, Rules 17Ad-22(b)(1)–(4) establish standards that are already largely adhered to in practice by each CCP registered with the Commission. Thus, while Rules 17Ad-22(b)(1)–(4) will require each currently registered CCP to continue the expenditures

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580 This number also reflects the costs of Rules 17Ad-22(d)(1)–(15).

581 Currently, the majority of the clearing agencies performing model validation employ a consulting firm; the remainder of the clearing agencies have created an internal model validation group that does not report to the person overseeing the development or operation of the models.

associated with maintaining current rules, policies, and procedures, they should impose limited incremental costs.

In the Proposing Release, the Commission identified potential costs and benefits resulting from Rules 17Ad-22(b)(1)–(4), as proposed, and requested comment on all aspects of the cost-benefit analysis, including the identification and assessment of any costs and benefits that were not discussed in the analysis. Although the Commission did not receive any comments on the specific cost-benefit analysis contained in the Proposing Release, several commenters raised concerns, which are discussed above in Section III.C.1.b, that have a bearing on the costs and benefits associated with the rule. In response to these comments, the Commission carefully considered alternatives to the approach we are adopting in Rule 17Ad-22, including more prescriptive alternatives (e.g., specifying how many times a day a clearing agency should measure its credit exposures to its participants). However, as noted above, clearing agencies match the frequency of credit exposure calculations to the horizon of the guarantee they provide. The requirement to measure credit exposure at least once per day does not preclude more frequent measurement of credit exposure, allowing those who guarantee intraday to measure exposures intraday. Therefore, the Commission believes the flexibility provided by Rules 17Ad-22(b)(1) and (2) appropriately reflects differences in clearing agency models.

The Commission also considered alternatives to Rule 17Ad-22(b)(3), such as (1) requiring each clearing agency, regardless of the securities cleared, to maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which it has the largest exposure in extreme but plausible market conditions, and (2) requiring each clearing agency, regardless of the securities cleared, to maintain sufficient financial resources to withstand, at a minimum, a default by the two participant families to which it has the largest

exposure in extreme but plausible market conditions. The Commission decided to create separate standards for the two different kinds of CCPs because it believes that clearing security-based swaps is inherently riskier than clearing other types of securities, as discussed above.

Furthermore, the Commission considered a number of alternatives to provisions in Rule 17Ad-22(b)(4). For example, one alternative was to be more prescriptive in identifying who could perform the annual model validations. The Commission recognizes there is a tradeoff between the need for expertise in conducting model validations and the independence of the validator. Therefore, Rule 17Ad-22(b)(4) sets a principle that allows the clearing agencies to balance this trade-off in a way that satisfies the purpose of the validation. The Commission also considered alternatives, which would have required that model validations occur more or less frequently than annually. The Commission believes that requiring model validation at least annually is appropriate because it complies with CPSS-IOSCO Recommendations and clearing agencies have economic incentives to evaluate their models more frequently if market conditions change, whether or not they are required to do so by Commission rules.

5. Participant Access Standards for CCPs (Rules 17Ad(b)(5)–(7))

These rules establish requirements for policies and procedures detailing membership practices. Although we believe that these rules reflect current practices for some CCPs, they may require a change in practice for others. Specifically, Rules 17Ad-22(b)(5), (6) and (7) would introduce certain requirements regarding access to CCPs, including that each CCP must: (1) provide the opportunity for a person who does not perform any dealer or security-based swap dealer services to obtain membership; (2) preclude the use of minimum portfolio size thresholds and minimum transaction volume thresholds as conditions to membership; and (3) provide the ability to obtain membership to persons who maintain net capital equal to or greater than $50

million.

The Commission is adopting Rules 17Ad-22(b)(5), (6) and (7) to establish a regulatory framework for registered CCPs regarding membership practices. These rules also address concerns about access to central clearing in light of the proposed implementation of mandatory clearing requirements around the world.[582] The Commission believes that Rules 17Ad-22(b)(5), (6) and (7) will complement Section 17A of the Exchange Act, which requires that a clearing agency shall not be registered unless the Commission determines, among other things, that the clearing agency's rules do not impose burdens on competition that are unnecessary or inappropriate to promote the purposes of the Exchange Act[583] and that the rules are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency.[584]

As described above, CCPs for securities other than security-based swaps generally do not engage in the practices that Rules 17Ad-22(b)(5), (6), and (7) are designed to prevent. However, CCPs for security-based swaps have required members to have a minimum portfolio size (e.g., $1 trillion outstanding) or minimum trading volume, meet very high minimum capital requirements (e.g., $5 billion), and require members to operate a dealer business. Rule 17Ad-22 is designed to prohibit these types of practices by all CCPs, irrespective of the types of products cleared, by establishing a minimum standard that would have the benefit of uniformity for currently registered CCPs and any future market entrants.

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582 See, e.g., CFTC-SEC Staff Roundtable on Clearing of Credit Default Swaps (Oct. 2010), available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission7_102210-transcrip.pdf.

583 15 U.S.C. 78q-1(b)(3)(F).

584 15 U.S.C. 78q-1(b)(3)(G).

CCPs have membership requirements so that the CCPs and their members can limit their exposures to less creditworthy market participants. However, as noted above, members may have the incentive to promote membership requirements that limit access to the CCP for competitive reasons. While such requirements have to date been adopted only by CCPs that engage in the clearance and settlement of credit default swaps, the Commission believes that preventing the introduction of such requirements also may be an important consideration for CCPs that clear other instruments.[585] If a clearing agency clears both security-based swaps and other securities, Rule 17Ad-22(b)(6) will prohibit the clearing agency from denying membership solely because the applicant did not maintain a minimum portfolio size or minimum volume in security-based swap transactions. The rule is being applied to all clearing agencies, regardless of the type of instrument cleared, so that an existing or future clearing agency could not use its market power to exclude potential applicants for the benefit of its existing members or unnecessarily restrict access to central clearing. Indeed, the concerns noted above about the incentives to control access to CCPs could apply to the clearing of any security. Accordingly, all CCPs, regardless of the type of security, will be subject to Rules 17Ad-22(b)(5), (6), and (7).

The Commission believes that no registered CCP should deny membership solely because a person does not perform any dealer or security-based swap dealer services or based on a minimum portfolio size or minimum transaction volume thresholds. The Commission does not believe that these factors are, by themselves, appropriate indicators of whether an applicant should be admitted to membership in a clearing agency. The Commission is adopting Rule 17Ad-22(b)(5) to help to foster the development of correspondent clearing arrangements that will allow market participants that are not dealers or security-based swap dealers to obtain access to a

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585 See supra Section V.B.2.b and note 547.

