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Commodity Futures Trading Commission

17 CFR Part 39
Risk Management Requirements for Derivatives Clearing Organizations; Proposed Rule

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 39

RIN 3038–AC98

Risk Management Requirements for Derivatives Clearing Organizations

AGENCY: Commodity Futures Trading Commission.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Commodity Futures Trading Commission (Commission) is proposing regulations to implement Title VII and Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Proposed regulations would establish the regulatory standards for compliance with derivatives clearing organization (DCO) Core Principles C (Participant and Product Eligibility), D (Risk Management), E (Settlement Procedures), F (Treatment of Funds), G (Default Rules and Procedures), and I (System Safeguards). For DCOs that are designated by the Financial Stability Oversight Council as systemically important DCOs (SIDCOs), the Commission is proposing heightened standards in the area of system safeguards supporting business continuity and disaster recovery and a provision that would implement the Commission's special enforcement authority over SIDCOs. The Commission also is proposing certain additional amendments including replacement of the current part 39 appendix A, Application Guidance and Compliance With Core Principles, with an application form for entities seeking to register as DCOs, technical amendments to reorganize part 39 of the Commission's regulations, and amendments to supplement reporting and public information requirements proposed in a previous rulemaking.

DATES: Submit comments on or before March 21, 2011.

ADDRESSES: You may submit comments, identified by RIN number, by any of the following methods:

- Agency Web site, via its Comments Online process: *http://comments.cftc.gov*. Follow the instructions for submitting comments through the Web site.
- Mail: David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.
- Hand Delivery/Courier: Same as mail above.
- Federal eRulemaking Portal: *http://www.Regulations.gov.* Follow the instructions for submitting comments. Please submit comments by only one method.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to *http://www.cftc.gov*. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that may be exempt from disclosure under the Freedom of Information Act (FOIA), a petition for confidential treatment of the exempt information may be submitted according to the procedures established in § 145.9 of the Commission's regulations.[1] The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse, or remove any or all of your submission from *http://www.cftc.gov* that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under FOIA.

FOR FURTHER INFORMATION CONTACT: John C. Lawton, Deputy Director, 202–418–5480, *jlawton@cftc.gov;* Phyllis P. Dietz, Associate Director, 202–418–5449, *pdietz@cftc.gov,* Robert B. Wasserman, Associate Director, 202–418–5092, *rwasserman@cftc.gov* (System Safeguards); and Jonathan Lave, Special Counsel, 202–418–5983, *jlave@cftc.gov,* Division of Clearing and Intermediary Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581; and Julie A. Mohr, Associate Director, 312–596–0568, *jmohr@cftc.gov;* and Anne C. Polaski, Special Counsel, 312–596–0575, *apolaski@cftc.gov,* Division of Clearing and Intermediary Oversight, Commodity Futures Trading Commission, 525 West Monroe Street, Chicago, Illinois 60661.

SUPPLEMENTARY INFORMATION:

Table of Contents

I. Background
A. Title VII of the Dodd-Frank Act
B. Title VIII of the Dodd-Frank Act
C. Dodd-Frank Act rulemaking initiative
II. Discussion
A. Registration procedures
B. Implementation of DCO core principles
1. Participant and product eligibility
(a) Participant eligibility
(i) Fair and open access
(ii) Financial resources
(iii) Operational requirements
(iv) Monitoring, reporting, and enforcement
(b) Product eligibility
2. Risk management
(a) General
(b) Risk management framework
(c) Chief risk officer
(d) Measurement of credit exposure
(e) Limitation of exposure to potential losses from defaults
(f) Margin requirements
(i) General
(ii) Methodology and coverage
(iii) Independent validation
(iv) Spread margins
(v) Price data
(vi) Daily review and back tests
(vii) Customer margin
(1) Gross margin for customer accounts
(2) Customer initial margin requirements
(3) Withdrawal of customer initial margin
(viii) Time deadlines
(g) Other risk control mechanisms
(i) Risk limits
(ii) Large trader reports
(iii) Stress tests
(iv) Portfolio compression
(v) Clearing members' risk management policies and procedures
(vi) Additional authority
3. Settlement procedures
(a) Daily settlements
(b) Settlement banks
(c) Settlement finality
(d) Recordkeeping
(e) Netting arrangements
(f) Physical delivery
4. Treatment of funds
(a) Required standards and procedures
(b) Segregation of funds and assets
(c) Holding of funds and assets
(i) Types of assets
(ii) Valuation
(iii) Haircuts
(iv) Concentration limits
(v) Pledged assets
(d) Permissible investments
5. Default rules and procedures
(a) General
(b) Default management plan
(c) Default procedures
(d) Insolvency of a clearing member
6. System safeguards
(a) General
(i) Definitions
(ii) Program of risk analysis
(iii) Elements of program
(iv) Standards for program
(v) Business continuity and disaster recovery
(vi) Location of resources; outsourcing
(vii) Notification of Commission staff; recordkeeping
(viii) Testing
(ix) Coordination of business continuity and disaster recovery plan
(b) SIDCOs
(i) Determining which DCOs will be subject to enhanced BC–DR obligations

[1] Commission regulations referred to herein are found at 17 CFR Ch. 1 (2010). They are accessible on the Commission's Web site at *http://www.cftc.gov.*

(ii) Recovery time objective
(iii) Geographic diversity
(iv) Testing
(v) Effective date
7. Special enforcement authority over SIDCOs
C. Additional amendments
1. Technical amendments to reorganize part 39
2. Supplemental provisions for proposed § 39.19
3. Technical amendments to proposed § 39.21
III. Effective Date
IV. Section 4(c)
V. Related Matters
A. Regulatory Flexibility Act
B. Paperwork Reduction Act
C. Cost-benefit analysis

I. Background

A. Title VII of the Dodd-Frank Act

On July 21, 2010, President Obama signed the Dodd-Frank Act.[2] Title VII of the Dodd-Frank Act[3] amended the Commodity Exchange Act (CEA)[4] to establish a comprehensive regulatory framework to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (1) Providing for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposing clearing and trade execution requirements on standardized derivative products; (3) creating rigorous recordkeeping and real-time reporting regimes; and (4) enhancing the Commission's rulemaking and enforcement authorities with respect to all registered entities and intermediaries subject to the Commission's oversight.

Section 725(c) of the Dodd-Frank Act amended Section 5b(c)(2) of the CEA, which sets forth core principles with which a DCO must comply to be registered and to maintain registration as a DCO.

The core principles were added to the CEA by the Commodity Futures Modernization Act of 2000 (CFMA).[5] The Commission did not adopt implementing rules and regulations, but instead promulgated guidance for DCOs on compliance with the core principles.[6] Under section 5b(c)(2), as amended by the Dodd-Frank Act, Congress expressly confirmed that the Commission may adopt implementing rules and regulations pursuant to its rulemaking authority under section 8a(5) of the CEA.[7]

The Commission continues to believe that each DCO should be afforded an appropriate level of discretion in determining how to operate its business within the statutory framework. At the same time, the Commission recognizes that specific, bright-line regulations may be necessary in order to facilitate DCO compliance with a given core principle and, ultimately, to protect the integrity of the U.S. clearing system. Accordingly, in developing the proposed regulations, the Commission has endeavored to strike an appropriate balance between establishing general prudential standards and prescriptive requirements.

In this notice of proposed rulemaking, the Commission proposes to adopt regulations to implement six DCO core principles. Those core principles, all of which were amended by the Dodd-Frank Act, are C (Participant and Product Eligibility), D (Risk Management), E (Settlement Procedures), F (Treatment of Funds), G (Default Rules and Procedures), and I (System Safeguards).

B. Title VIII of the Dodd-Frank Act

Section 802(b) of the Dodd-Frank Act states that the purpose of Title VIII is to mitigate systemic risk in the financial system and promote financial stability. Section 804 authorizes the Financial Stability Oversight Council (Council) to designate entities involved in clearing and settlement as systemically important.[8]

Section 805(a) of the Dodd-Frank Act allows the Commission to prescribe regulations for those DCOs that the Council has determined are systemically important. The Commission is proposing to adopt enhanced requirements for SIDCOs regarding system safeguards for business continuity and disaster recovery in proposed § 39.30.

Section 807(c) of the Dodd-Frank Act provides the Commission with special enforcement authority over SIDCOs, which the Commission is proposing to implement in proposed § 39.31.

C. Dodd-Frank Act Rulemaking Initiative

This proposed rulemaking is the last in a series of proposed rulemakings issued for the purpose of implementing the DCO core principles.[9] Through the proposed regulations, the Commission seeks to enhance legal certainty for DCOs, clearing members, and market participants by providing a regulatory framework to support DCO risk management practices overall and, in turn, strengthen the financial integrity of the futures markets and swap markets subject to Commission oversight.

With this in mind, the Commission also is proposing to establish greater uniformity and transparency in the DCO application process by adopting a registration application form that will facilitate greater efficiency and consistency in processing submissions. The Commission is further proposing certain technical amendments to update and conform provisions of part 39 to the CEA, as amended by the Dodd-Frank Act.

The Commission requests comment on all aspects of the rules proposed herein, as well as comment on the specific provisions and issues highlighted in the discussion below.

II. Discussion

A. Registration Procedures

As proposed in an earlier notice of proposed rulemaking, the Commission intends to continue to voluntarily apply a 180-day time frame for review of DCO registration applications, but eliminate the 90-day expedited review period for such applications.[10] Related to this, the Commission is now proposing additional revisions to the requirements for DCO registration in order to clarify the application submission and review process and to achieve greater efficiency for both applicants and the Commission.

The Commission is proposing to revise appendix A to part 39, "Application Guidance and Compliance With Core Principles," by removing the current content and substituting in its

[2] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at *http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm.*

[3] Pursuant to section 701 of the Dodd-Frank Act, Title VII may be cited as the "Wall Street Transparency and Accountability Act of 2010."

[4] 7 U.S.C. 1 *et seq.*

[5] *See* Commodity Futures Modernization Act of 2000, Pub. L. 106–554, 114 Stat. 2763 (2000).

[6] *See* 17 CFR part 39, app. A.

[7] Section 8a(5) of the CEA authorizes the Commission to promulgate such regulations "as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of [the CEA]." 7 U.S.C. 12a(5).

[8] *See* Advance Notice of Proposed Rulemaking Regarding Authority to Designate Financial Market Utilities as Systemically Important, available at *http://www.treasury.gov/initiatives/Pages/FSOC-index.aspx.*

[9] *See e.g.,* 75 FR 78185 (Dec. 15, 2010) (Core Principles J, Reporting; K, Recordkeeping; L, Public Information; and M, Information Sharing); 75 FR 77576 (Dec. 13, 2010) (Core Principles A, Compliance; H, Rule Enforcement; N, Antitrust Considerations; and R, Legal Risk); 75 FR 63732 (Oct. 18, 2010) (Core Principle P, Conflicts of Interest); and 75 FR 63113 (Oct. 14, 2010) (Core Principle B, Financial Resources).

[10] *See* 75 FR at 77586. Although the CEA does not require the Commission to review DCO applications within a prescribed time period or subject to any prescribed procedures, the Commission adopted a 90-day expedited review period and, in the alternative, the 180-day time period and procedures specified in section 6(a) of the CEA for review of applications for designation of a contract market.

place Form DCO, which would be comprised of two parts: (i) An application cover sheet for basic information about the DCO applicant, its ownership structure, officers, and application contact information, and (ii) instructions for a series of accompanying exhibits that would contain information demonstrating compliance with each of the DCO core principles. An application for DCO registration would consist of the completed Form DCO, including all applicable exhibits, and any supplemental information submitted to the Commission.[11]

The Commission's objective in adopting an application form is to streamline the DCO registration process, having learned from experience that the general guidance contained in the current appendix A does not provide sufficiently specific instructions to applicants. As a result, the registration process has been prolonged in some cases because of the need for Commission staff to provide applicants with additional guidance about the nature of the information that is required in order for the Commission to conclude that the applicant has demonstrated its ability to comply with the core principles.

The Commission proposes to amend § 39.3(d), "Guidance for applicants and registrants," and redesignate it as § 39.3(a)(2). The amended provision would state that any person seeking to register as a DCO would be required to submit a completed Form DCO as provided in appendix A to part 39, including all applicable exhibits. Use of the Form DCO also would be required for amendments to a pending application or requests for an amendment to an existing DCO registration. Section 39.3(a)(2) would clarify that an applicant, upon its own initiative, could file additional information that might be necessary or helpful to the Commission in processing the application. The Commission strongly encourages prospective applicants to submit any additional information that could be useful to the Commission.

The proposed appendix A containing the Form DCO is set forth in this notice of proposed rulemaking. The Commission requests comment on the potential benefits and disadvantages of requiring the use of a standardized application. In addition, the Commission requests comment on the content of the proposed application including specific exhibits.

Proposed § 39.3(a)(3) would clarify that the filing of a completed Form DCO would be a minimum requirement and would not create a presumption that the application is materially complete[12] or that supplemental information will not be required by the Commission. At any time during the application review process, the Commission may request that the applicant submit supplemental information in order for the Commission to process the application.

Under proposed § 39.3(a)(4), an applicant would be required to promptly amend its Form DCO if it discovered a material omission or error, or if there is a material change in any information already provided to the Commission.

Proposed § 39.3(a)(5) would largely incorporate applicable language of § 40.8(a), which identifies those parts of a DCO application that are available to the public.[13] Those parts are: the first page of the cover sheet, proposed rules (Exhibit A–1), the applicant's regulatory compliance chart (Exhibit A–2), a narrative summary of the applicant's proposed clearing activities (Exhibit A–3), documents establishing the applicant's legal status (Exhibit A–8), documents setting forth the applicant's corporate and governance structure (Exhibits A–7 and Q), and any other part of the application not covered by a request for confidential treatment subject to FOIA and filed in accordance with the requirements of § 145.9 of the Commission's regulations.[14] The Commission notes that it expects to continue its practice of posting DCO applications on its Web site for a public comment period (typically 30 days).

Proposed § 39.3(b)(1) would stay the running of the 180-day review period if an application was materially incomplete, consistent with the Commission's authority with respect to the designation of a contract market under section 6(a) of the CEA. The delegation provision of current § 39.3(g) would be redesignated as paragraph (b)(2). This provision authorizes the Director of the Division of Clearing and Intermediary Oversight or the Director's designee, with the concurrence of the General Counsel or the General Counsel's designee, to notify an applicant that the application is materially incomplete and the running of the 180-day period is stayed.

The Commission requests comment on all aspects of the proposed amendments to § 39.3, including the costs associated with the application process and possible means for streamlining the process further.

B. Implementation of DCO Core Principles

1. Participant and Product Eligibility

Core Principle C, as amended by the Dodd-Frank Act,[15] requires each DCO to establish appropriate admission and continuing eligibility standards for members of, and participants in, the DCO,[16] including sufficient financial resources and operational capacity to meet the obligations arising from participation. Core Principle C further requires that such participation and membership requirements be objective, be publicly disclosed, and permit fair and open access. Core Principle C also requires that each DCO establish and implement procedures to verify compliance with each participation and membership requirement, on an ongoing basis. With respect to product eligibility, Core Principle C requires that each DCO establish appropriate standards for determining the eligibility of agreements, contracts, or transactions submitted to the DCO for clearing.[17] The Commission is proposing to adopt

[11] In separate rulemakings, the Commission is proposing applications for designation as a contract market and registration as a swap execution facility. This approach is similar to the SEC's use of the Form CA for securities clearing agency applications, available at *https://www.sec.gov*.

[12] Section 6(a) of the CEA, 7 U.S.C. 8(a), provides that the Commission must approve or deny an application for designation of a contract market within 180 days of the filing of the application. However, "[i]f the Commission notifies the person that its application is materially incomplete and specifies the deficiencies in the application, the running of the 180-day period shall be stayed from the time of such notification until the application is resubmitted in completed form."

