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Clearinghouse regulatory basics for swap market participants

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A central tenet of the Dodd-Frank Act is that standardized swap transactions must be centrally cleared through a Commodity Futures Trading Commission-registered derivatives clearing organization or a clearinghouse that is exempt from DCO registration. Dozens of articles and law firm client alerts have discussed this new clearing requirement and related issues, including the CFTC regulatory provisions governing the protection of cleared swaps customer collateral, commonly known as the LSOC model. Yet relatively little attention has been focused on the rules and regulations governing the basic day-to-day operations of DCOs, even though these provisions have important implications for swap market participants.

This Learning Curve is intended to provide market participants with a general introduction to the basic DCO regulatory construct, including the DCO registration requirements, the statutorily-imposed "DCO Core Principles," and the CFTC's Part 39 Rules. It also describes in greater detail four specific DCO regulatory requirements that have a direct and significant impact on market participants.

The CFTC regulatory construct governing DCOs

The CFTC takes the position that any clearinghouse that clears a swap for a U.S. person–either directly for a U.S. clearing member or indirectly for a U.S. customer of any clearing member–must register with the CFTC as a DCO or obtain an exemption from DCO registration. This DCO registration requirement applies regardless of whether a cleared swap is subject to mandatory clearing. The scope of this registration requirement is further broadened by the CFTC's expansive U.S. person definition, which, for example, considers foreign branches of U.S. banks to be U.S. persons.

The CFTC has statutory discretionary authority to exempt a clearinghouse from the DCO registration requirement if the clearinghouse is subject to "comparable, comprehensive supervision and regulation" by regulatory authorities in the clearinghouse's home country or the SEC. The CFTC has not yet exempted any clearinghouses, or established a process or issued guidance concerning how a clearinghouse may apply for an exemption. As a result, some non-U.S. clearinghouses currently limit their services exclusively to non-U.S. persons.

In order to become and remain registered with the CFTC, a DCO must comply with 18 statutorily imposed "DCO Core Principles," which establish the minimum, baseline standards for the operation and governance of DCOs. The DCO Core Principles impose, among other things: requirements relating to the financial, operational and managerial resources of a clearinghouse; clearinghouse risk management standards; clearing member admission and eligibility standards; rules and procedures relating to the efficient, fair and safe management of clearing member defaults and insolvencies; and clearinghouse governance standards. All DCOs must also satisfy a panoply of prescriptive requirements set forth in Subparts A and B of the CFTC's Part 39 Rules, four of which are discussed in detail below. Any DCO designated by the U.S. Financial Stability Oversight Council as "systemically important" and for which the CFTC acts as the supervisory agency must also comply with additional standards set out in Subpart C of the CFTC's Part 39 Rules, which are intended to close gaps between the otherwise applicable DCO regulatory requirements and the Principles for Financial Market Infrastructures developed by CPSS-IOSCO. Non-systemically important DCOs may voluntarily comply with the Subpart C provisions in order to attain "QCCP status" for purposes of the Basel CCP Capital Requirements. DCOs must also comply with a number of other regulatory provisions, including certain aspects of the CFTC's Part 22 Rules (the LSOC model) and requirements concerning large trader reporting, among other things.

While all of the requirements governing the basic day-to-day operations of DCOs impact market participants, the following are particularly relevant.

The "agency model" for customer clearing

The DCO regulatory construct, including the LSOC model, is premised, at least in part, on the "agency model" of customer clearing established by CFTC Rule 39.12(b)(6). This provision requires DCOs to have rules providing that upon acceptance of a swap for clearing, the original swap is extinguished and replaced by an equal and opposite swap between the DCO and a clearing member acting as principal for a house trade or agent for a customer trade. As a result, when clearing swaps through a DCO on behalf of a customer, a futures commission merchant clearing member serves as a guarantor and agent for the cleared swap. This agency model of customer clearing differs from the "principal model" of customer clearing imposed by certain other jurisdictions. In the principal model, a customer and clearing member face each other as principal, and the clearing member in turn faces the clearinghouse as principal. The agency model facilitates portability of customer positions and customer protection provisions. Among other things, it also promotes operational efficiency, since it reduces the number of transactions that an FCM clearing »»

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member must enter into.

In order to simultaneously conform to both agency and principal models, some global clearinghouses have layered the CFTC-mandated agency model on top of the principal model by engineering multifaceted rulebooks that apply FCM-

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specific chapters and rules only to FCM cleared trades. This strategy also enables these clearinghouses to concurrently satisfy varying bankruptcy and customer collateral protection requirements in multiple jurisdictions. Regulators have acquiesced to this approach, even though it has added a tremendous amount of complexity to clearinghouse rulebooks.