CCP, which should have the beneficial result of greater competition in and access to central clearing because these persons do not execute securities trades for their own account. Instead, they provide correspondent clearing services for market participants.[586] As a result, their ability to provide correspondent clearing services would tend to increase as competition and transaction volumes increased. The Commission further believes that imposing minimum thresholds on the size or transaction volume of a participant's portfolio would not function as a good indicator of whether the participant is able to meet its obligations to a clearing agency.[587] New participants in a CCP that do not initially intend to or have the capacity to transact in substantial size or volume may nevertheless have the operational and financial capacity to perform the activities that other participants are able to perform but at lower size or volume levels. Accordingly, the Commission believes that Rule 17Ad-22(b)(6) will help facilitate the requirement in Section 17A of the Exchange Act that the rules of a clearing agency must permit fair and open access to qualified participants.

Rule 17Ad-22(b)(7) will significantly increase access to clearing membership in CCPs that clear credit default swaps while still allowing CCPs to maintain what the Commission believes will be sufficient net capital standards for members. For example, the rule establishes a minimum net capital requirement of $50 million that only approximately 201 broker-dealers, or four percent of the total number of registered broker-dealers, can satisfy today according to broker-dealer data available to the Commission. A net capital threshold of $100 million would reduce the number of broker-dealers that could meet the standard by 73 (36%) to 128 eligible firms, while a further reduction of the net capital requirement to $25 million would increase the number of eligible broker-

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586 See supra note 235.

587 Proposed Rule 17Ad-22(b)(6) would not prohibit a clearing agency from imposing maximum portfolio sizes or transaction volume amounts.

dealer firms by 86 (42%) to 287 (6% of all registered broker-dealers).[588] The Commission believes that firms that maintain a net capital level of at least $50 million have sufficient financial resources to participate at some level in a CCP, provided that they are able to comply with other reasonable membership standards, and that the increase in the potential pool of clearing members is consistent with the Commission's intention of expanding access to clearing.

The Commission carefully considered the tradeoffs of selecting a lower or higher net capital threshold. A higher net capital requirement may permit CCPs to exercise market power for the benefit of members by limiting membership to an unduly small group of firms.[589] This could limit competition in the market for supplying dealer services as dealers who are CCP members would have an advantage over other dealers. It could also increase overall systemic risk by concentrating the counterparty risk in relatively few participants. A less restrictive capital requirement may also result in incentives for firms that are not capable of participating in the default management process of a CPP to effectively "free ride" on the default services provided by the rest of the membership.[590] The Commission believes that the $50 million capital requirement appropriately balances these concerns and bridges the differences in current membership standards across registered clearing agencies. At the same time, the Commission notes that having a $50 million capital level does not create a right to membership.

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588 As stated above, the $50 million net capital requirement affects access to CCPs that clear CDS. The Commission recognizes that the number of dealers that clear CDS is significantly smaller than the total number of broker-dealers, and that even if Proposed Rule 17Ad-22(b)(7) is successful in encouraging the broadening of membership in CCPs that clear CDS, the Commission believes the number of broker-dealers newly eligible for clearing membership that become clearing members as a result of this change is likely to be substantially less than 201.

589 See Craig Pirrong, The Economics of Central Clearing: Theory and Practice (ISDA Discussion Papers Series, No. 1, May 2011), at 28.

590 See id. at 28.

In addition, we note that the $50 million requirement is the same as the CFTC's capital requirement for DCO membership.[591] Establishing a different requirement than that adopted by the CFTC could create opportunities for regulatory arbitrage and would in effect make one regulator's standard irrelevant for dually registered clearing agencies like CME, ICE Clear Credit and OCC. Furthermore, some of these competing concerns are addressed by the flexibility contemplated by Rule 17Ad-22(b)(7), as it permits each clearing agency to develop scalable policies and procedures to limit the activities of participants based on their level of net capital.[592] For example, a clearing agency can place limits on its potential exposure to participants operating at certain net capital thresholds by restricting the maximum size of the portfolio such participants are permitted to maintain at the clearing agency. The Commission also believes that Rule 17Ad-22(b)(7) would facilitate sound risk management practices by encouraging clearing agencies to examine and articulate the benefits of higher net capital requirements as a result of having clearing agencies develop scalable membership standards that link the nature and degree of participation with the potential risks posed by the participant.[593]

The Commission believes that Rules 17Ad-22(b)(5), (6) and (7) will create the potential for greater access to clearing services for, and opportunities for competition among market participants, particularly for credit default swaps. The Commission believes that greater access to clearing should benefit market participants by allowing them to provide equivalent access to CCP clearing services for security-based swaps to their customers. Doing so should increase

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591 See supra note 38.

592 The Commission notes that some clearing agencies currently utilize capital-related requirements that differentiate among types of participants. For instance, FICC has maintained a $50 million net worth requirement and $10 million excess net capital requirement for its Category 1 Dealer Netting Members and a $25 million net worth requirement and $10 million excess net capital requirement for its Category 2 Dealer Netting Members.

593 See supra note 264.

opportunities for competition among clearing firms on both price and service which should, in turn, reduce costs to the ultimate customers for the financial services being offered.

Rules 17Ad-22(b)(5), (6) and (7) may impose some costs on clearing agencies due to the increased complexity of the policies and procedures regulating access to the clearing agency. The Commission acknowledges that lowering membership standards to increase the number of participants may increase the likelihood of a participant default. Nevertheless, broadening direct access will tend to reduce the concentration of risk in any individual direct clearing member. Further, while Rules 17Ad-22(b)(5),(6) and (7) prohibit certain barriers to entry, these provisions nevertheless still provide clearing agencies with the flexibility to develop membership standards that maintain a robust risk management framework.

Typically, dealers innovate and customize in new financial contracts to address specific risk-management problems of their clients. It is not uncommon for these contracts to become exchange-traded, as the market for the product matures. Dealers, however, may have an incentive to maintain wider bid-ask spreads associated with a customized contract relative to the spreads that might apply if it were a standardized product. Greater access to a CCP could promote greater standardization because all CCP members could submit transactions to the CCP based on the CCP's pre-established rules. Accordingly, the Commission believes that expanded membership will promote the natural evolution of customized contracts to standardized contracts with deeper liquidity and reduced bid-asked spreads.

In terms of comments received, one commenter believed that the proposed rules are unnecessary and pointed to the existing requirement in Section 17A(b)(3)(F) of the Exchange Act that a clearing agency shall not be registered unless the Commission determines that the clearing agency's rules are not designed to permit unfair discrimination in the admission of

participants or among participants in the use of the clearing agency. The Commission believes Rules 17Ad-22(b)(5)–(7) will guide registered CCPs to practices that support the requirement to provide fair and open access.