[13] *See* 75 FR 67282 (Nov. 2, 2010) (provisions common to registered entities).

[14] *See* 5 U.S.C. 552 and § 145.9 of the Commission's regulations (regarding petitions for confidential treatment of information submitted to the Commission).

[15] Section 5b(c)(2)(C) of the CEA; 7 U.S.C. 7a–1(c)(2)(C) (Core Principle C).

[16] Core Principle C, as well as the other core principles that are discussed herein, refer to "members of, and participants in" a DCO. The Commission interprets this phrase to mean persons with clearing privileges, and has used the term "clearing member" in describing the requirements of each core principle and in the text of the proposed regulations described herein. In a separate notice of proposed rulemaking, the Commission has proposed to amend the definition of "clearing member" in § 1.3(c) to mean "any person that has clearing privileges such that it can process, clear and settle trades through a derivatives clearing organization on behalf of itself or others. The derivatives clearing organization need not be organized as a membership organization." *See* 75 FR at 77585.

[17] Prior to amendment by the Dodd-Frank Act, Core Principle C provided that

[t]he applicant shall establish—

(i) appropriate admission and continuing eligibility standards (including appropriate minimum financial requirements) for members of and participants in the organization; and

(ii) appropriate standards for determining eligibility of agreements, contracts, or transactions submitted to the applicant.

§ 39.12 to establish requirements that a DCO would have to meet in order to comply with Core Principle C.

(a) Participant eligibility.

As noted above, Core Principle C requires that a DCO's admission and continuing eligibility standards for clearing members must be objective and publicly disclosed.[18] Proposed § 39.12(a) would codify these requirements, and would make clear that such requirements must be risk-based.

(i) Fair and open access.

Core Principle C mandates that participation requirements must "permit fair and open access."[19] It also mandates that clearing members must have "sufficient financial resources and operational capacity to meet obligations arising from participation in the derivatives clearing organization."[20] Although there is potential for tension between these goals, the Commission believes that they can be harmonized. Proposed § 39.12 is designed to ensure that participation requirements do not unreasonably restrict any entity from becoming a clearing member while, at the same time, limiting risk to the DCO and its clearing members. The Commission believes that more widespread participation could reduce the concentration of clearing member portfolios and diversify risk. It could also increase competition by allowing more entities to become clearing members.

Proposed § 39.12(a)(1) would require a DCO to establish participation requirements that permit fair and open access. To achieve fair and open access, proposed § 39.12(a)(1)(i) would prohibit a DCO from adopting a particular restrictive participation requirement if it could adopt a less restrictive requirement that would not materially increase risk to the DCO or its clearing members.

Proposed § 39.12(a)(1)(ii) would require a DCO to permit a market participant to become a clearing member if it met the DCO's participation requirements. Proposed § 39.12(a)(1)(iii) would prohibit participation requirements that have the effect of excluding or limiting clearing membership of certain types of market participants unless the DCO can demonstrate that the restriction is necessary to address credit risk or deficiencies in the participants' operational capabilities that would prevent them from fulfilling their obligations as clearing members. Section 39.12(a)(1)(iv) would prohibit a DCO from requiring that clearing members must be swap dealers. Section 39.12(a)(1)(v) would prohibit a DCO from requiring that clearing members maintain a swap portfolio of any particular size, or that clearing members meet a swap transaction volume threshold.

The access and participation requirements discussed above meet or exceed international recommendations.[21]

(ii) Financial resources.

Core Principle C mandates that participation requirements must ensure that clearing members have "sufficient financial resources and operational capacity to meet obligations arising from participation in the [DCO]."[22] Proposed § 39.12(a)(2)(i) would require a DCO to establish participation requirements that require clearing members to have access to sufficient financial resources to meet obligations arising from participation in the DCO in extreme but plausible market conditions. The financial resources could include a clearing member's capital, a guarantee from a clearing member's parent, or a credit facility funding arrangement. The proposed regulation would further specify that, for purposes of proposed § 39.12(a)(2), "capital" would mean adjusted net capital as defined in § 1.17 of the Commission's regulations, for futures commission merchants (FCMs), and net capital as defined in SEC rule 15c3–1, for broker-dealers, or any similar risk adjusted capital calculation for all other prospective clearing members.

The Commission invites comment regarding whether a guarantee or a credit facility funding arrangement is sufficiently reliable and liquid such that it should be considered as a resource that would be available to meet obligations arising from participation in a DCO in extreme but plausible market conditions.

Proposed § 39.12(a)(2)(ii) would require a DCO to establish capital requirements that are based on objective, transparent, and commonly accepted standards that appropriately match capital to risk. The proposed regulation would require capital requirements to be scalable so that they are proportional to the risks posed by clearing members.

With respect to persons that seek clearing membership in order to clear swaps, proposed § 39.12(a)(2)(iii) would specify that a DCO is not permitted to set a minimum capital requirement of more than $50 million.

If the capital requirement is satisfied by a prospective clearing member, the DCO is prohibited from making a determination that the prospective clearing member does not satisfy its scalable capital requirements. Proposed §§ 39.12(a)(2)(ii) and 39.12(a)(2)(iii), considered together, would require a DCO to admit any person to clearing membership for the purpose of clearing swaps, if the person had $50 million in capital, but would permit a DCO to require each clearing member to hold capital proportional to its risk exposure.[23] Thus, if a clearing member's risk exposure were to increase in a non-linear manner, the DCO could increase the clearing member's corresponding scalable capital requirement in a non-linear manner.

The Commission requests comment on whether establishing a capital threshold is an effective approach to promoting fair and open access. If it is, the Commission further requests views on whether the $50 million figure is an appropriate amount and, if not, what alternative amount might be more appropriate.

(iii) Operational requirements.

Proposed § 39.12(a)(3) would require a DCO to establish participation requirements that ensure that clearing members have adequate operational

[18] Section 5b(c)(2)(C)(iii) of the CEA; 7 U.S.C. 7a–1(c)(2)(C)(iii) (Core Principle C).

[19] *Id.*

[20] *Id.*

[21] In November 2004, the Task Force on Securities Settlement Systems, jointly established by the Committee on Payment and Settlement Systems (CPSS) of the central banks of the Group of Ten countries and the Technical Committee of the International Organization of Securities Commissions (IOSCO), issued Recommendations for Central Counterparties. CPSS & Technical Comm. of IOSCO *Recommendations for Central Counterparties,* CPSS Publ'n No. 64 (Nov. 2004), available at *http://www.bis.org/publ/cpss64.pdf* (CPSS–IOSCO Recommendations). CPSS–IOSCO Recommendation 2 provides, in part, that "[a] CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access." The CPSS–IOSCO Recommendations further state that

> [t]o avoid discriminating against classes of participants and introducing competitive distortions, participation requirements should be objective and avoid limiting competition through unnecessarily restrictive criteria, thereby permitting fair and open access within the scope of services offered by the CCP. [footnote omitted] Participation requirements that limit access on grounds other than risks should be avoided.

(CPSS–IOSCO Recommendations, pg. 16). The Commission notes that CPSS and IOSCO are currently reviewing the CPSS–IOSCO Recommendations, which may be revised.

[22] Section 5b(c)(2)(C)(i)(I) of the CEA; 7 U.S.C. 7a–1(c)(2)(C)(i)(I).

[23] Conversely, as discussed, *infra,* in section II.B.2.g.i, proposed § 39.13(h)(1)(i) would require a DCO to impose risk limits on a clearing member to prevent a clearing member from carrying positions where the risk exposure of those positions exceeded a threshold specified by the DCO relative to the financial resources of the clearing member, the DCO, or both.

capacity to meet obligations arising from participation in the DCO. The requirements would have to include, at a minimum, the ability to process expected volumes and values of transactions cleared by the clearing member within required time frames, including at peak times and on peak days; the ability to fulfill collateral, payment, and delivery obligations imposed by the DCO; and the ability to participate in default management activities under the rules of the DCO and in accordance with § 39.16 of the Commission's regulations.

(iv) Monitoring, reporting, and enforcement.

Strong participation requirements will not limit risk if clearing members do not satisfy the requirements on an ongoing basis. Accordingly, Core Principle C requires each DCO to "establish and implement procedures to verify, on an ongoing basis, the compliance of each participation and membership requirement of the derivatives clearing organization." [24] Proposed § 39.12(a)(4) would codify this requirement.

A DCO cannot effectively monitor clearing members if it is not adequately informed about their financial status. Proposed § 39.12(a)(5) would address this concern. Specifically, proposed § 39.12(a)(5)(i) would require a DCO to require all of its clearing members, including non-FCMs, to file periodic financial reports with the DCO that contain any financial information that the DCO determines is necessary to assess whether participation requirements are met on an ongoing basis. A DCO would have to require its clearing members that are FCMs to file the financial reports that are specified in § 1.10 of the Commission's regulations with the DCO. The proposed regulation also would require a DCO to review these financial reports for risk management purposes. Proposed § 39.12(a)(5)(i) would further require a DCO to require its clearing members that are not FCMs to make the periodic financial reports that they file with the DCO available to the Commission upon the Commission's request. Proposed § 39.12(a)(5)(ii) would require a DCO to adopt rules that require a clearing member to provide to the DCO, in a timely manner, information that concerns any financial or business developments that could materially affect the clearing member's ability to continue to comply with participation requirements.

Finally, proposed § 39.12(a)(6) would require a DCO to have the ability to enforce compliance with its participation requirements. In particular, the DCO would be required to establish procedures for the suspension and orderly removal of clearing members that no longer meet the DCO's participation requirements.

(b) Product eligibility.

Core Principle C requires each DCO to establish "appropriate standards for determining the eligibility of agreements, contracts, or transactions submitted to the [DCO] for clearing." [25] Proposed § 39.12(b)(1) would require a DCO to establish appropriate requirements for determining the eligibility of agreements, contracts, or transactions submitted to the DCO for clearing, taking into account the DCO's ability to manage the risks associated with such agreements, contracts, or transactions. Factors to be considered in determining product eligibility would include, but would not be limited to: (i) trading volume; (ii) liquidity; (iii) availability of reliable prices; (iv) ability of market participants to use portfolio compression [26] with respect to a particular swap product; (v) ability of the DCO and clearing members to gain access to the relevant market for purposes of creating and liquidating positions; (vi) ability of the DCO to measure risk for purposes of setting margin requirements; and (vii) operational capacity of the DCO and clearing members to address any unique risk characteristics of a product.

Section 2(h)(1)(B) of the CEA requires a DCO to adopt rules providing that all swaps with the same terms and conditions submitted to the DCO for clearing are economically equivalent within the DCO and may be offset with each other within the DCO. Section 2(h)(1)(B) further requires a DCO to provide for non-discriminatory clearing of a swap executed bilaterally or on or subject to the rules of an unaffiliated designated contract market (DCM) or swap execution facility (SEF). Proposed § 39.12(b)(2) would codify these requirements in the Commission's regulations.

Proposed § 39.12(b)(3) would require a DCO to select contract unit sizes that maximize liquidity, open access, and risk management. To the extent appropriate to further these objectives, the proposed regulation would require a DCO to select contract units for clearing purposes that may be smaller than the contract units in which trades submitted for clearing were executed. The contract unit size of a particular swap executed bilaterally may reflect the immediate circumstances of the two parties to the transaction. Once submitted for clearing, it may be possible to split the trade into smaller units without compromising the interests of the two original parties. Smaller units can promote liquidity by permitting more parties to trade the product, facilitate open access by permitting more clearing members to clear the product, and aid risk management by enabling a DCO, in the event of a default, to have more potential counterparties for liquidation.

Finally, proposed § 39.12(b)(4) would require each DCO that clears swaps to have rules stating that upon acceptance of a swap by the DCO for clearing, (i) the original swap is extinguished, (ii) it is replaced by equal and opposite swaps between clearing members and the DCO, (iii) all terms of the cleared swaps must conform to templates established under DCO rules, and (iv) if a swap is cleared by a clearing member on behalf of a customer, all terms of the swap, as carried in the customer account on the books of the clearing member, must conform to the terms of the cleared swap established under the DCO's rules.

The purpose of this provision is to encourage the standardization of swaps and to avoid any differences between the terms of a swap as carried at the DCO level and as carried at the clearing member level. Any such differences would raise both customer protection and systemic risk concerns. From a customer protection standpoint, if the terms of the swap at the customer level differ from those at the clearing level, then the customer position cannot really be said to have been cleared. If the customer position differs from the cleared position, the customer may not receive the full transparency and liquidity benefits of clearing. Similarly, from a systemic perspective, any differences could diminish overall price discovery and liquidity. Standardizing the terms of a swap upon clearing would facilitate trading and promote the mitigation of risk for all participants in the swap markets. Furthermore, standardization would support the requirement in section 2(h)(1)(B) of the CEA and proposed § 39.12(b)(2) that a DCO must adopt rules providing that all swaps with the same terms and conditions submitted to the DCO are

[24] *See* section 5b(c)(2)(C)(ii) of the CEA; 7 U.S.C. 7a–1(c)(2)(C)(ii). Based on context, the Commission interprets the phrase "compliance of each participation and membership requirement" to mean compliance "with" each participation and membership requirement.

[25] Section 5b(c)(2)(C)(i)(II) of the CEA; 7 U.S.C. 7a–1(c)(2)(C)(i)(II).

[26] Portfolio compression is a mechanism by which superfluous transactions among two or more counterparties are compressed, terminated and replaced with a smaller number of transactions of decreased notional principal value in an effort to reduce the risk, cost, and inefficiency of maintaining unnecessary transactions on the counterparties' books.

economically equivalent within the DCO and may be offset with each other.

2. Risk Management Requirements

Core Principle D, as amended by the Dodd-Frank Act,[27] requires each DCO to ensure that it possesses the ability to manage the risks associated with discharging the responsibilities of the DCO through the use of appropriate tools and procedures. It further requires each DCO to measure its credit exposures to each clearing member not less than once during each business day and to monitor each such exposure periodically during the business day. Core Principle D also requires each DCO to limit its exposure to potential losses from defaults by clearing members, through margin requirements and other risk control mechanisms, to ensure that its operations would not be disrupted and that nondefaulting clearing members would not be exposed to losses that nondefaulting clearing members cannot anticipate or control. Finally, Core Principle D requires that the margin that the DCO requires from each clearing member must be sufficient to cover potential exposures in normal market conditions and that each model and parameter used in setting such margin requirements must be risk-based and reviewed on a regular basis.[28] The Commission is proposing to adopt § 39.13 to establish requirements that a DCO would have to meet in order to comply with Core Principle D.

(a) General.

Proposed § 39.13(a) would require a DCO to ensure that it possesses the ability to manage the risks associated with discharging its responsibilities through the use of appropriate tools and procedures. The specific requirements that are addressed in the remainder of proposed § 39.13, in addition to margin requirements, describe various tools and procedures that the Commission believes are necessary to ensure that DCOs are able to effectively manage the risks that are inherent in their roles as central counterparties. Many of those requirements reflect the current practices of most or all DCOs, and others may describe enhancements that would assist existing and new DCOs in mitigating their risks as they assume new responsibilities in connection with the clearing of swaps.

(b) Risk management framework.

Proposed § 39.13(b) would require a DCO to establish and maintain written policies, procedures, and controls, approved by its Board of Directors, which establish an appropriate risk management framework that, at a minimum, clearly identifies and documents the range of risks to which the DCO is exposed, addresses the monitoring and management of the entirety of those risks, and provides a mechanism for internal audit. Those risks may include, but are not limited to, legal risk, credit risk, liquidity risk, custody and investment risk, concentration risk, default risk, operational risk, market risk, and business risk. A DCO would be required to regularly review its risk management framework and update it as necessary.