Public information requirements

The Commodity Exchange Act and CFTC rules require DCOs to provide "sufficient information" to enable market participants to "identify and evaluate accurately the risks and costs associated" with using the DCO's services. More specifically, CFTC Rule 39.21 requires DCOs to post on their public websites: (1) their rulebooks; (2) their plans and procedures for the management of a clearing member default or insolvency; (3) their margin-setting methodologies; (4) their daily settlement prices, volume, and open interest for each type of swap cleared; (5) the names of their current clearing members; (6) the size and composition of their financial resources packages; (7) the terms and conditions of each type of swap offered for clearing; and (8) a list of fees charged to clearing members.

These public information requirements, together with other CFTC rules that require DCOs to publicize their rule changes and acceptance of new products, provide current and potential clearing members and their customers, and all market participants generally, with a trove of information that can be used to gain a better understanding of a DCO's services and strengths and weaknesses. For example, a clearinghouse's rulebook codifies the principles and conditions governing the clearinghouse's organization and operation. It provides information concerning, among other things, the clearinghouse's management and governance, membership requirements, account structures, methods of handling and investing collateral, and ability to declare an event of default and take certain actions thereafter. In addition, publicly available DCO fee and financial resources information can be used by market participants to evaluate the costs and risks associated with the use of a particular DCO. In the fall of 2013, CPSS-IOSCO released a consultative document that proposes detailed and standardized quantitative data disclosure requirements for global central counterparties.

Gross margin for customer accounts

The CFTC's Part 39 Rules also impose a number of requirements concerning a DCO's risk management and margin practices. CFTC Rule 39.13(g)(8)(i), for instance, requires DCOs to calculate and collect initial margin on a gross basis for each clearing member's customer account(s). DCOs have discretion to calculate customer gross margin based on either the individual customer position information obtained from clearing members or the sum of the gross positions of all of a clearing member's customers that the clearing member provides to the DCO (without forwarding individual customer position information to the DCO). In either case, the customer gross margin requirement must equal the sum of the initial margin amounts that the DCO would require of each individual customer within the account if each individual customer were a clearing member. In addition, CFTC Rule 39.13(g)(8) prohibits a DCO from netting positions of different customers against one another and from permitting clearing members to do so. That said, a DCO may collect initial margin on a net basis for its clearing members' house accounts.

Gross initial customer margin increases the amount of money that DCOs hold and represents a more accurate approximation of the risk posed to a DCO by its clearing members' customers. Gross margining may also increase the portability of customer positions in the event of a clearing member insolvency, since there would be a greater likelihood that sufficient collateral would be on deposit in support of a customer position to enable the DCO to transfer a customer position to a solvent clearing member. Not surprisingly, the CFTC's 2011 adoption of gross margining was controversial, as several commenters expressed concern that it would impose significant operational and technology costs on existing DCOs and FCMs that would be required to convert their net margin systems into gross margin systems with the capability of tracking margin on an individual customer basis.

Transfer of customer positions

CFTC Rule 39.15(d) requires DCOs to transfer all or a portion of a customer's portfolio of positions and related funds from the customer's current FCM clearing member to another consenting FCM clearing member promptly upon the customer's request when: (1) the customer has instructed the carrying FCM to make the transfer, (2) the customer is not currently in default to the carrying FCM, (3) the transferred positions will have appropriate margin at the receiving FCM, and (4) any remaining positions will have appropriate margin at the carrying FCM. The rule also requires a DCO to effect the transfer without first requiring the close-out and re-booking of the positions.

This rule, together with a National Futures Association rule that requires FCMs to transfer customer positions upon request, allows a customer to promptly and efficiently transfer its cleared swap positions to a different FCM clearing member when, for example, the customer has concerns about the financial strength of its current FCM or for competitive reasons relating to customer service or pricing. The CFTC adopted Rule 39.15(d) in order to formalize and apply to swaps clearing the futures clearinghouse practice of transferring customer positions and related funds without the close-out and rebooking of the positions. Under previous market practice for cleared swaps, a customer's request for the transfer of its swap positions was commonly subject to delay, and customers were often required to either

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enter into offsetting positions without terminating the original position or unwind their current position with the clearinghouse.

Conclusion

This article discusses the basics of several important–and sometimes overlooked–regulatory provisions. Traders, risk managers, compliance personnel and legal departments will all benefit from a greater understanding of the regulatory framework in which clearinghouses operate. ■