The Commission is mindful of the costs associated with the final rules. In particular, the Commission recognizes that creating new policies and procedures can impose costs even if those policies and procedures largely codify current practice.

As noted above, the standards contained in Rules 17Ad-22(b)(5)–(7) would impose certain burdens and related costs on respondent clearing agencies. As discussed in Section IV.C.3, based on policies and procedures requirements for Regulation NMS, and based on staff conversations with industry representatives, the Commission has estimated the burdens and related costs of these requirements for clearing agencies.

The clearing agency standards in Rules 17Ad-22(b)(5)–(7) would require respondent clearing agencies to create policies and procedures. The standards contained in Rules 17Ad-22(b)(5)–(7) would also impose ongoing costs on clearing agencies. For example, the clearing agency standards in Rules 17Ad-22(b)(5)–(7) would collectively require respondent clearing agencies to perform certain ongoing monitoring and enforcement activities with respect to the policies and procedures the clearing agency creates in response to the standard. The costs of creating these policies and procedures, and performing ongoing monitoring and enforcement activities were included, respectively, in the $3.7 million startup costs and $10.1 million annual ongoing costs discussed earlier. These provisions may also impose incremental costs related to, for example, employee training, systems testing, and other operational considerations designed to ensure both initial and continued compliance with the clearing agency's participant access policies and procedures.

6. Record of Financial Resources and Annual Audited Financial Statements (Rules 17Ad-22(c)(1)–(2)).

Rule 17Ad-22(c)(1) provides that each fiscal quarter (based on calculations made as of the last business day of the clearing agency's fiscal quarter), or at any time upon Commission request, a CCP shall calculate and maintain a record[594] of the financial resources necessary to meet its requirement in proposed Rule 17Ad-22(b)(3) and sufficient documentation to explain the methodology it uses to compute such financial resource requirement.

Rule 17Ad-22(c)(2) requires a clearing agency, within 60 days after the end of its fiscal year, to post on its website annual audited financial statements. Such financial statements shall: (i) include, for the clearing agency and its subsidiaries, consolidated balance sheets as of the end of the two most recent fiscal years and statements of income, changes in stockholders' equity and other comprehensive income[595] and cash flows for each of the two most recent fiscal years; (ii) be prepared in accordance with U.S. GAAP, except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country the consolidated[596] financial statements may be prepared in accordance with U.S. GAAP or IFRS; (iii) be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in

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594 See Exchange Act Rule 17a-1 (17 CFR 240.17a-1). Clearing agencies may destroy or otherwise dispose of records at the end of five years consistent with Exchange Act Rule 17a-6 (17 CFR 240.17a-6).

595 The added language, "changes in stockholders' equity and other comprehensive income," does not change the substance of the rule as provided in the Proposing Release. This language has been added in the final rule to clarify the scope of what is meant by complete set of financial statements consistent with customary industry accounting practices.

596 The "consolidation" language does not change the substance of the rule as provided in the Proposing Release, but has been added to clarify that the financial statements requirement pertains to that of the clearing agencies and its subsidiaries on a consolidated basis.

accordance with Rule 2-01 of Regulation S-X (17 CFR 210.2-01); and (iv) include a report of the registered public accounting firm that complies with paragraphs (a) through (d) of Rule 2-02 of Regulation S-X (17 CFR 210.2-02).

Rule 17Ad-22(c)(1) is, for the most part, identical to what is described in the baseline section above, and thus, this rule will, for the most part, codify an existing practice of clearing agencies. The difference is that CCPs will now have to format and synthesize existing information in a manner sufficient to explain the methodology the clearing agency uses to meet the requirement of Rule 17Ad-22(b)(3).

In addition, Rule 17Ad-22(c)(2) is substantially similar to what is described in the baseline section above. Most clearing agencies report financial statements in accordance with Rule 17Ad-22(c)(2) with one exception.[597] Accordingly, Rule 17Ad-22(c)(2) is largely consistent with current practice and will impose minimal costs on registered clearing agencies.[598]

As described above, these two rules, except where noted above, codify current practice. To the extent that current practice is not currently required by rule, the rules being adopted today allow for greater enforceability of these disclosure practices, and as a result ensure that CCPs continue to maintain an environment of transparency.

Rule 17Ad-22(c)(1) ensures that the Commission continues to be able to monitor whether CCPs maintain the financial resources necessary to meet its requirement in proposed Rule 17Ad-22(b)(3). The requirement that CCPs will have to format and synthesize existing information in a manner sufficient to explain the methodology the clearing agency uses to meet the requirement of Rule 17Ad-22(c)(1), facilitates the Commission's access to this information in a format that is

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597 See supra note 549.

598 Because BSECC and SCCP conduct no operations, we also expect their respective costs to be minimal.

clear and understandable, and ensures that the Commission can obtain sufficient documentation to understand and evaluate the methodology used by the CCP to compute such financial resource requirement.

Rule 17Ad-22(c)(2) ensures that CCPs continue to provide transparency to regulators and market participants. Transparency helps to ensure that market participants in general have better information about the stability of the system, and facilitates monitoring by the Commission and other regulators, clearing members, investors, academics and the public in general. Further, to the extent that CCPs are systemically important institutions, regulators may also be monitoring systemic risk when monitoring CCPs.

Transparency is particularly important to clearing members, whose capital is at risk if a clearing member fails. Clearing members can use the information codified in this rule to assess risks related to their participation in the CCP and manage those risks. The information codified in this rule can also be used by clearing members in a way that promotes competition. In situations where multiple CCPs clear the same product, clearing members may base their decision on which CCP to use on the financial information codified in Rule 17Ad-22(c)(2), which requires that CCPs make their financial information available to the public, even during times of market stress. It is possible that if the financial position of the CCP deteriorates, clearing members and investors may discontinue membership in or otherwise limit their use of that CCP, therefore driving CCPs with substandard risk management practices out of business.

The Commission carefully considered alternatives to these provisions. For example, an alternative to the requirements of Rule 17Ad-22(c)(2) would be to permit registered clearing agencies to post audited financial statements prepared in accordance with the laws of their country of origin, reconciled to U.S. GAAP. Indeed, one registered clearing agency, ICE Clear

Europe, currently posts on its website audited financial statements prepared according to UK GAAP. Having foreign CCPs prepare financial statements using more widely applied bases of accounting such as U.S. GAAP or IFRS may offer greater utility to market participants, regulators and other stakeholders of clearing agencies. Therefore, we have limited the different bases of accounting upon which the annual audited consolidated financial statements may be prepared to IFRS and U.S. GAAP. The Commission recognizes that there are costs associated with requiring that a registered CCP comply with these reporting standards. However, to the extent that the parent company of ICE Clear Europe already prepares financial statements according to U.S. GAAP, we expect the costs of this requirement to be less burdensome. The Commission also believes that allowing CCPs to prepare financial statements in accordance with the laws of their countries of origin and then reconcile the differences to U.S. GAAP would add complexity associated with the reconciliation that may offer less utility to market participants, regulators and other stakeholders of clearing agencies because of the burden of understanding and interpreting additional bases of accounting would create for users.