The Commission believes that a DCO should adopt a comprehensive and documented risk management framework that addresses all of the various types of risks to which it is exposed, including the manner in which they may relate to each other. A DCO's risk management framework should be subject to the approval of its Board of Directors, as the Board is ultimately responsible for managing a DCO's risks. The Commission is proposing to leave it to the discretion of each DCO to determine the frequency with which it reviews its risk management framework as long as it is reviewed on a regular basis.

(c) Chief risk officer.

Proposed § 39.13(c) would require a DCO to have a chief risk officer who would be responsible for the implementation of the risk management framework and for making appropriate recommendations regarding the DCO's risk management functions to the DCO's Risk Management Committee or Board of Directors, as applicable. In a separate rulemaking, the Commission has proposed to adopt § 39.13(d) to require DCOs to have a Risk Management Committee with defined composition requirements and specified minimum functions.[29]

DCOs generally have a chief risk officer or an individual who performs such a function, and the Commission believes this is a "best practice." Although Core Principle D does not specifically require a DCO to have a chief risk officer, the Commission believes that given the importance of the risk management function, each DCO should have a member of senior management who is responsible for overseeing the implementation of the DCO's comprehensive risk management framework and making appropriate recommendations regarding risk management issues to the DCO's Risk Management Committee (for matters within its jurisdiction) or directly to the Board.

The CEA, as amended by the Dodd-Frank Act, requires a DCO to have a chief compliance officer with defined responsibilities.[30] These requirements have been addressed in a separate rulemaking.[31] Given the importance of the risk management function and the comprehensive nature of the responsibilities of the chief compliance officer as defined in the statute, the Commission expects that the chief risk officer and the chief compliance officer would be two different individuals.

(d) Measurement of credit exposure.

Proposed § 39.13(e) would require a DCO to measure and monitor its credit exposures to its clearing members. The proposed regulation uses the term "credit exposure" in order to be consistent with the statutory language of Core Principle D. In this context, "credit exposure" does not refer to an extension of credit by the DCO to a clearing member. Rather, it refers to any amounts that a clearing member would owe to a DCO if the clearing member were to default in its obligations to the DCO. It includes both current exposures and potential future exposures.

Specifically, § 39.13(e) would require a DCO to: (1) Measure its credit exposure to each clearing member and mark to market such clearing member's open positions at least once each business day; and (2) monitor its credit exposure to each clearing member periodically during each business day. Proposed § 39.13(e) goes hand in hand with proposed § 39.14(b), which addresses daily settlements based on a DCO's measurement of its credit exposures to its clearing members.[32]

(e) Limitation of exposure to potential losses from defaults.

Proposed § 39.13(f) would require a DCO, through margin requirements and other risk control mechanisms, to limit its exposure to potential losses from defaults by its clearing members to ensure that: (1) Its operations would not be disrupted; and (2) nondefaulting clearing members would not be exposed to losses that nondefaulting clearing members cannot anticipate or control. The language of proposed § 39.13(f) is virtually identical to the language in

[27] Section 5b(c)(2)(D) of the CEA; 7 U.S.C. 7a–1(c)(2)(D) (Core Principle D).

[28] Prior to amendment by the Dodd-Frank Act, Core Principle D provided that "[t]he applicant shall have the ability to manage the risks associated with discharging the responsibilities of a derivatives clearing organization through the use of appropriate tools and procedures."

[29] *See* 75 FR at 63750. In that proposed rulemaking, the provisions relating to the Risk Management Committee were designated as § 39.13(g). In the final rulemaking, the provisions will be redesignated as § 39.13(d).

[30] *See* section 5b(i) of the CEA; 7 U.S.C. 7a–1(i).

[31] 75 FR at 77587.

[32] *See infra* section II.B.3.a of this notice.

section 5b(c)(2)(D)(iii) of the CEA, as amended by the Dodd-Frank Act.

(f) Margin requirements.

(i) General.

As specified in section 5b(c)(2)(D)(iv) of the CEA, proposed § 39.13(g)(1) would require that the initial margin that a DCO requires from each clearing member must be sufficient to cover potential exposures in normal market conditions and that each model and parameter used in setting initial margin requirements must be risk-based and reviewed on a regular basis.[33] The Commission has not defined "normal market conditions" in the proposed regulation. Current international recommendations define "normal market conditions" as "price movements that produce changes in exposures that are expected to breach margin requirements or other risk control mechanisms only 1% of the time, that is, on average on only one trading day out of 100."[34] The Commission invites comment regarding whether a definition of "normal market conditions" should be included in the proposed regulation and, if so, how normal market conditions should be defined.

(ii) Methodology and coverage.

Proposed § 39.13(g)(2) would set forth requirements regarding margin methodology and coverage. First, it would require a DCO to establish initial margin requirements that are commensurate with the risks of each product or portfolio, including any unique characteristics of, or risks associated with, particular products or portfolios. In particular, proposed 39.13(g)(2)(i) would require a DCO that clears credit default swaps (CDS) to appropriately address jump-to-default risk in setting initial margins.[35] With the exception of jump-to-default risk, the Commission has not defined specific risks that a DCO should consider in light of the fact that such risks would be product-specific and portfolio-specific. In addition, there may be risks that might apply to products or portfolios that are cleared in the future that cannot be anticipated at this time. The Commission invites comment regarding whether there are specific risks that should be identified and addressed in the proposed regulation in addition to jump-to-default risk.

Proposed § 39.13(g)(2)(ii) would require a DCO to use margin models that generate initial margin requirements sufficient to cover the DCO's potential future exposures to clearing members based on price movements in the interval between the last collection of variation margin[36] and the time within which the DCO estimates that it would be able to liquidate a defaulting clearing member's positions (liquidation time). A DCO would be required to use a liquidation time that is a minimum of five business days for cleared swaps that are not executed on a DCM, whether the swaps are carried in a customer account subject to section 4d(a) or 4d(f) of the CEA, or a house account.[37] A DCO would be required to use a liquidation time that is a minimum of one business day for all other products that it clears, although it would be required to use longer liquidation times, if appropriate, based on the unique characteristics of particular products or portfolios.

A minimum of one business day is the current standard that DCOs generally apply to futures and options on futures contracts. The Commission believes that a minimum of five business days is appropriate for cleared swaps that are not executed on a DCM in that such a time period may be necessary to close out swap positions in a cost-effective manner.[38] Several clearing organizations currently use a five-day liquidation time in determining margin requirements for certain cleared swaps. The Commission invites comment regarding whether the minimum liquidation times specified in proposed § 39.13(g)(2)(ii) are appropriate, or whether there are minimum liquidation times that are more appropriate.

Proposed § 39.13(g)(2)(iii) would require that the actual coverage of the initial margin requirements produced by a DCO's margin models, along with projected measures of the models' performance, would have to meet a confidence level of at least 99%, based on data from an appropriate historic time period with respect to: (A) Each product that is margined on a product basis; (B) each spread within or between products for which there is a defined spread margin rate, as described in proposed § 39.13(g)(3); (C) each account held by a clearing member at the DCO, by customer origin and house origin, and (D) each swap portfolio, by beneficial owner. These requirements meet or exceed international recommendations.[39]

The Commission recognizes that while some DCOs generally apply a 99% confidence level to some or all products that they clear, other DCOs apply a confidence level of between 95% and 99% with respect to certain products. In addition, certain DCOs may achieve an average confidence level of 99% across all products that they clear, although not every product may meet the 99% confidence level. The Commission invites comment regarding whether a confidence level of 99% is appropriate with respect to all applicable products, spreads, accounts, and swap portfolios.[40]

Proposed § 39.13(g)(2)(iv) does not specify the historic time period that a DCO would have to use when calculating a 99% confidence level for any particular product, account, or portfolio. Rather, it would permit each

[33] The Commission has proposed to define "initial margin" as "money, securities, or property posted by a party to a futures, option, or swap as performance bond to cover potential future exposures arising from changes in the market value of the position." *See* 75 FR at 77585 (proposing § 1.3(lll)).

[34] CPSS–IOSCO Recommendations, pg. 21.

[35] Jump-to-default risk refers to the possibility that a CDS portfolio with large net sales of protection on an underlying reference entity could experience significant losses over a very short period of time following an unexpected event of default by the reference entity.

[36] The Commission has proposed to define "variation margin" as "a payment made by a party to a futures, option, or swap to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market." *See* 75 FR at 77585 (proposing § 1.3(ooo)).

[37] *See infra* section II.B.4.b of this notice, discussing commingling of customer futures and cleared swaps positions.

[38] Pursuant to section(s) 4(c) and/or 4d of the CEA, the Commission has previously issued several orders allowing funds margining cleared swaps to be commingled with funds margining futures and options on futures. In those orders, the Commission permitted such swaps to be margined using liquidation times that were less than five business days. *See, e.g.,* 74 FR 12316 (Mar. 24, 2009) (corn, wheat and soybean swaps); 73 FR 77015 (Dec. 18, 2008) (coffee, sugar and cocoa swaps); and Order of the Commodity Futures Trading Commission, dated Sep. 26, 2008, entitled "Treatment of Funds Held in Connection with the Clearing of Over-the-Counter Products by The Chicago Mercantile Exchange," available at *http://www.cftc.gov/stellent/groups/public/@requestsandactions/documents/ifdocs/cbot4dorder9-26-08.pdf* (ethanol swaps). The Commission intends to grandfather the swaps subject to previously issued orders, such that the relevant liquidation time periods for those swaps would continue to be governed by the terms of the orders.

[39] For example, on September 15, 2010, the European Commission (EC) proposed the European Market Infrastructure Regulation (EMIR), available at *http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf,* "to ensure implementation of the G20 commitments to clear standardized derivatives [which can be accessed at *http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf*], and that Central Counterparties (CCPs) comply with high prudential standards * * *," among other things, and expressed its intent to be consistent with the Dodd-Frank Act. (EMIR, pg. 2–3). The EMIR requires that margins "* * * shall be sufficient to cover losses that result from at least 99 per cent of the exposures movements over an appropriate time horizon . * * *" (EMIR, Article 39, paragraph 1, pg. 46).

[40] For example, the CPSS–IOSCO Recommendations state that "[m]argin requirements for new and low-volume products might be set at a lower coverage level [than the major products cleared by a CCP] if the potential losses resulting from such products are minimal." (CPSS–IOSCO Recommendations, pg. 23).

DCO to exercise its discretion with respect to the appropriate time periods that should be used in each instance, based on the characteristics, including volatility patterns, as applicable, of the products, spreads, accounts, or portfolios.

(iii) Independent validation.

Historically, many U.S. DCOs have used Chicago Mercantile Exchange's (CME) proprietary risk-based portfolio margining system, Standard Portfolio Analysis of Risk® (SPAN) as the basis for their margin models for futures and options. However, there is at least one other margin model that is currently being used for futures and options, and there are also multiple margin models that DCOs are using for swaps that are currently cleared. As DCOs begin to clear additional swaps it can be anticipated that they will develop new margin models to address the risks of particular products.

Proposed § 39.13(g)(3) would require that, on a regular basis, a DCO's systems for generating initial margin requirements, including the DCO's theoretical models, would have to be reviewed and validated by a qualified and independent party. A validation should include a comprehensive analysis to ensure that such systems and models achieve their intended goals. Although the proposed regulation does not define the term "regular basis," the Commission would expect that, at a minimum, a DCO would obtain such an independent validation prior to implementation of a new margin model and when making any significant change to a model that is in use by the DCO. Significant changes would be those that could materially affect the nature or level of risks to which a DCO would be exposed. The Commission would expect a DCO to obtain an independent validation prior to any significant change that would relax risk management standards. However, if a DCO needed to adopt a significant change in an expedited manner to enhance risk protections, the Commission would expect the DCO to obtain an independent validation promptly after the change was made.

The Commission has not proposed a definition of the term "qualified and independent party." The Commission invites comment regarding whether a qualified and independent party must be a third party or whether there may be circumstances under which an employee of the relevant DCO could be considered to be independent.

(iv) Spread margins.

Proposed § 39.13(g)(4)(i) would permit a DCO to allow reductions in initial margin requirements for related positions (spread margins), if the price risks with respect to such positions were significantly and reliably correlated. Under the proposed regulation, the price risks of different positions would only be considered to be reliably correlated if there was a theoretical basis for the correlation in addition to an exhibited statistical correlation. A non-exclusive list of possible theoretical bases includes the following: (A) The products on which the positions are based are complements of, or substitutes for, each other; (B) one product is a significant input into the other product(s); (C) the products share a significant common input; or (D) the prices of the products are influenced by common external factors. An example of such an external factor might be interest rates. An offset may not be based solely on the fact that the prices of certain products have exhibited a statistical correlation in the past. The DCO would be required to be able to articulate a theoretical explanation for such a correlation. The Commission requests comment regarding the appropriateness of requiring a theoretical basis for the correlation between related positions before reductions in initial margin requirements would be permitted.

Proposed § 39.13(g)(4)(ii) would require a DCO to regularly review its spread margins and the correlations on which they are based.

(v) Price data.

Proposed § 39.13(g)(5) would require a DCO to have a reliable source of timely price data to measure its credit exposure accurately, and to have written procedures and sound valuation models for addressing circumstances where pricing data is not readily available or reliable. Both initial margin and variation margin calculations require timely and reliable price data to be effective. DCOs should rely on prices from continuous, transparent, and liquid markets, wherever possible. It may be difficult to determine current market prices for certain over-the-counter (OTC) products if there is no continuous liquid market or if bid-ask spreads are volatile. In these circumstances, DCOs would need to ensure that they would be able to measure their credit exposures accurately through the use of sound valuation models. The nature of such valuation models would necessarily depend on the particular products and the source of any relevant pricing data.

(vi) Daily review and back tests.

Daily review and periodic back testing are essential to enable a DCO to ensure that its margin models continue to provide adequate coverage of the DCO's risk exposures to its clearing members. Proposed § 39.13(g)(6) would require a DCO to determine the adequacy of its initial margin requirements for each product, on a daily basis, with respect to those products that are margined on a product basis. Proposed § 39.13(g)(7) would require a DCO to conduct certain back tests. The Commission has proposed to define "back test" in a separate rulemaking, as "a test that compares a derivatives clearing organization's initial margin requirements with historical price changes to determine the extent of actual margin coverage."[41] Thus, the back tests required by proposed § 39.13(g)(7), which would require a comparison of initial margin requirements with historical price changes, are distinguished from the daily review required by proposed § 39.13(g)(6), which would require a determination of whether a margin breach had occurred on the particular day under review. For purposes of proposed § 39.13(g)(7)(i) and (ii), proposed § 39.13(g)(7) specifies that, in conducting back tests, a DCO would be required to use historical price change data based on a time period that is equivalent in length to the historic time period used by the applicable margin model for establishing the minimum 99% confidence level or a longer time period. The applicable time period is separately specified for the back tests required by proposed § 39.13(g)(7)(iii), as discussed below.

Proposed § 39.13(g)(7)(i) would require a DCO, on a daily basis, to conduct back tests with respect to products that are experiencing significant market volatility. Specifically, a DCO would be required to test the adequacy of its initial margin requirements and its spread margin requirements for such products that are margined on a product basis.

Proposed § 39.13(g)(7)(ii) would require a DCO, on at least a monthly basis, to conduct back tests to test the adequacy of its initial margin requirements and spread margin requirements for each product that is margined on a product basis. The Commission requests comment regarding whether initial margin requirements for all products should be subject to back tests on a monthly basis or whether some other time period, such as quarterly, would be sufficient to meet prudent risk management standards.