The Commission is mindful of the costs associated with the final rule. The exact nature of the procedures a clearing agency will establish to support this requirement is likely to vary between clearing agencies. Nevertheless, clearing agencies already make this type of information available to the Commission and/or on their websites. Therefore, the incremental cost of this Rule is unlikely to be significant.

As noted above, the standards contained in Rules 17Ad-22 (c)(1) and (2), would impose certain burdens and related costs on respondent clearing agencies. As discussed in Section IV.C.4, based on policies and procedures requirements for Regulation NMS, and based on staff

conversations with industry representatives, the Commission has estimated the burdens and related costs of these requirements for clearing agencies.

The clearing agency standards in Rules 17Ad-22(c)(1) and (2) would require respondent clearing agencies to create policies and procedures. The requirements would impose one-time costs related to the adjustment of systems. These costs are included in the $3.7 million in startup costs discussed earlier.

The standards contained in Rule 17Ad-22(c) would also impose ongoing costs on clearing agencies. For example, the clearing agency standards in Rules 17Ad-22 (c)(1) and (2) would collectively require respondent clearing agencies to perform certain ongoing monitoring and enforcement activities with respect to the policies and procedures the clearing agency creates in response to the standard. These costs are included in the $10.1 million in annual costs discussed earlier. These rules may impose additional incremental costs related to, for example, employee training, systems testing, and other operational considerations designed to ensure both initial and continued compliance with such policies and procedures.

Rule 17Ad-22(c)(2) would require each clearing agency to post on its website its annual audited financial statements. The audited financial statements would have to (i) be a complete set of consolidated financial statements of the clearing agency and its subsidiaries for the most recent two fiscal years and be prepared in accordance with U.S. GAAP, except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country the consolidated financial statements may be prepared according to U.S. GAAP or IFRS; (ii) be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with Rule 2-01 of Regulation S-X (17 CFR 210.2-01); and (iii) include a report of

the registered public accounting firm that complies with paragraphs (a) through (d) of Rule 2-02 of Regulation S-X (17 CFR 210.2-02). This requirement would necessitate work hours of compliance personnel and finance personnel at the clearing agency to compile relevant data, organize and analyze that data, and then post it to the clearing agency's website consistent with the rule. The requirement would also require the services of a registered public accounting firm. These costs are included in the $10.1 million in annual costs discussed earlier.

7. Minimum Standards for All Clearing Agencies.

Rules 17Ad-22(d)(1)–(15) require certain minimum standards for rules and procedures to be met by all clearing agencies. Rule 17Ad-22(d)(1) requires that clearing agencies have rules and procedures that are well-founded, transparent and enforceable for each aspect of their activities in all relevant jurisdictions.[599] Rules 17Ad-22(d)(2)–(15) require that clearing agencies reasonably establish, implement, maintain and enforce written policies and procedures reasonably designed to:

- require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency
- hold assets in a manner whereby risk of loss or of delay in access to them is minimized,
- identify sources of operational risk and minimize these risks through the development of appropriate systems, controls, and procedures,
- employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks,

[599] A relevant jurisdiction would include, among others, activities (i) in the United States, (ii) involving any means of interstate commerce, or (iii) in respect to providing clearing services to any U.S. person. Clearing agencies that operate in multiple jurisdictions may need to resolve possible conflicts of laws issues that they may encounter.

- provide that their operations are cost-effective in meeting the requirements of participants while maintaining the safety and security of operations,
- evaluate the potential sources of risks that can arise when the clearing agency establishes links either cross-border or domestically to clear or settle trades, and to ensure that these risks are managed prudently on an ongoing basis,
- have governance arrangements that are clear and transparent to fulfil the public interest requirements in Section 17A of Exchange Act applicable to clearing agencies,[600] to support the objectives of owners and participants, and to promote the effectiveness of the clearing agency's risk management procedures,
- provide market participants with sufficient information for them to identify and evaluate the risks and costs associated with using clearing agencies' services,
- immobilize or dematerialize securities certificates and transfer them by book entry to the greatest extent possible when the clearing agency provides CSD services,
- make key aspects of their default procedures publicly available and establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default,
- ensure that final settlement occurs no later than the end of the settlement day and that intraday or real-time finality is provided where necessary to reduce risks.

600 Section 17A(b)(3)(F) of the Exchange Act requires that the rules of a clearing agency be designed to protect investors and the public interest. 15 U.S.C. 78q-1(b)(3)(F).

- eliminate principal risk by linking securities transfers to funds transfers to achieve delivery versus payment (DVP) [601],
- institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant family exposure fully, that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle when the clearing agency provides CSD services[602] and extends intraday credit to participants.
- disclose to their participants the clearing agency's obligations with respect to physical deliveries.[603]

In the Proposing Release, the Commission identified potential costs and benefits resulting from Rules 17Ad-22(d)(1)–(15), as proposed, and requested comment on all aspects of the cost-benefit analysis, including the identification and assessment of any costs and benefits that were not discussed in the analysis. The Commission did not receive any comments on the specific cost-benefit analysis contained in the Proposing Release.

Rules 17Ad-22(d)(1)–(15) are consistent with CPSS-IOSCO Recommendations.[604] As discussed below, Rules 17Ad-22(d)(1)–(15) for the most part codify existing practices of clearing agencies registered with the Commission. Adopting rules that reflect current practices has the benefit of ensuring that future business practices are both consistent with current practice

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601 See supra note 422.

602 See proposed Rule 17Ad-22(a)(2) for definition of "central securities depository services."

603 The proposed rule would provide clearing agencies with the flexibility to determine the method by which the clearing agency will state this information to its participants. However, the clearing agencies should take care to develop an approach that provides sufficient notice to its participants regarding the clearing agency's obligations.

604 See table in Section V.B.2.d.

and conform to international standards without subjecting clearing agencies to significant costs. Accordingly, the Commission believes that registered clearing agencies would not need to build new infrastructure or modify operations to meet the requirements of Rule 17Ad-22(d).[605] The primary costs of implementing such rules will be the incremental costs of enhancing and reviewing existing policies and procedures for compliance and updating existing policies and procedures where appropriate as discussed above in Section IV.

The requirements would impose one-time costs and ongoing costs to perform certain ongoing monitoring and enforcement activities with respect to the policies and procedures that are included in the $3.7 million in startup costs and $10.1 million in ongoing cost discussed earlier.[606] The Rules also may impose incremental costs related to, for example, employee training, systems testing, and other operational considerations designed to ensure both initial and continued compliance with such policies and procedures.

As stated above, there are currently seven clearing agencies registered with the Commission that provide CCP or CSD services. These clearing agencies are SROs so the rules and procedures governing each aspect of the clearance and settlement process are filed with the Commission for notice and approval. Rule 17Ad-22(d)(1) will codify the existing practices of registered clearing agencies of establishing a rule book and developing policies and procedures to address each aspect of their operations. Therefore, the SRO rule filing process should help to

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605 See generally International Monetary Fund, Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of the NSCC's Observance of the CPSS-IOSCO Recommendations for Central Counterparties (2010), at 4-29, available at http://www.imf.org/external/pubs/ft/scr/2010/cr10129.pdf; International Monetary Fund, Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of the DTC's Observance of the CPSS-IOSCO Recommendations for Securities Settlement Systems (2010), at 4-40, available at http://www.imf.org/external/pubs/ft/scr/2010/cr10128.pdf.

606 This number also reflects the costs of Rules 17Ad-22(b)(1)–(3).

ensure that such rules are well-founded, transparent, and provide an enforceable legal framework for its activities.

As described above, each registered clearing agency has established membership criteria and has procedures in place to monitor the sufficiency of its participants' financial resources. Rule 17Ad-22(d)(2) will codify these existing practices. The operational and financial stability of participants is subject to market forces and can therefore change over time. Because participants collectively contribute to the operational and financial stability of a registered clearing agency, the Commission believes that the proposed requirement to continue to monitor compliance with the registered clearing agency's participation requirements supports the Exchange Act requirement that clearing agencies are able to facilitate prompt and accurate clearance and settlement.[607]

In addition, clearing agencies would be required to have participation requirements that are objective,[608] publicly disclosed, and facilitate fair and open access.[609] The Commission believes this requirement would foster compliance with the requirement under Section 17A of

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607 15 U.S.C 78q-1(b)(3)(A).

608 Objective criteria would generally include, but not be limited to, criteria that are based on measureable facts such as capital requirements.

609 Having open access, in part, involves having a process for admission of participants that does not unfairly discriminate. See 15 U.S.C. 78q-1(b)(3)(F) ("The rules of a registered clearing agency… are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the registered clearing agency"). In addition, the Dodd-Frank Act added Section 3C to the Exchange Act which provides in relevant part: "(2) OPEN ACCESS.—The rules of a registered clearing agency described in paragraph (1) shall— (A) prescribe that all security-based swaps submitted to the registered clearing agency with the same terms and conditions are economically equivalent within the registered clearing agency and may be offset with each other within the registered clearing agency; and (B) provide for non-discriminatory clearing of a security-based swap executed bilaterally or on or through the rules of an unaffiliated national securities exchange or security-based swap execution facility." Pub. L. No. 111-203 § 763(a) (adding Section 3C to the Exchange Act).

the Exchange Act that the rules of a registered clearing agency must not be designed to permit unfair discrimination in the admission of participants by requiring standards that are designed to be measurable, open and fair.[610]

During the clearance and settlement process, registered clearing agencies are responsible for safeguarding assets that secure participants' obligations. Registered clearing agencies currently seek to minimize the risk of loss or delay in access by holding assets that are highly-liquid (e.g., cash, U.S. Treasury securities or securities issued by a U.S. government agency) and engaging banks to custody the assets and facilitate settlement. The requirements of Rule 17Ad-22(d)(3) are intended to codify existing practices and help ensure the ability of the registered clearing agency to meet its settlement obligations by reducing the likelihood that assets securing participant obligations to the registered clearing agency would be unavailable or insufficient when the registered clearing agency needs to draw on them.

Pursuant to guidance provided by the Division's Automated Review Policy Statements[611], and Interagency White Paper on Disaster Recovery[612], all registered clearing agencies, among other things, develop and maintain plans to assure the safeguarding of securities and funds, the integrity of the automated data processing systems, and recovery of securities, funds, or data under a variety of loss or destruction scenarios. In addition, the rule requires that clearing agencies have business continuity plans that allow for timely recovery of operations and ensure the fulfillment of a registered clearing agency's obligations. Rule 17Ad-22(d)(4) would

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610 15 U.S.C. 78q-1(b)(3)(F).

611 See Automation Review Policy Statements, supra note 330. The Automation Review Policy Statements are not rules, but rather general statements of policy based on cooperation between the SROs and the Commission.

612 Sound Practices to Strengthen the Resilience of the U.S. Financial System (Interagency Paper), Release No. 34-47638; File No. S7-32-02 (Apr. 7, 2003).

codify existing practice and strengthen the requirement in Section 17A(b)(3)(F) of the Exchange Act, which requires that the rules of a registered clearing agency must be designed to ensure the safeguarding of securities and funds in the custody or control of the registered clearing agency or for which the registered clearing agency is responsible.[613] In this way, the Commission believes the rule also would promote protection of the financial market served by the registered clearing agency.

Registered clearing agencies use settlement banks to facilitate the cash portion of the securities transaction. Failure by that bank to effectuate timely and final settlement adversely affects the registered clearing agency by exposing it to credit and liquidity pressures that can adversely affect the registered clearing agency's ability to facilitate prompt and accurate clearance and settlement. Rule 17Ad-22(d)(5) is designed to reduce the risk that financial obligations related to the activities of a registered clearing agency are not settled in a timely manner or not discharged with finality. The Commission also believes that the rule would assist a registered clearing agency in meeting the requirement of Section 17A(b)(3)(F) of the Exchange Act, which requires the rules of a registered clearing agency to be designed to assure the safeguarding of securities and funds which are in the custody or control of the registered clearing agency or for which it is responsible.[614]

Registered clearing agencies have procedures to control costs and to regularly review pricing levels against operating costs. The Commission believes that Rule 17Ad-22(d)(6) codifies this practice and may help to reduce the fees a participant in a registered clearing agency incurs for clearance and settlement services while also helping to ensure that registered clearing agency maintains appropriate operational standards. Having clearing agencies be mindful of the

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613 15 U.S.C. 78q-1(b)(3)(F).

614 15 U.S.C. 78q-1(b)(3)(F).

costs that are incurred by their participants, while maintaining such compliance, should help to reduce inefficiencies in the provision of clearance and settlement services. Because there is often only a single registered clearing agency per asset class per market, competitive forces may not be sufficient by themselves in creating incentives to be cost-effective in meeting the requirements of participants.