Proposed § 39.13(g)(7)(iii) would require a DCO, on at least a monthly basis, to conduct back tests to test the adequacy of its initial margin

[41] *See* 75 FR at 77585 (proposing definitions in § 39.1(b), to be redesignated as § 39.2).

requirements for each clearing member's accounts, by customer origin and house origin, and each swap portfolio, by beneficial owner, over at least the previous 30 days. The Commission has proposed that the initial margin requirements for such clearing member accounts and swap portfolios must be compared to 30 days of historical data since the composition of such accounts and swap portfolios may change on a daily basis. The Commission anticipates that back tests with respect to such accounts and portfolios would involve a review of the initial margin requirements for each account and portfolio as it existed on each day during the 30-day period. The Commission requests comment regarding whether initial margin requirements for all clearing members' accounts, by origin, and swap portfolios, by beneficial owner, should be subject to back tests on a monthly basis or whether some other time period, such as quarterly (based on the previous quarter's historical data), would be sufficient to meet prudent risk management standards.

(vii) Customer margin.

Proposed § 39.13(g)(8) addresses three different proposed requirements regarding customer margin, including the collection of gross margin for customer accounts, customer initial margin levels, and withdrawals of customer initial margin.[42]

(1) Gross margin for customer accounts.

Proposed § 39.13(g)(8)(i) would require a DCO to collect initial margin on a gross basis for each clearing member's customer account equal to the sum of the initial margin amounts that would be required by the DCO for each individual customer within that account if each individual customer were a clearing member. A DCO would not be permitted to net positions of different customers against one another, but it could collect initial margin for its clearing members' house accounts on a net basis.

The Commission recognizes that gross margining of customer accounts would be a change from current margin practices at certain DCOs. However, the Commission believes that gross margining of customer accounts would more appropriately address the risks posed to a DCO by its clearing members' customers than margining all of a particular clearing member's customer accounts on a net basis. Gross margining would increase the financial resources available to a DCO in the event of a customer default. Moreover, with respect to cleared swaps, the requirement for gross margining of customers' portfolios supports the requirement in proposed § 39.13(g)(2)(iii) that a DCO would have to margin each swap portfolio at a minimum 99% confidence level.

The Commission recently proposed a new § 39.19(c)(1)(iv) under which a DCO would be required, on a daily basis, to report the end-of-day positions for each clearing member, by origin.[43] In connection with the proposed § 39.13(g)(8)(i) requirement for DCOs to collect initial margin for customer accounts on a gross basis, the Commission is proposing to amend proposed § 39.19(c)(1)(iv) to additionally require a DCO, for the customer origin, to report the gross positions of each beneficial owner.

(2) Customer initial margin requirements.

Proposed § 39.13(g)(8)(ii) would require a DCO to require its clearing members to collect customer initial margin from their customers for non-hedge positions at a level that is greater than 100% of the DCO's initial margin requirements with respect to each product and swap portfolio. Such a cushion would enable clearing members to deposit additional margin with a DCO on behalf of their customers, as necessitated by adverse market movements, without the need for the clearing members to make frequent margin calls to their customers.

Historically, DCMs have mandated the amounts of customer initial margin and maintenance margin that their FCM members must collect from their customers.[44] DCMs typically impose customer initial margin requirements that are higher, by a specified percentage, than the initial margin requirements imposed upon clearing FCMs by the relevant DCO, and maintenance margin requirements that are equivalent to the DCO's initial margin requirements. Customer initial margin requirements have typically been between 125% and 140% of a DCO's initial margin requirements.

The Commission believes that DCOs should determine how much margin their FCM clearing members must collect from their customers because a DCO must ensure that its clearing members are able to meet their obligations to the DCO. Moreover, although it may be appropriate for a DCM to determine the customer initial margin requirements for non-clearing FCM members of the DCM, with respect to products traded on the DCM, a DCO may be the only entity in a position to assume any responsibility for setting customer initial margin requirements for cleared swaps that may be traded on SEFs or executed bilaterally.

Proposed § 39.13(g)(8)(ii) would permit a DCO to have reasonable discretion in determining the percentage by which customer initial margins would have to exceed the DCO's initial margin requirements with respect to particular products or swap portfolios. A DCO would be familiar with the risk characteristics of particular products and swap portfolios that it clears, which should enable it to determine the extent of the cushion that a clearing member should have with respect to customer initial margins. However, under the proposed regulation, the Commission may review such percentage levels and require different percentage levels, but not specific margin amounts, if the Commission deems the levels insufficient to protect the financial integrity of the clearing members or the DCO.

The customer initial margin requirement set forth in proposed § 39.13(g)(8)(ii) would only apply with respect to customers' non-hedge positions. Hedge margins are typically equal to maintenance margins.

(3) Withdrawal of customer initial margin.

Proposed § 39.13(g)(8)(iii) would require a DCO to require its clearing members to prohibit their customers from withdrawing funds from their accounts with such clearing members unless the net liquidating value plus the margin deposits remaining in the customer's account after the withdrawal would be sufficient to meet the customer initial margin requirements with respect to the products or portfolios in the customer's account, which were cleared by the DCO. This is consistent with the definition of "Margin Funds Available for Disbursement" in the Margins Handbook prepared by the Joint Audit Committee[45] and, therefore, codifies current practices.

(viii) Time deadlines.

[42] The Commission has proposed to define "customer initial margin" as "initial margin posted by a customer with a futures commission merchant, or by a non-clearing futures commission merchant with a clearing member." *See* 75 FR at 77585 (proposing § 1.3(kkk)).

[43] *See* 75 FR at 78195.

[44] "Maintenance margin" refers to an amount that must be maintained on deposit at all times. If the equity in a customer's account drops below the level of maintenance margin because of adverse price movement, the FCM must issue a margin call to restore the customer's equity to the customer initial margin level.

[45] *See http://www.nfa.futures.org/NFA-compliance/publication-library/margins-handbook.pdf.*

Proposed § 39.13(g)(9) would require a DCO to establish and enforce time deadlines for initial and variation margin payments. If margin payments are not made on time, DCOs and clearing members face uncollateralized risk.

(g) Other Risk Control Mechanisms

(i) Risk limits.

Proposed § 39.13(h)(1)(i) would require a DCO to impose risk limits on each clearing member, by customer origin and house origin, in order to prevent a clearing member from carrying positions where the risk exposure of those positions exceeds a threshold set by the DCO relative to the clearing member's financial resources, the DCO's financial resources, or both. The DCO would have reasonable discretion in determining: (A) the method of computing risk exposure; (B) the applicable threshold(s); and (C) the applicable financial resources, provided however, that the ratio of exposure to capital would have to remain the same across all capital levels. The Commission could review any of these determinations and require different methods, thresholds, or financial resources, as appropriate.

Proposed § 39.13(h)(1)(ii) would allow a DCO to permit a clearing member to exceed the threshold(s) applied pursuant to paragraph (h)(1)(i) provided that the DCO required the clearing member to post additional initial margin that the DCO deemed sufficient to appropriately eliminate excessive risk exposure at the clearing member. The Commission could review the amount of additional initial margin and require a different amount, as appropriate.

(ii) Large trader reports.

Proposed § 39.13(h)(2) would require a DCO to obtain from its clearing members, copies of all reports that such clearing members were required to file with the Commission pursuant to part 17 of the Commission's regulations, *i.e.,* large trader reports. A DCO would be required to obtain such reports directly from the relevant reporting market if the reporting market exclusively listed self-cleared contracts, and were therefore required to file such reports on behalf of clearing members, pursuant to § 17.00(i).

Proposed § 39.13(h)(2) would require a DCO to review the large trader reports that it received from its clearing members, or reporting markets, as applicable, on a daily basis to ascertain the risk of the overall portfolio of each large trader. A DCO would be required to review large trader positions for each large trader, across all clearing members carrying an account for the large trader. A DCO would also be required to take additional actions with respect to such clearing members in order to address any risks posed by a large trader, when appropriate. Such actions would include actions specified in proposed § 39.13(h)(6), as discussed in section II.B.2(g)(vi) below.

(iii) Stress tests.

Proposed § 39.13(h)(3) would require a DCO to conduct certain daily and weekly stress tests. The Commission has proposed to define "stress test" in a separate rulemaking, as "a test that compares the impact of a potential price move, change in option volatility, or change in other inputs that affect the value of a position, to the financial resources of a derivatives clearing organization, clearing member, or large trader, to determine the adequacy of such financial resources." [46] The Commission has not proposed a definition of financial resources in this context, although it would be expected to include, at a minimum, margin on deposit, and with respect to a clearing member, its capital.

Proposed § 39.13(h)(3) would require a DCO to conduct certain types of stress tests with respect to certain large traders on a daily basis and with respect to all clearing member accounts and swap portfolios on at least a weekly basis.

Proposed § 39.13(h)(3)(i) would require a DCO to conduct daily stress tests with respect to each large trader who poses significant risk to a clearing member or the DCO in the event of default, including positions at all clearing members carrying accounts for the large trader. The DCO would have reasonable discretion in determining which traders to test and the methodology used to conduct the stress tests. However, the Commission could review the selection of accounts and the methodology and require changes, as appropriate.

Proposed § 39.13(h)(3)(ii) would require a DCO to conduct stress tests, at least once a week with respect to each account held by a clearing member at the DCO, by customer origin and house origin, and each swap portfolio, by beneficial owner, under extreme but plausible market conditions. The DCO would have reasonable discretion in determining the methodology used to conduct these stress tests. However, the Commission may review the methodology and require any appropriate changes. The Commission requests comment regarding whether all clearing member accounts, by origin, and all swap portfolios should be subject to such stress tests on a weekly basis or whether some other time period, such as monthly, would be sufficient to meet prudent risk management standards.

(iv) Portfolio compression.

Proposed § 39.13(h)(4)(i) would require a DCO to offer multilateral portfolio compression exercises, on a regular basis, for its clearing members that clear swaps, to the extent that such exercises are appropriate for those swaps that it clears. The Commission has not specified the frequency with which DCOs must offer multilateral portfolio compression exercises in proposed § 39.13(h)(4)(i), other than to state that they would have to be offered on a regular basis. The Commission requests comment regarding whether such exercises should be offered monthly, quarterly, or another frequency. In addition, the Commission requests comment regarding whether the frequency of such exercises should vary for different categories of swaps.

Under proposed § 39.13(h)(4)(ii), a DCO must require its clearing members to participate in all multilateral portfolio compression exercises offered by the DCO, to the extent that any swap in the applicable portfolio is eligible for inclusion in the exercise, unless including the swap would be reasonably likely to significantly increase the risk exposure of the clearing member. Proposed § 39.13(h)(4)(iii) would permit a DCO to allow clearing members participating in such exercises to set risk tolerance limits for their portfolios, provided that the clearing member could not set such risk tolerances at an unreasonable level or use such risk tolerances to evade the requirements of proposed § 39.13(h)(4).

(v) Clearing members' risk management policies and procedures.

The Commission believes that in order for a DCO to adequately manage its own risks, it must ensure that its clearing members also have adequate risk management policies and procedures. In order to do this, a DCO must have the authority to obtain documents and information from its clearing members regarding such policies and procedures, and must review their implementation on a periodic basis.

Proposed § 39.13(h)(5) would impose several requirements upon DCOs relating to their clearing members' risk management policies and procedures. Specifically, a DCO must adopt rules that: (a) Require its clearing members to maintain current written risk management policies and procedures; (b) ensure that the DCO has the authority to request and obtain information and documents from its

[46] *See* 75 FR at 77585–86 (proposing definitions in § 39.1(b), to be redesignated as § 39.2).

clearing members regarding their risk management policies, procedures, and practices, including, but not limited to, information and documents relating to the liquidity of their financial resources and their settlement procedures; and (c) require its clearing members to make information and documents regarding their risk management policies, procedures, and practices available to the Commission upon the Commission's request. In addition, a DCO would be required to review the risk management policies, procedures, and practices of each of its clearing members on a periodic basis and document such reviews.

Proposed § 39.13(h)(5) does not define how DCOs would have to conduct clearing member risk management reviews, and has not specified a required frequency of such reviews except to state that they would have to be conducted on a periodic basis. The Commission invites comment regarding whether it should require that a DCO must conduct risk reviews of its clearing members on an annual basis or within some other time frame. The Commission also requests comment regarding whether the Commission should require that such reviews be conducted in a particular manner, *e.g.,* whether there must be an on-site visit or whether any particular testing should be required. In addition, the Commission invites comment regarding whether, and to what extent, a DCO should be permitted to vary the method and depth of such reviews based upon the nature, risk profiles, or other regulatory supervision of particular clearing members.

The risk management reviews contemplated by proposed § 39.13(h)(5) would also support DCOs' compliance with Core Principle C and proposed § 39.12, by providing a means for the DCO and the Commission to ensure that clearing members continue to meet participation requirements relating to risk management.

(vi) Additional authority.

Proposed § 39.13(h)(6) would require a DCO to take additional actions with respect to particular clearing members, when appropriate, based on the application of objective and prudent risk management standards. Such actions would include, but would not be limited to: (i) Imposing enhanced capital requirements; (ii) imposing enhanced margin requirements; (iii) imposing position limits; (iv) prohibiting an increase in positions; (v) requiring a reduction of positions; (vi) liquidating or transferring positions; and (vii) suspending or revoking clearing membership. The Commission believes that a DCO should have the authority to take any of the specified actions or other appropriate actions, and should take such actions, when necessary to address risks posed to the DCO by particular clearing members or their customers. However, a DCO would have the discretion to determine when to take additional actions, and what actions to take, based on its exercise of objective and prudent risk management standards.

3. Settlement Procedures

Core Principle E, as amended by the Dodd-Frank Act,[47] requires a DCO to: (a) Complete money settlements on a timely basis, but not less frequently than once each business day; (b) employ money settlement arrangements to eliminate or strictly limit its exposure to settlement bank risks (including credit and liquidity risks from the use of banks to effect money settlements); (c) ensure that money settlements are final when effected; (d) maintain an accurate record of the flow of funds associated with money settlements; (e) possess the ability to comply with the terms and conditions of any permitted netting or offset arrangement with another clearing organization; (f) establish rules that clearly state each obligation of the DCO with respect to physical deliveries; and (g) ensure that it identifies and manages each risk arising from any of its obligations with respect to physical deliveries.[48] The Commission is proposing to adopt § 39.14 to establish requirements that a DCO would have to meet in order to comply with Core Principle E.

Proposed § 39.14(a) would define "settlement" and "settlement bank" for purposes of § 39.14. In particular, "settlement" is defined in proposed § 39.14(a)(1) to include: (i) Payment and receipt of variation margin for futures, options and swap positions; (ii) payment and receipt of option premiums; (iii) deposit and withdrawal of initial margin for futures, options and swap positions; (iv) all payments due in final settlement of futures, options and swap positions on the final settlement date with respect to such positions; and (v) all other cash flows collected from or paid to each clearing member, including but not limited to, payments related to swaps such as coupon amounts. "Settlement bank" is defined in proposed § 39.14(a)(2) as "a bank that maintains an account either for the [DCO] or for any of its clearing members, which is used for the purpose of transferring funds and receiving transfers of funds in connection with settlements with the [DCO]."

(a) Daily settlements.

The daily settlement of financial obligations arising from the addition of new positions and price changes with respect to all open positions is an essential element of the clearing process at a DCO. Proposed § 39.14(b) would require a DCO to effect a settlement with each clearing member at least once each business day, and to have the authority and operational capacity to effect a settlement with each clearing member, on an intraday basis, either routinely, when thresholds specified by the DCO were breached, or in times of extreme market volatility.