Section 17A(a)(1)(D) of the Exchange Act states that the linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement will reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors.[615] Further, Section 17A(b)(3)(F) of the Exchange Act requires that the rules of a registered clearing agency foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions.[616] Each registered clearing agency is linked to other clearing organizations, trading platforms, and service providers. The Commission believes that in the clearance and settlement process, links should help improve market liquidity and make it easier for participants to trade in other markets.[617] Rule 17Ad-22(d)(7) promotes these statutory requirements under the Exchange Act and establishes a requirement that links created between clearing agencies are managed in a safe and prudent manner.

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615 15 U.S.C. 78q-1(a)(1)(D).

616 15 U.S.C. 78q-1(b)(3)(F).

617 For example, DTC Canadian Link Service allows qualifying DTC participants to clear and settle valued securities transactions with participants of a Canadian securities depository. The link is designed to facilitate cross-border transactions by allowing participants to use a single depository interface for U.S. and Canadian dollar transactions and eliminate the need for split inventories. See Exchange Act Release Nos. 52784 (Nov. 16, 2005), 71 FR 70902 (Nov. 23, 2005) and 55239 (Feb. 5, 2007), 72 FR 6797 (Feb. 13, 2007) (File No. SR-DTC 2006-15).

Each registered clearing agency has a board that governs the operations of the entity and supervises its senior management. Rule 17Ad-22(d)(8) is designed enhance the board's governance of the registered clearing agency and the ability of the registered clearing agency to serve the interests of its various constituencies while maintaining prudent risk management processes. Clear and transparent governance arrangements promote accountability and reliability in the decisions, rules and procedures of the registered clearing agency because they provide interested parties (such as owners, participants, and the general public) with information about how such decisions are made and what the rules and procedures are designed to accomplish.[618]

Governance arrangements have the potential to play an important role in making sure that clearing agencies fulfill the Exchange Act requirements that the rules of a registered clearing agency be designed to protect investors and the public interest and to support the objectives of owners and participants. Similarly, governance arrangements may promote the effectiveness of a registered clearing agency's risk management procedures by creating an oversight framework that fosters a focus on the critical role that risk management plays in promoting prompt and accurate clearance and settlement.[619]

Because clearing agencies are SROs, their rules are published by the Commission and are available on each registered clearing agency's website. In addition information regarding the operations and services of each clearing agency can be found either on the clearing agency's

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618 The Exchange Act currently requires that certain aspects of a registered clearing agency's governance arrangements be made clear and transparent. Section 19(b) of the Exchange Act requires that clearing agencies, as SROs, file with the Commission any proposed rule or any proposed change in, addition to, or deletion from the rules of the registered clearing agency, accompanied by a concise general statement of the basis and purpose of the proposed rule change. 15 U.S.C. 78s(b).

619 The role of governance arrangements in promoting effective risk management has also been a focus of rules recently proposed by the Commission to mitigate conflicts of interest at security-based swap clearing agencies. See Exchange Act Release No. 63107, 75 FR 65882, supra note 231.

website or a website maintained by an affiliated entity of the clearing agency. Rule 17Ad-22(d)(9) will maintain and enhance this existing practice by requiring a registered clearing agency to disclose information sufficient for participants to identify risks and costs associated with using the registered clearing agency, thereby allowing participants to make informed decisions about the use of the registered clearing agency and to take appropriate actions to mitigate their risks and costs associated with the use of the registered clearing agency.

While U.S. markets have made great strides in achieving immobilization and/or dematerialization for institutional and broker-to-broker transactions, many industry representatives believe that the small percentage of securities held in certificated form impose unnecessary risk and expense to the industry and to investors. Rule 17Ad-22(d)(10) will codify the existing practice, and promote further immobilization and dematerialization of securities and their transfer by book entry. This would result in reduced costs and risks associated with securities settlements and custody for both clearing agencies and participants by removing the need to hold and transfer many, if not most, physical certificates.[620]

Each registered clearing agency makes public rules, policies or procedures that set forth the actions the clearing agency may take in the event of a participant default and each makes key aspects of their default procedures publicly available, with the exception of certain of their policies and procedures that are kept non-public to ensure their integrity, such as those associated with the oversight of clearing participants. Rule 17Ad-22(d)(11) codifies this existing practice. The Commission believes that default procedures reduce the likelihood that a default by a participant, or multiple participants, will disrupt the operations of the clearing agency and have a cascading effect on the viability of the other participants of the clearing agency. Default

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[620] See Exchange Act Release No. 8398 (Mar. 11, 2004), 69 FR 12921 (Mar. 18, 2004).

procedures also allow a clearing agency to wind down positions in an orderly way and continue to perform its obligations in the event of a participant default, assuring continued functioning of the securities market in times of stress and reducing systemic risk.

The Commission believes that Rule 17Ad-22(d)(11) would increase the probability that defaults by participants, should they occur, would proceed in an orderly and transparent manner. This is the case because the rule would help to ensure that all participants are aware of the default process and are able to plan accordingly and that clearing agencies would have sufficient time to take corrective actions to mitigate potential losses. In addition, the transparency of default procedures will increase the confidence of market participants as well as members of the general public, that should a default occur, the proper procedures would be followed, decreasing uncertainty and lessening the likelihood of further market stress.

Each registered clearing agency has rules, policies or procedures that provide for the settlement of its respective securities transactions no later than the end of a pre-defined settlement day. Rule 17Ad-22(d)(12) codifies this existing practice. The Commission believes that settlement finality should occur no later than the end of the settlement day to limit the volume of outstanding obligations that are subject to settlement at any one time and thereby reduce the settlement risk exposure of participants and the registered clearing agency. Intraday or real-time finality may be necessary to reduce risk in circumstances where the lack of intraday or real-time finality may impede the registered clearing agency's ability to facilitate prompt and accurate clearance and settlement, cause the registered clearing agency's participants to fail to meet their obligations, or cause significant disruptions in the securities markets.[621]

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[621] See FMI Report, Principle 8, supra note 32.

Generally, Rules 17Ad-22(d)(13)–(15) would apply to registered clearing agencies that provide CSD services. DTC currently is the only registered clearing agency that is a CSD. DTC operates a Model 2 DVP system which provides for gross settlements of securities transfers during the day followed by an end of day net funds settlement.[622] Rule 17Ad-22(d)(13) codifies this existing practice. Delivery versus payment eliminates the risk that a buyer would lose the purchase price of a security purchased from a defaulting seller (or that a seller would lose the sold security without receiving payment for a security acquired by a defaulting buyer), because payment is made only if securities are delivered. While the use of this payment method eliminates principal risk, DVP procedures do not eliminate the risk that the failure of the defaulting participant could result in systemic disruptions, because the failure of a participant could produce substantial liquidity pressures and replacement costs.