Proposed § 39.14(b) would permit DCOs to exercise their discretion regarding whether they would effect routine intraday settlements or whether they would settle positions on an intraday basis only when certain thresholds were breached or in times of extreme market volatility. Moreover, a DCO would have the discretion to establish any relevant thresholds and to define extreme market volatility in the context of the products and portfolios that it clears. These provisions are consistent with international recommendations.[49]

(b) Settlement banks.

A DCO generally requires its clearing members to effect settlement through one of a specified set of settlement banks. In addition, a DCO itself often has a lead, concentration, or central settlement bank.

Proposed § 39.14(c) would set forth three specific requirements in furtherance of the general requirement that DCOs must employ settlement arrangements to eliminate or strictly limit their exposure to settlement bank risks. First, proposed § 39.14(c)(1) would require a DCO to have documented criteria for those banks that it would use, and that it would permit its clearing members to use, as settlement banks, including criteria addressing the capitalization, creditworthiness, access to liquidity, operational reliability, and regulation or supervision of such banks. Second, proposed § 39.14(c)(2) would require a DCO to monitor each approved

[47] Section 5b(c)(2)(E) of the CEA; 7 U.S.C. 7a–1(c)(2)(E) (Core Principle E).

[48] Prior to amendment by the Dodd-Frank Act, Core Principle E provided that [t]he applicant shall have the ability to—

(i) complete settlements on a timely basis under varying circumstances;

(ii) maintain an adequate record of the flow of funds associated with each transaction that the applicant clears; and

(iii) comply with the terms and conditions of any permitted netting or offset arrangements with other clearing organizations.

[49] *See* CPSS–IOSCO Recommendations, pg. 21; EMIR, Article 39, paragraph 3, pg. 46.

settlement bank on an ongoing basis to ensure that it continues to meet the documented criteria. Finally, proposed § 39.14(c)(3) would require a DCO to monitor the full range and concentration of its exposures to its own and its clearing members' settlement banks [50] and assess its own and its clearing members' potential losses and liquidity pressures in the event that the settlement bank with the largest share of settlement activity were to fail. If action were reasonably necessary in order to eliminate or strictly limit exposures to settlement banks, a DCO would be required to: (i) Maintain settlement accounts at additional settlement banks; (ii) approve additional settlement banks for use by its clearing members; (iii) impose concentration limits with respect to its own or its clearing members' settlement banks; and/or (iv) take any other appropriate actions. The determination of whether any such actions were necessary would be left to the discretion of the DCO in the first instance, but such determination would have to be reasonable.

(c) Settlement finality.

Proposed § 39.14(d) would require that a DCO must ensure that settlement fund transfers are irrevocable and unconditional when the DCO's accounts are debited or credited. In addition, the proposed regulation would require that a DCO's legal agreements with its settlement banks would have to state clearly when settlement fund transfers would occur and a DCO would have to routinely confirm that its settlement banks were effecting fund transfers as and when required by those legal agreements.

(d) Recordkeeping.

Proposed § 39.14(e) would incorporate Core Principle E's requirement that a DCO must maintain an accurate record of the flow of funds associated with each settlement.[51]

(e) Netting arrangements.

Proposed § 39.14(f) would incorporate Core Principle E's requirement that a DCO must possess the ability to comply with each term and condition of any permitted netting or offset arrangement with any other clearing organization.[52]

(f) Physical delivery.

Proposed § 39.14(g) would set forth requirements with respect to contracts, agreements, and transactions that are settled by physical transfers of the underlying instruments or commodities. In particular, the proposed regulation would require a DCO to establish rules clearly stating each obligation that the DCO has assumed with respect to physical deliveries, including whether it has an obligation to make or receive delivery of a physical instrument or commodity, or whether it indemnifies clearing members for losses incurred in the delivery process, and to ensure that the risks of each such obligation are identified and managed. Proposed § 39.14(g) would not require DCOs to assume any particular obligations in connection with physical deliveries, in recognition of the fact that DCOs would need to determine what, if any, obligations to assume on a product-specific basis, in the exercise of prudent risk management standards.

4. Treatment of Funds

Core Principle F, as amended by the Dodd-Frank Act,[53] requires a DCO to:(a) Establish standards and procedures that are designed to protect and ensure the safety of its clearing members' funds and assets; (b) hold such funds and assets in a manner by which to minimize the risk of loss or of delay in the DCO's access to the assets and funds; and (c) only invest such funds and assets in instruments with minimal credit, market, and liquidity risks.[54] The Commission is proposing to adopt § 39.15 to establish requirements that a DCO would have to meet in order to comply with Core Principle F.

(a) Required standards and procedures.

Proposed § 39.15(a) would require a DCO to establish standards and procedures that are designed to protect and ensure the safety of funds and assets belonging to clearing members and their customers.[55]

(b) Segregation of funds and assets.

Proposed § 39.15(b)(1) would require a DCO to comply with the segregation requirements of section 4d of the CEA and Commission regulations thereunder, or any other applicable Commission regulation or order requiring that customer funds and assets be segregated, set aside, or held in a separate account. The Commission has included this language because it is an essential element of the standards and procedures described in proposed § 39.15(a). However, proposed § 39.15(b)(1) would not impose any new requirements on DCOs that are in addition to those required by section 4d of the CEA and those that are currently required, or may in the future be required, by applicable Commission regulations or orders.

Proposed § 39.15(b)(2)(i) would permit a DCO to commingle, and a DCO to permit clearing member FCMs to commingle, customer positions in futures, options on futures, and swaps, and any money, securities, or property received to margin, guarantee, or secure such positions, in an account subject to the requirements of section 4d(f) of the CEA (cleared swap account), pursuant to DCO rules that have been approved by the Commission under § 40.5 of the Commission's regulations. The proposed regulation would establish minimum informational requirements for such rule submissions, consistent with the informational requirements the Commission has previously imposed upon petitioners requesting orders under section 4d of the CEA.

The rule filing would have to be submitted electronically to the Commission, in the form and manner required by the Commission, and would have to include, at a minimum, the following: (A) An identification of the futures, options on futures, and swaps that would be commingled, including contract specifications or the criteria that would be used to define eligible futures, options on futures, and swaps; (B) an analysis of the risk characteristics of the eligible products; (C) a description of whether the swaps would be executed bilaterally and/or executed on a DCM and/or a SEF; (D) an analysis of the liquidity of the respective markets for the futures, options on futures, and swaps that would be commingled, the ability of clearing members and the DCO to offset or mitigate the risks of such products in a timely manner, without compromising the financial integrity of the account, and, as appropriate, proposed means for addressing insufficient liquidity; (E) an analysis of the availability of reliable prices for each of the eligible products; (F) a description of the financial, operational, and managerial standards or requirements for clearing members that would be permitted to commingle the eligible products; (G) a description of the systems and procedures that would be used by the DCO to oversee such clearing members' risk management of the commingled positions; (H) a

[50] A DCO may have multiple exposures to a settlement bank, *e.g.,* if the bank is also a clearing member or extends a credit facility funding arrangement to the DCO.

[51] Section 5b(c)(2)(E)(iv) of the CEA; 7 U.S.C. 7a–1(c)(2)(E)(iv).

[52] Section 5b(c)(2)(E)(v) of the CEA; 7 U.S.C. 7a–1(c)(2)(E)(v).

[53] Section 5b(c)(2)(F) of the CEA; 7 U.S.C. 7a–1(c)(2)(F) (Core Principle F).

[54] Prior to amendment by the Dodd-Frank Act, Core Principle F provided that "[t]he applicant shall have standards and procedures designed to protect and ensure the safety of member and participant funds."

[55] Such "assets" would include any securities or property that clearing members deposit with a DCO in order to satisfy initial margin obligations, which are also sometimes referred to as "collateral." Proposed § 39.15 uses the term "assets" rather than "securities or property" or "collateral" in order to be consistent with the statutory language.

description of the financial resources of the DCO, including the composition and availability of a guaranty fund with respect to the commingled products; (I) a description and analysis of the margin methodology that would be applied to the commingled products, including any margin reduction applied to correlated positions, and any applicable margin rules with respect to both clearing members and customers;[56] (J) an analysis of the ability of the DCO to manage a potential default with respect to any of the commingled products; (K) a discussion of the procedures that the DCO would follow if a clearing member defaulted, and the procedures that a clearing member would follow if a customer defaulted, with respect to any of the commingled products; and (L) a description of the arrangements for obtaining daily position data from each beneficial owner of the commingled products.

Proposed § 39.15(b)(2)(ii) addresses situations where customer positions in futures, options on futures, and cleared swaps could be carried in a futures account subject to section 4d(a) of the CEA. In recent years, the Commission, in its discretion, has issued orders permitting cleared swaps to be carried in a futures account, on a case-by-case basis.[57] Proposed § 39.15(b)(2)(ii) would incorporate the informational requirements of proposed § 39.15(b)(2)(i), but would still require that the Commission issue an order granting permission to commingle customer positions in futures, options on futures, and swaps in a futures account.

Proposed § 39.15(b)(2)(iii)(A) would provide that the Commission may request additional information in support of a rule submission and it may approve the rules in accordance with § 40.5.[58] Proposed § 39.15(b)(2)(iii)(B) would provide that the Commission may request additional information in support of a petition and it may issue an order under section 4d of the CEA in its discretion.

In the case of a rule approval under § 39.15(b)(2)(i), as well as the issuance of an order under § 39.15(b)(2)(ii), the Commission would take action pursuant to section 4d of the CEA (permitting commingling) and section 4(c) of the CEA (exempting the DCO and clearing members from the requirement to hold customer positions in a particular account, as applicable, 4d(a) or 4d(f)).[59]

The Commission requests comment on whether it should take the same approach (rule submission or petition for an order) with respect to the futures account and the cleared swap account and, if so, what that approach should be. In addition, the Commission requests comment on whether the enumerated informational requirements fully capture the relevant considerations for making a determination on either rule approval or the granting of an order, and whether the Commission's analysis should take into consideration the type of account in which the positions would be carried, the particular type of products that would be involved, or the financial resources of the clearing members that would hold such accounts. The Commission further requests comment on what, if any, additional or heightened requirements should be imposed to manage the increased risks introduced to a futures account that also holds cleared swaps.

(c) Holding of funds and assets.

Proposed § 39.15(c) would require that a DCO must hold funds and assets belonging to clearing members and their customers in a manner that minimizes the risk of loss or of delay in the DCO's access to those funds and assets. In furtherance of this objective, the Commission has proposed certain requirements addressing types of assets that a DCO may accept, the valuation of such assets, applicable haircuts, concentration limits, and requirements that would apply if assets were pledged to a DCO but were held in the name of a clearing member, as described below.

(i) Types of assets.

Proposed § 39.15(c)(1) would require a DCO to limit the assets it accepts as initial margin to those that have minimal credit, market, and liquidity risks. The proposed regulation would also state that a DCO may not accept letters of credit as initial margin. The Commission has not specified the assets that a DCO may accept, and with the exception of letters of credit, it has not specified the assets that a DCO may not accept. In general, proposed § 39.15(c)(1) would set forth the criteria of minimal credit, market, and liquidity risks and would leave it to the discretion of each DCO to determine which assets the DCO would accept, subject to their meeting those criteria. The Commission has proposed to prohibit the acceptance of letters of credit because they are unfunded financial resources with respect to which funds might be unavailable when most needed. The Commission expects that DCOs would continue their current practice of re-evaluating the types of assets that they would accept as initial margin as necessitated by changes in market conditions that could affect the credit, market, and liquidity risks of those assets.

(ii) Valuation.

Proposed § 39.15(c)(2) would require a DCO to use prudent valuation practices to value assets posted as initial margin on a daily basis. The Commission has not specified what such valuation practices should entail, as the nature of the valuations would depend on the nature of the particular assets. However, whatever method would be used to determine the value of margin assets, it is crucial that such assets be valued daily, because a DCO cannot evaluate the adequacy of margin coverage on a daily basis without knowing the value of the assets that are components of the margin on deposit. Such daily valuation of margin assets is currently the standard practice of DCOs.

(iii) Haircuts.

Proposed § 39.15(c)(3) would require a DCO to apply appropriate reductions in value to reflect the market and credit risk of the assets that it accepts in satisfaction of initial margin obligations. Such reductions are known as haircuts, and DCOs currently apply haircuts to the margin assets that they accept as initial margin. Haircuts are designed to mitigate the potential future exposure that could result from potential changes in the value of particular assets.

Haircut levels would be dependent on the nature of the particular assets. DCOs would be required to calculate their haircuts taking into account stressed market conditions. Incorporating stressed market conditions into the calculation of haircuts can limit the effects of procyclicality, which refers to changes that are positively correlated with business or credit cycle fluctuations and that may cause or exacerbate financial instability.[60] In

[56] *See supra* section II.B.2.f.ii of this notice, discussing the minimum liquidation time of five business days for margining cleared swaps that are not executed on a DCM.

[57] *See supra* n.38.

[58] Rules submitted for prior approval would be approved unless the rule is inconsistent with the CEA or the Commission's regulations. *See* section 5c(c)(5) of the CEA; 7 U.S.C. 7a–2(c)(5); and 75 FR at 67295.

[59] 7 U.S.C. 6(c). *See infra* section IV. (further discussing the 4(c) exemption and requesting comment).

[60] While changes in collateral values tend to be procyclical, collateral arrangements can increase procyclicality if haircut levels fall during periods of low-market stress and increase during periods of high-market stress. For example, in a stressed market, if a DCO required the posting of additional collateral due to both the decline of asset prices and an increase in haircut levels, it could exacerbate market stress and drive down asset prices further, resulting in additional collateral requirements. This cycle could exert further downward pressure on asset prices in already stressed markets. To limit the effects of this procyclicality, a DCO should establish stable and conservative haircuts that are calibrated to include periods of stressed market conditions.

addition, the proposed regulation would require a DCO to evaluate the appropriateness of its haircuts on at least a quarterly basis.

(iv) Concentration limits.

Proposed § 39.15(c)(4) would require a DCO to apply appropriate limitations on the concentration of assets posted as initial margin, as necessary, in order to ensure the DCO's ability to liquidate those assets quickly with minimal adverse price effects. Any concentration limits would be set by the DCO, in its discretion, depending on the nature of the assets. The proposed regulation would require a DCO to evaluate the appropriateness of its concentration limits, on at least a monthly basis.

(v) Pledged assets.

Some DCOs permit their clearing members to pledge assets for initial margin while retaining those assets in accounts in the names of the pledging clearing members. Proposed § 39.15(c)(5) would require that if such pledged assets were held in an account in the name of a clearing member, the DCO would have to ensure that the assets were unencumbered and that the pledge had been validly created and validly perfected in the relevant jurisdiction, in order to ensure that the DCO had immediate access to those assets.

(d) Permissible investments.

Proposed § 39.15(d) would require that clearing members' funds and assets that are invested by a DCO must be held in instruments with minimal credit, market, and liquidity risks.[61] The proposed regulation further adds that any investment of customer funds or assets by a DCO would have to comply with § 1.25 of the Commission's regulations, which itself is designed to ensure that such investments would be subject to minimal credit, market, and liquidity risks. Moreover, the proposed regulation would apply the limitations contained in § 1.25 to all customer funds and assets, whether they were the funds and assets of futures and options customers subject to the segregation requirements of section 4d(a) of the CEA, or the funds and assets of swaps customers subject to the segregation requirements of section 4d(f) of the CEA.

The proposed regulation does not enumerate the specific instruments in which DCOs may invest clearing members' own funds and assets, leaving it to the discretion of each DCO to determine which instruments have minimal credit, market, and liquidity risks. As regards those assets that DCOs would accept as initial margin, the Commission expects that DCOs would continue their current practice of re-evaluating the instruments in which they would invest clearing members' own funds and assets, as necessitated by changes in market conditions that could affect the credit, market, and liquidity risks of those instruments.

5. Default Rules and Procedures

Core Principle G, as amended by the Dodd-Frank Act,[62] requires each DCO to have rules and procedures designed to allow for the efficient, fair, and safe management of events during which clearing members become insolvent or otherwise default on their obligations to the DCO. In addition, Core Principle G requires each DCO to clearly state its default procedures, make its default rules publicly available, and ensure that it may take timely action to contain losses and liquidity pressures and to continue meeting its obligations.[63] The Commission is proposing to adopt § 39.16 to establish requirements that a DCO would have to meet in order to comply with Core Principle G.

(a) General.

It is essential that DCOs have clearly defined and effective default management rules and procedures in order to protect the defaulting clearing members' customers, non-defaulting clearing members, and the DCO, to the extent possible. Proposed § 39.16(a) would require DCOs to adopt rules and procedures designed to allow for the efficient, fair, and safe management of events during which clearing members become insolvent or default on the obligations of such clearing members to the DCO.[64] Existing DCOs have rules and procedures to address possible defaults.

(b) Default management plan.

Proposed § 39.16(b) would require a DCO to maintain a current written default management plan that delineates the roles and responsibilities of its Board of Directors, its Risk Management Committee, any other committee that has responsibilities for default management, and the DCO's management, in addressing a default, including any necessary coordination with, or notification of, other entities and regulators. The proposed regulation would also require the default management plan to address any differences in procedures with respect to highly liquid contracts (such as certain futures) and less liquid contracts (such as certain swaps). In addition, proposed § 39.16(b) would require a DCO to conduct and document a test of its default management plan on at least an annual basis.

(c) Default procedures.

Proposed § 39.16(c)(1) would require a DCO to adopt procedures that would permit the DCO to take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a default on the obligations of a clearing member to the DCO.[65]

Proposed § 39.16(c)(2) would require a DCO to include certain identified procedures in its default rules. In particular, proposed § 39.16(c)(2)(i) would require a DCO to set forth its definition of a default. Proposed § 39.16(c)(2)(ii) would require a DCO to set forth the actions that it is able to take upon a default, which must include the prompt transfer, liquidation, or hedging of the customer or proprietary positions of the defaulting clearing member, as applicable. Proposed § 39.16(c)(2)(ii) would further state that such procedures could also include, in the DCO's discretion, the auctioning or allocation of such positions to other clearing members. Proposed § 39.16(c)(2)(iii) would require a DCO to include in its default rules any obligations that the DCO imposed on its clearing members to participate in auctions, or to accept allocations, of a defaulting clearing member's positions, and specifically would provide that any allocation would have to be proportional to the size of the participating or accepting clearing member's positions at the DCO. For example, certain DCO rules currently address the DCO's authority to auction a defaulting clearing member's

[61] IOSCO Recommendation 7 (custody and investment risks) also states, in part, that "[a]ssets invested by a CCP should be held in instruments with minimal credit, market, and liquidity risks." (CPSS–IOSCO Recommendations, pg. 31).

[62] Section 5b(c)(2)(G) of the CEA; 7 U.S.C. 7a–1(c)(2)(G) (Core Principle G).

[63] Prior to amendment by the Dodd-Frank Act, Core Principle G provided that "[t]he applicant shall have rules and procedures designed to allow for efficient, fair, and safe management of events when members or participants become insolvent or otherwise default on their obligations to the derivatives clearing organization."

[64] Core Principle G specifically refers to events during which clearing members "(I) become insolvent; or (II) otherwise default * * *." However, it is possible that a clearing member could become insolvent and not default on its obligations to the DCO. For example, the insolvency could be a consequence of a clearing member's meeting all such obligations. Nevertheless, the Commission believes that a clearing member should be required to follow certain procedures, beginning with notifying the DCO, if it becomes subject to a bankruptcy petition, receivership proceeding, or the equivalent, and such proposed requirements are contained in proposed § 39.16(d), discussed *infra* in section II.B.5.d.

[65] Similarly, IOSCO Recommendation 6 (Default procedures) states that "[a] CCP's default procedures should be clearly stated, and they should ensure that the CCP can take timely action to contain losses and liquidity pressures and to continue meeting its obligations." (CPSS–IOSCO Recommendations, pg. 27).

swaps to other clearing members that participate in the market for that category of swaps.

Proposed § 39.16(c)(2)(iv) would require that a DCO's default rules address the sequence in which the funds and assets of the defaulting clearing member and the financial resources maintained by the DCO would be applied in the event of a default. The proposed regulation would not specify the sequence in which a DCO would be required to apply its own resources or those of the defaulting clearing member, but it would set forth two related requirements.

First, proposed § 39.16(c)(2)(v) would require that a DCO's default rules contain a provision that customer margin posted by a defaulting clearing member could not be applied in the event of a proprietary default. This is consistent with the segregation requirements of section 4d of the CEA and § 1.20 of the Commission's regulations.

Second, proposed § 39.16(c)(2)(vi) would require that a DCO's default rules contain a provision that proprietary margins posted by a defaulting clearing member would have to be applied in the event of a customer default, if the relevant customer margin were insufficient to cover the shortfall. This is consistent with § 190.08(a)(ii)(J), which defines customer property to include the trading accounts of an FCM, to the extent that other enumerated customer property is insufficient to satisfy all claims of public customers in the bankruptcy of the FCM.

Proposed § 39.16(c)(3) would incorporate the Core Principle G requirement that a DCO must make its default rules publicly available,[66] and it cross-references proposed § 39.21, which has been proposed in a separate rulemaking and which also addresses this requirement.[67]

(d) Insolvency of a clearing member.

Proposed § 39.16(d) would set forth specific procedures that a DCO would have to require its clearing members to follow, and that a DCO itself would have to follow, if a clearing member became the subject of a bankruptcy petition (either voluntary or involuntary), a receivership proceeding, or an equivalent proceeding, *e.g.,* a foreign liquidation proceeding. The Commission believes that such procedures would be necessary in order to provide for "the efficient, fair, and safe management of events" when a clearing member becomes insolvent, as required by Core Principle G.

Proposed § 39.16(d)(1) would require a DCO to adopt rules that would require a clearing member to provide prompt notice to the DCO of such a petition or proceeding. Proposed § 39.13(d)(2) would require a DCO to review the clearing member's continuing eligibility for clearing membership upon receiving such notice. Proposed § 39.16(d)(3) would require a DCO to take any appropriate action, in its discretion, with respect to the clearing member or its positions, including but not limited to liquidation or transfer of positions, and suspension or revocation of clearing membership. Proposed § 39.16(d)(2) does not outline specific review procedures, and § 39.16(d)(3) would leave it to the discretion of the DCO to determine whether any particular action were appropriate with respect to the clearing member.

6. System Safeguards

Core Principle I, as amended by the Dodd-Frank Act,[68] requires each DCO to establish and maintain a program of risk analysis and oversight to identify and minimize sources of operational risk through the development of appropriate controls and procedures, and automated systems that are reliable, secure, and have adequate scalable capacity. Core Principle I also requires each DCO to establish and maintain emergency procedures, backup facilities, and a plan for disaster recovery that allows for the timely recovery and resumption of operations of, and the fulfillment of each obligation and responsibility of, the DCO. Finally, Core Principle I requires each DCO to periodically conduct tests to verify that its backup resources are sufficient to ensure daily processing, clearing, and settlement.[69] The Commission is proposing to adopt § 39.18 to establish requirements that a DCO would have to meet in order to comply with Core Principle I.

(a) General.

Proposed § 39.18 would codify the requirements of Core Principle I and would establish additional standards for a DCO's business continuity and disaster recovery procedures. On July 14, 2010,[70] the Commission published proposed regulations regarding business continuity and disaster recovery applicable to DCOs and DCMs. After consideration of the provisions of the Dodd-Frank Act, the Commission has determined to re-propose the provisions concerning DCOs. The Commission appreciates the comments made with respect to those earlier proposed regulations, and has taken them into account in developing the proposed regulations described below.

(i) Definitions.

Proposed § 39.18(a) would set forth relevant definitions for the system safeguards provisions applicable to DCOs set forth in § 39.18 and the modified system safeguards provisions applicable to SIDCOs set forth in § 39.30, including "recovery time objective" (the time period, after disruption, within which a DCO should be able to achieve recovery and resumption of clearing activities) (RTO), "relevant area" (the geographic area within which a DCO has necessary resources, as well as adjacent communities), and "wide-scale disruption" (an event that causes severe disruption of critical infrastructure, or an evacuation or unavailability of the population, in a relevant area).[71]

(ii) Program of risk analysis.

Because automated systems play a central and critical role in today's electronic financial market environment, oversight of core principle compliance by DCOs with respect to automated systems is an essential part of effective clearing oversight. Sophisticated computer systems are crucial to a DCO's ability to meet its obligations and responsibilities. Safeguarding the reliability, security, and capacity of such systems is also essential to mitigation of systemic risk for the nation's financial sector as a whole.

Proposed § 39.18(b) would require that a DCO maintain a program of risk analysis and oversight with respect to its operations and automated systems to identify and minimize sources of operational risk, establish and maintain resources that allow for the fulfillment of the DCO's obligations and responsibilities in light of those risks, and verify that those resources are

[66] *See* section 5b(c)(2)(G)(ii)(II) of the CEA; 7 U.S.C. 7a–1(c)(2)(G)(ii)(II).

[67] *See* 75 FR at 78197.

[68] Section 5b(c)(2)(I) of the CEA; 7 U.S.C. 7a–1(c)(2)(I) (Core Principle I).

[69] Prior to amendment by the Dodd-Frank Act, Core Principle I provided that

[t]he applicant shall demonstrate that the applicant (i) has established and will maintain a program of oversight and risk analysis to ensure that the automated systems of the applicant function properly and have adequate capacity and security; and (ii) has established and will maintain emergency procedures, and a plan for disaster recovery, and will periodically test backup facilities sufficient to ensure daily processing, clearing, and settlement of transactions.

[70] *See* 75 FR 42633 (July 22, 2010) (July Proposal).

[71] The Commission may consider, in a future rulemaking, placing an expanded version of these definitions (to include, *e.g.,* recovery time objectives with respect to DCMs and other registered entities) in part 1, and, as appropriate, incorporating those definitions by reference in part 39 of its regulations.

adequate to ensure daily processing, clearing, and settlement.

(iii) Elements of program.

Proposed § 39.18(c) would require that the program of risk analysis and oversight address each of six categories: information security, business continuity and disaster recovery (BC–DR), capacity and performance planning, systems operations, systems development and quality assurance, and physical security and environmental controls.

(iv) Standards for program.

DCO compliance with generally accepted standards and best practices with respect to the development, operation, reliability, security, and capacity of automated systems can reduce the frequency and severity of automated system security breaches or functional failures, thereby augmenting efforts to mitigate systemic risk. Accordingly, proposed § 39.18(d) would require that a DCO follow generally accepted standards and industry best practices with respect to the development, operation, reliability, security, and capacity of automated systems.

(v) Business continuity and disaster recovery.

Proposed § 39.18 (e) would require that a DCO maintain a BC–DR plan, procedures, and physical (*e.g.,* buildings, generators, and related physical infrastructure), technological (*e.g.,* computers, replacement parts, and software), and personnel resources (*e.g.,* trained employees or other committed human resources) sufficient to enable timely recovery and resumption of operations, and fulfillment of responsibilities (*e.g.,* daily processing, clearing and settlement of transactions cleared) of the DCO following a disruption. The required recovery time objective would be no later than the next business day. As noted below, proposed § 39.30 would set a more stringent RTO for SIDCOs.

(vi) Location of resources; outsourcing.

Proposed § 39.18(f) would clarify that a DCO could maintain the resources required pursuant to § 39.18(e) on its own or through an outsourcing arrangement with another DCO or other service provider. Proposed § 39.18(f)(i) would provide that an outsourcing DCO would retain complete liability for any failure to meet the specified responsibilities, and must employ personnel with the expertise necessary to enable the DCO to supervise the service provider. Proposed § 39.18(f)(ii) would require that testing include all of the DCO's own and outsourced resources, and verify that such resources will work effectively together.

In response to the July Proposal, a number of commenters expressed concern that it was impractical for DCOs to have all key job functions fully duplicated. The proposed regulation clarifies that a DCO may maintain such functions on its own (including, *e.g.,* through cross-training) or through written outsourcing arrangements, including with another DCO.

The Commission seeks comment on whether these provisions governing outsourcing are appropriate, and whether the clarifications concerning the retention of responsibility and the necessity for integrated testing should be expanded to cover all functions of a DCO.

(vii) Notification of Commission staff; recordkeeping.

Proposed § 39.18(g) would require each DCO to notify Commission staff of various exceptional events, such as technology malfunctions, system security-related incidents, or targeted threats. The proposed regulation attempts to achieve a reasonable balance, requiring notification only of such events that materially impair, or create a significant likelihood of material impairment, of automated system operation, reliability, security, or capacity. The proposed regulation would also require notification of any activation of the DCO's BC–DR plan.

Proposed § 39.18(h) would require a DCO to give Commission staff timely advance notice of planned changes, either changes to automated systems that are likely to have a significant impact on such systems, or changes to the DCO's program of risk analysis and oversight.

Proposed § 39.18(i) would require a DCO to maintain current copies of its business continuity plan and other emergency procedures, its assessments of its operational risks, and records of testing protocols and results; to provide copies of such records to Commission staff pursuant to § 1.31; and to provide other documents requested by Commission staff for the purpose of maintaining a current profile of the DCO's automated systems.

(viii) Testing.

Proposed § 39.18(j) would require a DCO to conduct regular, periodic, objective testing and review of its automated systems to ensure that they are reliable, secure, and have adequate scalable capacity, and of its BC–DR capabilities, using testing protocols adequate to ensure that the DCO's backup resources are sufficient to meet the RTO specified in § 39.18(e). The testing would be required to be conducted by qualified, independent professionals. While such professionals could include employees of the DCO, they could not be persons responsible for development or operation of the systems or capabilities being tested.

Reports setting forth the protocols for, and results of, such tests would be required to be communicated to, and reviewed by, senior management of the DCO. Because tests that result in few or no exceptions raise the possibility of an insufficiently rigorous protocol, such results would be required to be subject to more searching review.

(ix) Coordination of business continuity and disaster recovery plans.

Proposed § 39.18(k) would require each DCO, to the extent practicable, to coordinate its BC–DR plan with those of its clearing members, to initiate coordinated testing of such plans, and to take into account in its own BC–DR plan the BC–DR plans of its providers of essential services, including telecommunications, power, and water.

(b) SIDCOs.

(i) Determining which DCOs will be subject to enhanced BC–DR obligations.

As DCOs, SIDCOs would remain subject to the requirements of Title VII and the regulations thereunder, except to the extent the Commission promulgates higher standards pursuant to Title VIII of the Dodd-Frank Act.

Unlike the July Proposal,[72] these proposed regulations do not provide a means for the Commission to determine which DCOs are "core clearing and settlement organizations." In light of the provisions of section 804 of the Dodd-Frank Act for designation of systemically important clearing or settlement activities, the Commission proposes to avoid duplication by applying the enhanced BC–DR obligations described below to SIDCOs.

(ii) Recovery time objective.

Proposed § 39.30(a) would set an RTO for SIDCOs of recovery no later than two hours following the disruption, for any disruption including a wide-scale disruption,[73] in light of the important

[72] *See id.* at 42639 (proposed appendix E to part 40—Guidance on Critical Financial Market and Core Clearing and Settlement Organization Determination).