As discussed above, DTC has policies and procedures in place to ensure that timely settlement can be completed in the event of the default participant with the largest settlement obligation. DTC establishes setting limits (called net debit caps) for each participant. The net debit cap ensures that the amount of cash that a participant owes the clearing agency does not exceed this pre-defined limit or cap. Rule 17Ad-22(d)(14) codifies this existing practice. The Commission believes it is important for clearing agencies that provide CSD services to institute risk controls, including collateral requirements and limits to cover the registered clearing agency's credit exposure to each participant exposure fully, that ensure timely settlement in these circumstances to address the risk that the participant may fail to settle after credit has been extended. The Commission also believes that requiring the controls to be designed to withstand

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622 See DTC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Dec. 12, 2011), available at http://www.dtcc.com/legal/compliance/DTC_Self-Assessment.pdf.

the inability of the participant with the largest payment obligation to settle, in such circumstances, would reduce the likelihood of disruptions at the registered clearing agency by having controls in place to account for the largest possible loss from any individual participant and thereby help the registered clearing agency to provide prompt and accurate clearance and settlement during times of market stress.

A registered clearing agency faces both credit and liquidity risks from the delivery process. At delivery, the entire principal value of a transaction may be at risk, and this form of credit risk is often termed principal risk. Liquidity risk arises because the registered clearing agency, faced with a defaulting participant, must still make payment to the non-defaulting party. The Commission believes that a registered clearing agency should therefore ensure that its rules and procedures provide clear risk management controls so that it can identify and mitigate the credit and liquidity risks to which it is exposed in the delivery process. These procedures should ensure that the registered clearing agency will be able to adapt its risk management framework as appropriate, as the steps necessary to mitigate risks will depend on the obligations the registered clearing agency has assumed, the mechanisms available for settlement, and the importance of the risks from physical settlement to its overall operations.

The Commission also believes that providing such information to participants would promote a shared understanding regarding physical delivery practices between the registered clearing agency and its participants that could help reduce the potential for fails and thereby facilitate prompt and accurate clearance and settlement.

Registered clearing agencies have rules and procedures that describe their obligations to its participants when they assume deliveries of physical instruments. The Commission believes that Rule 17Ad-22(d)(15), by requiring a statement by the registered clearing agency to its

participants about the cleaning agency's obligations with respect to physical deliveries, among other things, would ensure that participants have information that is likely to enhance the participants' understanding of their rights and responsibilities with respect to using the clearance and settlement services of the registered clearing agency. The Commission believes that ensuring delivery of this information to participants about the clearing agency's physical delivery obligations would promote a shared understanding about physical delivery practices between the clearing agency and its participants that would help mitigate misunderstandings in the clearing agency's physical delivery operations and would therefore facilitate prompt and accurate clearance and settlement.

The Commission carefully considered alternatives to Rule 17Ad-22(d), including a more prescriptive approach suggested by some of the commenters, and has decided to adopt the rule, modeled after recognized international standards, in the form proposed. The Commission believes the final rule will have the effect of harmonizing the Commission's regulatory requirements with such standards as are now contemplated by the Exchange Act and the Clearing Supervision Act, as well as international standards. In particular, the Commission believes Rule 17Ad-22(d) will help market participants compare the operations of U.S. clearing agencies with non-U.S. clearing organizations. The Commission's adoption of Rule 17Ad-22(d) may also reduce some of the potential regulatory burden for CCPs and CSDs that may be dually-regulated by the SEC and another domestic or foreign regulator because it is modeled on standards already employed by other regulatory authorities.

VI. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act ("RFA")[623] requires the Commission, in promulgating

[623] 5 U.S.C. 601 et seq.

rules, to consider the impact of those rules on small entities. The Commission certified in the Proposing Release, pursuant to Section 605(b) of the Regulatory Flexibility Act of 1980 ("RFA"),[624] that the proposed rule would not, if adopted, have a significant impact on a substantial number of small entities. We received no comments on this certification.

A. Registered Clearing Agencies

Rule 17Ad-22 applies to all registered clearing agencies and sets standards for such clearing agencies. For the purposes of Commission rulemaking and as applicable to Rule 17Ad-22, a small entity includes, when used with reference to a clearing agency, a clearing agency that (i) compared, cleared and settled less than $500 million in securities transactions during the preceding fiscal year, (ii) had less than $200 million of funds and securities in its custody or control at all times during the preceding fiscal year (or at any time that it has been in business, if shorter) and (iii) is not affiliated with any person (other than a natural person) that is not a small business or small organization.[625] Under the standards adopted by the Small Business Administration, small entities in the finance industry include the following: (i) for entities engaged in investment banking, securities dealing and securities brokerage activities, entities with $6.5 million or less in annual receipts; (ii) for entities engaged in trust, fiduciary and custody activities, entities with $6.5 million or less in annual receipts; and (iii) funds, trusts and other financial vehicles with $6.5 million or less in annual receipts.[626]

Based on the Commission's existing information about the clearing agencies currently registered with the Commission, the Commission believes that such entities exceed the thresholds defining "small entities" set out above. While other clearing agencies may emerge

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624 See 5 U.S.C. 605(b).

625 17 CFR 240.0-10(d).

626 13 CFR 121.201, Sector 52.

and become eligible to operate as registered clearing agencies and while other security-based swap lifecycle event service providers may be required to register as clearing agencies, the Commission does not believe that any such entities would be "small entities" as defined in Exchange Act Rule 0-10.[627] Furthermore, we believe it is unlikely that any registered clearing agencies, security-based swap clearing agencies or security-based swap lifecycle event services providers would have annual receipts of less than $6.5 million. Accordingly, the Commission believes that any registered clearing agencies will exceed the thresholds for "small entities" set forth in Exchange Act Rule 0-10.

B. Certification

For the reasons described above, the Commission again certifies that Rule 17Ad-22 will not have a significant economic impact on a substantial number of small entities.

VII. Statutory Authority and Text of Rule 17Ad-22

Pursuant to the Exchange Act, particularly, Sections 17A(d) thereof, 15 U.S.C. 78q-1(d), Sections 17A(i), 17A(j) and 3C(j) thereof, 15 U.S.C. 78q-1(i), 78q-1(j) and 78c-3(j), respectively, Pub. L. 111-203, §763, 124 Stat. 1841 (2010), and Sections 30(b) and 30(c) thereof, 15 U.S.C. 78dd(b)and (c), and Section 805(a)(2) of the Clearing Supervision Act, 12 U.S.C. 5464(a)(2), the Commission adopts new Rule 17Ad-22 to govern clearing agencies.