[73] *See Interagency Paper on Sound Practices To Strengthen the Resilience of the U.S. Financial System,* 68 FR 17809, 17812 (Apr. 11, 2003) (White Paper) which states

"core clearing and settlement organizations are necessary to the completion of most transactions in critical markets; accordingly, they must recover and resume their critical functions in order for other market participants to process pending transactions and complete large-value payments. It also is reasonable to assume that there will be firms that play significant roles and other market participants in locations not affected by a particular disruption

Continued

role that SIDCOs play in the financial system. The term "wide-scale disruption" is defined in proposed § 39.18(a).

(iii) Geographic diversity.

Because of the importance of SIDCOs to the financial system, and the fact that a wide-scale disruption may cause the physical or technological resources that are located within the relevant area, or personnel who live or work within the relevant area, to be temporarily or permanently unavailable, proposed § 39.30(b) would require each SIDCO to maintain geographic dispersal of physical and technological resources and personnel.

Physical and technological resources must, pursuant to proposed § 39.30(b)(1), be located outside the relevant area of the infrastructure the entity normally relies upon to conduct activities necessary to the clearance and settlement of existing and new contracts, and the SIDCO could not rely on the same critical transportation, telecommunications, power, water, or other critical infrastructure components the entity normally relies upon for such activities. Moreover, proposed § 39.30(b)(2) would require personnel, sufficient to enable the SIDCO to meet the recovery time objective after interruption of normal clearing by a wide-scale disruption affecting the relevant area, who live and work outside that relevant area.

While these proposed requirements would likely lead to a considerable expense, the Commission believes that the systemic importance of SIDCOs carries with it a responsibility to be reliably available on a near-continuous basis, to fulfill their obligations. Moreover, to provide an opportunity to meet this responsibility in a flexible manner, proposed § 39.30(b)(3) would make it explicit that the outsourcing provisions of proposed § 39.18(f) would apply to these resource requirements.

(iv) Testing.

Proposed § 39.30(c) would require each SIDCO to conduct regular, periodic tests of its business continuity and disaster recovery plans and resources and its capacity to achieve the required recovery time objective in the event of a wide-scale disruption, and would state that the provisions of proposed § 39.18(j), concerning testing by DCOs, would apply. Moreover, with respect to outsourcing, proposed § 39.18(f)(2)(ii) would provide that the testing referenced in proposed § 39.30(c) "shall include all [of the DCO's] own and outsourced resources, and shall verify that all such resources will work effectively together."

(v) Effective date.

A number of commenters on the July Proposal suggested that the establishment of geographically diverse capabilities would require an extended implementation period, such as 24 months. The Commission observes with approval, however, that a number of potential SIDCOs already have geographic dispersal of certain resources, and/or are already working to achieving such dispersal. Accordingly, the Commission proposes an effective date for the SIDCO requirements of the later of one year from the effective date of these regulations, or July 30, 2012. Moreover, § 39.30(d) provides that proposed § 39.30 will apply to a DCO no earlier than one year after such DCO is designated as systemically important.

7. Special Enforcement Authority Over SIDCOs

Under section 807(c) of the Dodd-Frank Act, for purposes of enforcing the provisions of Title VIII, a SIDCO is subject to, and the Commission has authority under the provisions of subsections (b) through (n) of section 8 of, the Federal Deposit Insurance Act[74] in the same manner and to the same extent as if the SIDCO were an insured depository institution and the Commission were the appropriate Federal banking agency for such insured depository institution. This special authority is codified in proposed § 39.31.

C. Additional Amendments

1. Technical Amendments To Reorganize Part 39

The Commission is proposing to reorganize part 39 into three subparts. Subpart A would contain general provisions applicable to all DCOs including definitions, procedures for DCO registration, and procedures for implementation of DCO rules and clearing new products. Subpart B would contain the regulations that codify and implement the DCO core principles. The regulations in subpart B would apply to all DCOs except to the extent that a DCO is a SIDCO and there are superseding provisions in subpart C. Subpart C would contain regulations that apply only to SIDCOs. As proposed, for purposes of clarity, each subpart would have an introductory section stating the scope of the subpart.[75]

The Commission is proposing to amend § 39.1 to update the citation to the definition of the term "derivatives clearing organization" and to restate the scope of part 39 to reflect the reorganization of part 39 into subparts A, B, and C.

The Commission is additionally proposing to remove § 39.2, which exempts DCOs from all Commission regulations except those explicitly enumerated in the exemption.[76] The Commission believes that this exemption is inconsistent with the regulatory approach established by the Dodd-Frank Act. Moreover, a preliminary review indicates that by eliminating the exemption, DCOs would be subject to only one additional regulation of significance, § 1.49 (denomination of customer funds and location of depositories).[77] Section 1.49 was promulgated after § 39.2 was adopted. It is noteworthy that, notwithstanding § 39.2, the Commission and the industry have proceeded as if the requirements of § 1.49 applied to DCOs. The absence of a reference in § 39.2 to § 1.49 in the exemption was an oversight. This situation points out the unintended consequences of attempting to carve out "reverse" exemptions in this manner, and the Commission believes it is a better regulatory policy to amend the terms of inapplicable regulations or rescind them, as appropriate, rather than attempt to maintain an up-to-date list of applicable regulations.

that will need to clear and settle pending transactions in critical markets. Therefore, core clearing and settlement organizations should plan both to recover and resume their processing and other activities that support critical markets. In light of the large volume and value of transactions/payments that are cleared and settled on a daily basis, failure to complete the clearing and settlement of pending transactions within the business day could create systemic liquidity dislocations, as well as exacerbate credit and market risk for critical markets. Therefore, core clearing and settlement organizations should develop the capacity to recover and resume clearing and settlement activities within the business day on which the disruption occurs with the overall goal of achieving recovery and resumption within two hours after an event"

[74] 12 U.S.C. 1818.

[75] *See* proposed subpart A, § 39.1; proposed subpart B, § 39.9; and proposed subpart C, § 39.28.

[76] Section 39.2 provides, in relevant part, as follows:

A derivatives clearing organization and the clearing of agreements, contracts and transactions on a derivatives clearing organization are exempt from all Commission regulations except for the requirements of this part 39, §§ 1.3, 1.12(f)(1), 1.20, 1.24, 1.25, 1.26, 1.27, 1.29, 1.31, 1.36, 1.38(b), part 40 and part 190 of this chapter, and as applicable to the agreement, contract, or transaction cleared, parts 15 through 18 of this chapter.

[77] The other provisions relate to governance and conflicts of interest issues, and may be superseded by pending rules. *See* § 1.59 (activities of self-regulatory organization employees, governing board members, committee members, and consultants); § 1.63 (service on self-regulatory organization governing boards or committees by persons with disciplinary histories); and § 1.69 (voting by interested members of self-regulatory organization governing boards and various committees).

In place of the exemption, the Commission proposes to insert the definitions proposed as § 39.1(b) in an earlier proposed rulemaking.[78] Section 39.1(a), as proposed in the earlier rulemaking, would be redesignated as § 39.1.[79]

2. Supplemental Provisions for Proposed § 39.19

The Commission recently proposed a new § 39.19(c) which would require certain reports to be made by a DCO to the Commission.[80] Where the primary reporting requirement would be specified elsewhere in the Commission's regulations, the Commission intends to cross-reference these requirements in § 39.19. The following are recently proposed reporting requirements for which the Commission proposes to add a cross-reference in proposed § 39.19:

(1) The Commission recently proposed a new § 39.24(b)(4) which would require each DCO to collect and verify certain information related to governance fitness standards and provide that information to the Commission on an annual basis.[81] By this notice, the Commission is proposing a new § 39.19(c)(3)(iii)[82] under which a DCO would be required to satisfy the annual reporting requirements of § 39.24(b)(4). The Commission also is proposing to amend proposed § 39.24(b)(4) to require the report to be submitted in accordance with the requirements of proposed § 39.19(c)(3)(iv) (which would require the report to be filed not more than 90 days after the end of the DCO's fiscal year).

(2) The Commission recently proposed a new § 39.25(b) under which a DCO would be required to submit a report to the Commission in the event that the Board of Directors of a DCO rejects a recommendation or supersedes an action of the Risk Management Committee, or the Risk Management Committee rejects a recommendation or supersedes an action of its subcommittee.[83] The report would have to include the following details: (i) The recommendation or action of the Risk Management Committee (or subcommittee thereof); (ii) the rationale for such recommendation or action; (iii) the rationale of the Board of Directors (or the Risk Management Committee, if applicable) for rejecting such recommendation or superseding such action; and (iv) the course of action that the Board of Directors (or the Risk Management Committee, if applicable) decided to take contrary to such recommendation or action. By this notice, the Commission is proposing a new § 39.19(c)(4)(xvi) under which a DCO would be required to report to the Commission as required by § 39.25(b). The Commission also is proposing to amend proposed § 39.25(b) to require the report to be submitted to the Commission within 30 days of such a rejection or supersession.

(3) The Commission also recently proposed a new § 40.9(b)(1)(iii) under which a DCO (as well as other registered entities) would have to submit to the Commission, within 30 days after the election of its Board of Directors, certain information regarding the Board of Directors.[84] By this notice, the Commission is proposing a new § 39.19(c)(4)(xvii) under which a DCO would have to submit to the Commission a report in accordance with the requirements of proposed § 40.9(b)(1)(iii).

(4) In this notice, the Commission is proposing that a DCO notify staff of the Division of Clearing and Intermediary Oversight of certain exceptional events and certain planned changes related to system safeguards (Core Principle I).[85] The Commission is proposing a new § 39.19(c)(4)(xviii) under which a DCO would be required to notify staff of the Division of Clearing and Intermediary Oversight of exceptional events related to system safeguards in accordance with proposed § 39.18(g) and of planned changes related to system safeguards in accordance with proposed § 39.18(h).

3. Technical Amendments to Proposed § 39.21

The Commission recently proposed a new § 39.24(a)(2) which would require each DCO to make available to the public and to the relevant authorities, including the Commission, a description of the manner in which its governance arrangements permit the consideration of the views of its owners, whether voting or non-voting, and its participants, including, without limitation, clearing members and customers.[86] The Commission also recently proposed § 40.9(d) which would require a DCO (as well as other registered entities) to, at a minimum, make certain information available to the public and relevant authorities, including the Commission.[87]

The Commission also recently proposed a new § 39.21(c) which lists certain information a DCO would be required to disclose publicly and to the Commission.[88] By this notice, the Commission is proposing to amend proposed § 39.21(c) to cross-reference the transparency requirements of proposed §§ 39.24(a)(2) and 40.9(d).

III. Effective Date

The Commission is proposing that the requirements proposed in this notice become effective 180 days from the date the final rules are published in the **Federal Register**, with the exception of (1) the system safeguard requirements that would be applicable to SIDCOs, set forth in proposed § 39.30, for which the proposed effective date is discussed in section II.B.6(b)(v) above, and (2) the provisions of § 39.15(b)(2) relating to the commingling of customer futures, options on futures, and swaps positions, which would become effective 30 days after the date of publication of the final rules. The provisions relating to commingling of customer funds do not require additional time for planning and implementation because they relate to a voluntary action on the part of a DCO.

The Commission believes that a period of 180 days would give DCOs adequate time to implement any additional technology and enhanced procedures that may be necessary to fulfill the proposed requirements related to participant and product eligibility, risk management, settlement procedures, treatment of funds, default rules and procedures, and system safeguards (insofar as they would apply to all DCOs). The Commission requests comment on whether 180 days is an appropriate time frame for compliance with these proposed rules. The Commission further requests comment on possible alternative effective dates and the basis for any such alternative dates.

IV. Section 4(c)

Section 4(c) of the CEA provides that, in order to promote responsible

[78] *See* 75 FR at 77585–86.

[79] *Id.*

[80] *See* 75 FR at 78194.

[81] *See* 76 FR 722, 736 (Jan. 6, 2011).

[82] The Commission is proposing to redesignate what is currently proposed as § 39.19(c)(3)(iii) as § 39.19(c)(3)(iv). This proposed regulation currently states:

The reports required by this paragraph (c)(3) shall be submitted concurrently to the Commission not more than 90 days after the end of the derivatives clearing organization's fiscal year; *provided that,* a derivatives clearing organization may request from the Commission an extension of time to submit either report, provided the derivatives clearing organization's failure to submit the report in a timely manner could not be avoided without unreasonable effort or expense. Extensions of the deadline will be granted at the discretion of the Commission.

[83] *See supra* n.81.

[84] *Id.*

[85] *See supra,* section II.B.6.a.vii.

[86] *See* 76 FR at 735.

[87] *Id.* at 736.

[88] *See* 75 FR at 78197.

economic or financial innovation and fair competition, the Commission, by rule, regulation or order, after notice and opportunity for hearing, may exempt any agreement, contract, or transaction, or class thereof, including any person or class of persons offering, entering into, rendering advice or rendering other services with respect to, the agreement, contract, or transaction, from the contract market designation requirement of section 4(a) of the CEA, or any other provision of the CEA other than certain enumerated provisions, if the Commission determines that the exemption would be consistent with the public interest.[89]

Proposed §§ 39.15(b)(2)(i) and 39.15(b)(2)(ii) would be promulgated under Core Principle F, which sets forth requirements for treatment of funds by a DCO.[90] Proper treatment of customer funds requires, among other things, segregation of customer money, securities and property received to margin, guarantee, or secure positions in futures or options on futures, in an account subject to section 4d(a) of the CEA (*i.e.,* a futures account), and segregation of customer money, securities and property received to margin, guarantee, or secure positions in cleared swaps, in an account subject to section 4d(f) of the CEA (*i.e.,* a cleared swap account). Customer funds required to be held in a futures account cannot be commingled with non-customer funds and cannot be held in an account other than an account subject to section 4d(a), absent Commission approval in the form of a rule, regulation or order. Section 4d(f) of the CEA mirrors these limitations as applied to customer positions in cleared swaps.

In proposing a regulation that would permit futures and options on futures to be carried in a cleared swap account if the Commission approves DCO rules providing for such treatment of funds, and in proposing a regulation that would permit cleared swap positions to be carried in a futures account if the Commission issues an order permitting such treatment of funds, the Commission is exercising its authority to grant an exemption under section 4(c) of the CEA. In this regard, the DCO and its clearing members would be exempt from complying with the segregation requirements of section 4d(a) when holding customer segregated funds in a cleared swap account subject to section 4d(f) of the CEA, instead of a futures account; and similarly, the DCO and its clearing members would be exempt from complying with the segregation requirements of section 4d(f) when holding customer funds related to cleared swap positions in a futures account subject to section 4d(a) of the CEA, instead of a cleared swap account.

While this rule-based exemption would streamline the approval process for commingling customer positions in futures, options on futures, and cleared swaps, the Commission would still conduct a case-by case analysis when permitting cleared swaps to be carried in a futures account, in keeping with its past practice in issuing orders under section 4d. The Commission believes that there can be benefits to commingling customer positions in futures, options on futures, and cleared swaps, primarily in the area of greater capital efficiency due to margin reductions for correlated positions. The Commission views this form of portfolio margining as a positive step toward financial innovation within a framework of responsible oversight, and it believes that the public can benefit from such innovation.

In light of the foregoing, the Commission believes that the adoption of proposed §§ 39.15(b)(2)(i) and 39.15(b)(2)(ii) would promote responsible economic and financial innovation and fair competition, and would be consistent with the "public interest," as that term is used in section 4(c) of the CEA.

The Commission solicits public comment on whether the proposed regulation satisfies the requirements for exemption under section 4(c) of the CEA.

V. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.[91] The rules proposed by the Commission will affect only DCOs (some of which will be designated as SIDCOs). The Commission has previously established certain definitions of "small entities" to be used by the Commission in evaluating the impact of its regulations on small entities in accordance with the RFA.[92] The Commission has previously determined that DCOs are not small entities for the purpose of the RFA.[93] Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed rules will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

The Paperwork Reduction Act ("PRA")[94] imposes certain requirements on Federal agencies in connection with their conducting or sponsoring any collection of information as defined by the PRA. 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 control number. OMB has not yet assigned a control number to the new collection.