List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

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627 See 17 CFR 240.0-10(d). The Commission based this determination on its review of public sources of financial information about existing CCPs serving the OTC derivatives market and lifecycle event service providers.

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE

1. The authority citation for Part 240 is revised in numerical order to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et. seq.; 12 U.S.C. 5221(e)(3), 15 U.S.C. 8302, and 18 U.S.C. 1350, unless otherwise noted.

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Section 240.17Ad-22 is also issued under 12 U.S.C. 5464(a)(2).

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2. Section 240.17Ad-22 is added to read as follows:

§ 240.17Ad-22 Standards for clearing agencies.

(a) Definitions. For purposes of this section:

(1) Central counterparty means a clearing agency that interposes itself between the counterparties to securities transactions, acting functionally as the buyer to every seller and the seller to every buyer.

(2) Central securities depository services means services of a clearing agency that is a securities depository as described in Section 3(a)(23) of the Act (15 U.S.C. 78c(a)(23)(A)).

(3) Participant family means that if a participant directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with, another participant then the affiliated participants shall be collectively deemed to be a single participant

family for purposes of paragraphs (b)(3) and (d)(14) of this section.

(4) Normal market conditions as used in paragraphs (b)(1) and (2) of this section means conditions in which the expected movement of the price of cleared securities would produce changes in a clearing agency's exposures to its participants that would be expected to breach margin requirements or other risk control mechanisms only one percent of the time.

(5) Net capital as used in paragraph (b)(7) of this section means net capital as defined in § 240.15c3-1 for broker-dealers or any similar risk adjusted capital calculation for all other prospective clearing members.

(b) A registered clearing agency that performs central counterparty services shall establish, implement, maintain and enforce written policies and procedures reasonably designed to:

(1) Measure its credit exposures to its participants at least once a day and limit its exposures to potential losses from defaults by its participants under normal market conditions so that the operations of the clearing agency would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.

(2) Use margin requirements to limit its credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin requirements and review such margin requirements and the related risk-based models and parameters at least monthly.

(3) Maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which it has the largest exposure in extreme but plausible market conditions; provided that a registered clearing agency acting as a central counterparty for security-based swaps shall maintain additional financial resources sufficient to withstand, at a

minimum, a default by the two participant families to which it has the largest exposures in extreme but plausible market conditions, in its capacity as a central counterparty for security-based swaps. Such policies and procedures may provide that the additional financial resources may be maintained by the security-based swap clearing agency generally or in separately maintained funds.

(4) Provide for an annual model validation consisting of evaluating the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who is free from influence from the persons responsible for the development or operation of the models being validated.

(5) Provide the opportunity for a person that does not perform any dealer or security-based swap dealer services to obtain membership on fair and reasonable terms at the clearing agency to clear securities for itself or on behalf of other persons.

(6) Have membership standards that do not require that participants maintain a portfolio of any minimum size or that participants maintain a minimum transaction volume.

(7) Provide a person that maintains net capital equal to or greater than $50 million with the ability to obtain membership at the clearing agency, provided that such persons are able to comply with other reasonable membership standards, with any net capital requirements being scalable so that they are proportional to the risks posed by the participant's activities to the clearing agency; provided, however, that the clearing agency may provide for a higher net capital requirement as a condition for membership at the clearing agency if the clearing agency demonstrates to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures and the Commission approves the higher net capital requirement as part of a rule filing or clearing agency registration application.

(c) Record of financial resources and annual audited financial statements.

(1) Each fiscal quarter (based on calculations made as of the last business day of the clearing agency's fiscal quarter), or at any time upon Commission request, a registered clearing agency that performs central counterparty services shall calculate and maintain a record, in accordance with § 240.17a-1 of this chapter, of the financial resources necessary to meet the requirements of paragraph (b)(3) of this section, and sufficient documentation to explain the methodology it uses to compute such financial resource requirement.

(2) Within 60 days after the end of its fiscal year, each registered clearing agency shall post on its website its annual audited financial statements. Such financial statements shall:

(i) Include, for the clearing agency and its subsidiaries, consolidated balance sheets as of the end of the two most recent fiscal years and statements of income, changes in stockholders' equity and other comprehensive income and cash flows for each of the two most recent fiscal years;

(ii) Be prepared in accordance with U.S. generally accepted accounting principles, except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country the consolidated financial statements may be prepared in accordance with U.S. generally accepted accounting principles or International Financial Reporting Standards as issued by the International Accounting Standards Board;

(iii) Be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with 17 CFR 210.2-01; and

(iv) Include a report of the registered public accounting firm that complies with paragraphs (a) through (d) of 17 CFR 210.2-02.

(d) Each registered clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:

(1) Provide for a well-founded, transparent, and enforceable legal framework for each aspect of its activities in all relevant jurisdictions.

(2) Require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency; have procedures in place to monitor that participation requirements are met on an ongoing basis; and have participation requirements that are objective and publicly disclosed, and permit fair and open access.

(3) Hold assets in a manner that minimizes risk of loss or of delay in its access to them; and invest assets in instruments with minimal credit, market and liquidity risks.

(4) Identify sources of operational risk and minimize them through the development of appropriate systems, controls, and procedures; implement systems that are reliable, resilient and secure, and have adequate, scalable capacity; and have business continuity plans that allow for timely recovery of operations and fulfillment of a clearing agency's obligations.

(5) Employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants; and require funds transfers to the clearing agency to be final when effected.

(6) Be cost-effective in meeting the requirements of participants while maintaining safe and secure operations.

(7) Evaluate the potential sources of risks that can arise when the clearing agency

establishes links either cross-border or domestically to clear or settle trades, and ensure that the risks are managed prudently on an ongoing basis.

(8) Have governance arrangements that are clear and transparent to fulfill the public interest requirements in Section 17A of the Act (15 U.S.C. 78q-1) applicable to clearing agencies, to support the objectives of owners and participants, and to promote the effectiveness of the clearing agency's risk management procedures.

(9) Provide market participants with sufficient information for them to identify and evaluate the risks and costs associated with using its services.

(10) Immobilize or dematerialize securities certificates and transfer them by book entry to the greatest extent possible when the clearing agency provides central securities depository services.

(11) Make key aspects of the clearing agency's default procedures publicly available and establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default.

(12) Ensure that final settlement occurs no later than the end of the settlement day; and require that intraday or real-time finality be provided where necessary to reduce risks.

(13) Eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.

(14) Institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant family exposure fully, that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle when the clearing agency provides central securities depository services and extends intraday

credit to participants.

(15) State to its participants the clearing agency's obligations with respect to physical deliveries and identify and manage the risks from these obligations.

By the Commission.

Elizabeth M. Murphy
Secretary

Date: October 22, 2012