This proposed rulemaking would result in new collection of information requirements within the meaning of the PRA. The Commission therefore is submitting this proposal to the Office of Management and Budget ("OMB") for review. If adopted, responses to this collection of information would be mandatory.

The Commission will protect proprietary information according to FOIA and 17 CFR part 145, "Commission Records and Information." In addition, section 8(a)(1) of the CEA strictly prohibits the Commission, unless specifically authorized by the CEA, from making public "data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers." The Commission also is required to protect certain information contained in a government system of records according to the Privacy Act of 1974, 5 U.S.C. 552a.

1. Information Provided by Reporting Entities/Persons

The proposed regulations would require each respondent to maintain records of all activities related to its business as a DCO, including all information required to be created, generated, or reported under part 39, including but not limited to the results of and methodology used for all tests, reviews, and calculations.

The Commission staff estimates this would result in a total of one response per respondent on an annual basis and that respondents could expend up to $500 annually, based on an hourly rate of $10, to comply with the proposed regulations. This would result in an aggregated cost of $6,000 per annum (12 respondents × $500).

[89] 7 U.S.C. 6(c).

[90] Section 5b(c)(2)(F) of the CEA; 7 U.S.C. 7a-1(c)(2)(F).

[91] 5 U.S.C. 601 *et seq.*

[92] 47 FR 18618 (Apr. 30, 1982).

[93] *See* 66 FR 45605, 45609 (Aug. 29, 2001).

[94] 44 U.S.C. 3501 *et seq.*

The proposed regulations also would require the submission of an application form by entities seeking to register as DCOs. The applicant burden is estimated to take, on average, approximately 400 hours, with an hourly rate ranging from $75–$400, for a total estimated cost of $100,000 per application. These estimates include the time needed to review instructions and to develop, acquire, install, and utilize technology and systems for the purposes of collecting, validating, and verifying information. Staff estimates that three entities will seek to register as a DCO on an annual basis.

2. Information Collection Comments

The Commission invites the public and other Federal agencies to comment on any aspect of the reporting and recordkeeping burdens discussed above. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comment in order to: (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Comments may be submitted directly to the Office of Information and Regulatory Affairs, by fax at (202) 395–6566 or by e-mail at *OIRAsubmissions@omb.eop.gov.* Please provide the Commission with a copy of submitted comments so that all comments can be summarized and addressed in the final rule preamble. Refer to the **ADDRESSES** section of this notice of proposed rulemaking for comment submission instructions to the Commission. A copy of the supporting statements for the collections of information discussed above may be obtained by visiting RegInfo.gov. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this document in the **Federal Register**. Therefore, a comment is best assured of having its full effect if OMB receives it within 30 days of publication.

C. Cost-Benefit Analysis

Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its actions before issuing a rulemaking under the CEA. By its terms, section 15(a) does not require the Commission to quantify the costs and benefits of a rule or to determine whether the benefits of the rulemaking outweigh its costs; rather, it requires that the Commission "consider" the costs and benefits of its action.

Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular regulation is necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the CEA.

Summary of proposed requirements. The proposed regulations would implement the participant and product eligibility, risk management, settlement procedures, treatment of funds, default procedures and system safeguards core principles for DCOs and would adopt an application form for DCO registration under the CEA, as amended by the Dodd-Frank Act.

Costs. With respect to costs, the Commission has determined that the costs to market participants and the public if these regulations are not adopted are substantial. Significantly, without these regulations to ensure that DCOs fully comply with the core principles of participant and product eligibility, risk management, settlement procedures, treatment of funds, default procedures and system safeguards, sound risk management and the financial integrity of the futures and swap markets would not be enhanced, to the detriment of market participants and the public.

The Commission has also determined that the costs of the new reporting requirements imposed on DCOs will consist primarily of recordkeeping requirements, which the Commission estimates will cost DCOs $500 annually. For purposes of this rulemaking, the estimated reporting and recordkeeping costs do not include other costs addressed by other rulemakings. However, the costs do take into account the costs of implementing certain reporting requirements which many DCOs already have in place, and thus, the actual costs to many DCOs may be far less than the Commission's estimates.

Benefits. With respect to benefits, the Commission has determined that the benefits of the proposed rules are many and substantial. DCO registration applications will be processed transparently and efficiently, making clearing services available to the futures and swap markets in order to protect the integrity of these markets through the sound risk management practices associated with clearing and the efficiency that competition between clearinghouses will foster. The protection of market participants, financial integrity of the markets, and sound risk management will further be promoted by the compliance of each DCO with the rules and standards that are being adopted to implement the core principles, notably those associated with participant and product eligibility, risk management, settlement procedures, treatment of funds, default procedures and system safeguards.

The Commission has also determined that the recordkeeping requirements allow for making certain records available for Commission inspection, which helps further the goals of the reporting requirements and is necessary for the Commission to effectively monitor a DCO's financial integrity and compliance with the CEA and Commission regulations.

Public Comment. The Commission invites public comment on its cost-benefit considerations. Commenters are also invited to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the proposal with their comment letters.

List of Subjects in 17 CFR Part 39

Commodity futures, Participant and product eligibility, Risk management, Settlement procedures, Treatment of funds, Default rules and procedures, System safeguards, Enforcement authority application form.

In light of the foregoing, the Commission hereby proposes to amend part 39 of Title 17 of the Code of Federal Regulations as follows:

PART 39—DERIVATIVES CLEARING ORGANIZATIONS

1. Revise the authority citation for part 39 to read as follows:

Authority: 7 USC 2, 5, 6, 6d, 7a–1, 7a–2, and 7b as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376.

Subpart A—General Provisions Applicable to Derivatives Clearing Organizations

2. Designate existing §§ 39.1 through 39.7 as subpart A and add a subpart heading to read as set forth above.

3. Revise § 39.1 to read as follows:

§ 39.1 Scope.

The provisions of this subpart A apply to any derivatives clearing organization, as defined under section 1a(15) of the Act and § 1.3(d) of this chapter, which is registered or deemed to be registered with the Commission as a derivatives clearing organization, is required to register as such with the Commission pursuant to section 5b(a) of the Act, or which voluntarily registers as such with the Commission pursuant to section 5b(b) or otherwise.

4. Revise § 39.2 to read as follows:

§ 39.2 Definitions.

For the purposes of this part,

Back test means a test that compares a derivatives clearing organization's initial margin requirements with historical price changes to determine the extent of actual margin coverage.

Compliance policies and procedures means all policies, procedures, codes, including a code of ethics, safeguards, rules, programs, and internal controls that are required to be adopted or established by a derivatives clearing organization pursuant to the Act, Commission regulations, or orders, or that otherwise facilitate compliance with the Act and Commission regulations.

Customer account or customer origin means a clearing member's account held on behalf of customers, as defined in § 1.3(k) of this chapter. A customer account is also a futures account, as that term is defined by § 1.3(vv) of this chapter.

House account or house origin means a clearing member's combined proprietary accounts, as defined in § 1.3(y) of this chapter.

Key personnel means derivatives clearing organization personnel who play a significant role in the operations of the derivatives clearing organization, the provision of clearing and settlement services, risk management, or oversight of compliance with the Act and Commission regulations and orders. Key personnel include, but are not limited to, those persons who are or perform the functions of any of the following: chief executive officer; president; Chief compliance officer; chief operating officer; Chief risk officer; chief financial officer; chief technology officer; and emergency contacts or persons who are responsible for business continuity or disaster recovery planning or program execution.

Stress test means a test that compares the impact of a potential price move, change in option volatility, or change in other inputs that affect the value of a position, to the financial resources of a derivatives clearing organization, clearing member, or large trader, to determine the adequacy of such financial resources.

Systemically *important derivatives clearing organization* means a financial market utility that is a derivatives clearing organization registered under section 5b of the Act (7 U.S.C. 7a–1), which has been designated by the Financial Stability Oversight Council to be systemically important.

5. Amend § 39.3 by revising paragraphs (a)(2), (a)(3), (b), (c), (d) and (e) and by adding paragraphs (a)(4) and (a)(5) to read as follows:

§ 39.3 Procedures for registration.

(a) * * *

(2) Application. Any person seeking to register as a derivatives clearing organization, any applicant amending its pending application, or any registered derivatives clearing organization seeking to amend its order of registration (applicant), shall submit to the Commission a completed Form DCO, which shall include a cover sheet, all applicable exhibits, and any supplemental materials, including amendments thereto, as provided in appendix A to this part 39 (application). The Commission will not commence processing an application unless the applicant has filed the application as required by this section. Failure to file a completed application will preclude the Commission from determining that an application is materially complete, as provided in section 6(a) of the Act. Upon its own initiative, an applicant may file with its completed application additional information that may be necessary or helpful to the Commission in processing the application.

(3) *Submission of supplemental information.* The filing of a completed application is a minimum requirement and does not create a presumption that the application is materially complete or that supplemental information will not be required. At any time during the application review process, the Commission may request that the applicant submit supplemental information in order for the Commission to process the application. The applicant shall file electronically such supplemental information with the Secretary of the Commission in the form and manner provided by the Commission.

(4) *Application amendments.* An applicant shall promptly amend its application if it discovers a material omission or error, or if there is a material change in the information provided to the Commission in the application or other information provided in connection with the application.

(5) *Public information.* The following sections of all applications to become a registered derivatives clearing organization will be public: first page of the Form DCO cover sheet, proposed rules, regulatory compliance chart, narrative summary of proposed clearing activities, documents establishing the applicant's legal status, documents setting forth the applicant's corporate and governance structure, and any other part of the application not covered by a request for confidential treatment, subject to § 145.9 of this chapter.

(b) *Stay of application review.* (1) The Commission may stay the running of the 180-day review period if an application is materially incomplete, in accordance with section 6(a) of the Act.

(2) *Delegation of authority.* (i) The Commission hereby delegates, until it orders otherwise, to the Director of the Division of Clearing and Intermediary Oversight or the Director's designee, with the concurrence of the General Counsel or the General Counsel's designee, the authority to notify an applicant seeking registration under section 6(a) of the Act that the application is materially incomplete and the running of the 180-day period is stayed.

(ii) The Director of the Division of Clearing and Intermediary Oversight may submit to the Commission for its consideration any matter which has been delegated in this paragraph.

(iii) Nothing in this paragraph prohibits the Commission, at its election, from exercising the authority delegated in paragraph (b)(2)(i) of this section.

(c) *Withdrawal of application for registration.* An applicant for registration may withdraw its application submitted pursuant to paragraph (a) of this section by filing electronically such a request with the Secretary of the Commission in the form and manner provided by the Commission. Withdrawal of an application for registration shall not affect any action taken or to be taken by the Commission based upon actions, activities, or events occurring during the time that the application for registration was pending with the Commission.

(d) *Reinstatement of dormant registration.* Before listing or relisting products for clearing, a dormant registered derivatives clearing organization as defined in § 40.1 of this chapter must reinstate its registration under the procedures of paragraph (a) of this section; *provided, however,* that an application for reinstatement may rely upon previously submitted materials that still pertain to, and accurately describe, current conditions.

(e) *Request for vacation of registration.* A registered derivatives clearing organization may vacate its registration under section 7 of the Act by filing electronically such a request with the Secretary of the Commission in the form and manner provided by the Commission. Vacation of registration shall not affect any action taken or to be taken by the Commission based upon actions, activities or events occurring during the time that the entity was registered by the Commission.

* * * * *

§ 39.7 [Redesignated as § 39.8]

6. Redesignate § 39.7 as § 39.8.

§ 39.6 [Redesignated as § 39.7]

7. Redesignate § 39.6 as § 39.7.

8. Add subpart B to read as follows:

Subpart B—Compliance with Core Principles

Sec.
39.9 Scope.
39.10 [Reserved]
39.11 [Reserved]
39.12 Participant and product eligibility.
39.13 Risk management.
39.14 Settlement procedures.
39.15 Treatment of funds.
39.16 Default rules and procedures.
39.17 [Reserved]
39.18 System safeguards.
39.19 Reporting.
39.20 [Reserved]
39.21 Public information.
39.22 [Reserved]
39.23 [Reserved]
39.24 Governance fitness standards.
39.25 Conflicts of interest.

Subpart B—Compliance with Core Principles

§ 39.9 Scope.

Except as otherwise provided with respect to systemically important derivatives clearing organizations subject to subpart C of this part, the provisions of this subpart B apply to any derivatives clearing organization, as defined under section 1a(15) of the Act and § 1.3(d) of this chapter, which is registered or deemed to be registered with the Commission as a derivatives clearing organization, is required to register as such with the Commission pursuant to section 5b(a) of the Act, or which voluntarily registers as such with the Commission pursuant to section 5b(b) or otherwise.

§ 39.10 [Reserved]

§ 39.11 [Reserved]

§ 39.12 Participant and product eligibility.

(a) *Participant eligibility.* A derivatives clearing organization shall establish appropriate admission and continuing participation requirements for clearing members of the derivatives clearing organization that are objective, publicly disclosed, and risk-based.

(1) *Fair and open access for participation.* The participation requirements shall permit fair and open access;

(i) A derivatives clearing organization shall not adopt restrictive clearing member standards if less restrictive requirements that would not materially increase risk to the derivatives clearing organization or clearing members could be adopted;

(ii) A derivatives clearing organization shall allow all market participants who satisfy participation requirements to become clearing members;

(iii) A derivatives clearing organization shall not exclude or limit clearing membership of certain types of market participants unless the derivatives clearing organization can demonstrate that the restriction is necessary to address credit risk or deficiencies in the participants' operational capabilities that would prevent them from fulfilling their obligations as clearing members.

(iv) A derivatives clearing organization shall not require that clearing members must be swap dealers.

(v) A derivatives clearing organization shall not require that clearing members maintain a swap portfolio of any particular size, or that clearing members meet a swap transaction volume threshold.

(2) *Financial resources.* (i) The participation requirements shall require clearing members to have access to sufficient financial resources to meet obligations arising from participation in the derivatives clearing organization in extreme but plausible market conditions. The financial resources may include, but are not limited to, a clearing member's capital, a guarantee from the clearing member's parent, or a credit facility funding arrangement. For purposes of this paragraph, "capital" means adjusted net capital as defined in § 1.17 of this chapter, for futures commission merchants, and net capital as defined in § 15c3–1 of this title, for broker-dealers, or any similar risk adjusted capital calculation for all other prospective clearing members.

(ii) The participation requirements shall set forth capital requirements that are based on objective, transparent, and commonly accepted standards that appropriately match capital to risk. Capital requirements shall be scalable so that they are proportional to the risks posed by clearing members.

(iii) A derivatives clearing organization 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.

(3) *Operational requirements.* The participation requirements shall require clearing members to have adequate operational capacity to meet obligations arising from participation in the derivatives clearing organization. The requirements shall include, but are not limited to: the ability to process expected volumes and values of transactions cleared by a clearing member within required time frames, including at peak times and on peak days; the ability to fulfill collateral, payment, and delivery obligations imposed by the derivatives clearing organization; and the ability to participate in default management activities under the rules of the derivatives clearing organization and in accordance with § 39.16 of this part.

(4) *Monitoring.* A derivatives clearing organization shall establish and implement procedures to verify, on an ongoing basis, the compliance of each clearing member with each participation requirement of the derivatives clearing organization.

(5) *Reporting.* (i) A derivatives clearing organization shall require all clearing members, including those that are not futures commission merchants, to file periodic financial reports with the derivatives clearing organization which contain any financial information that the derivatives clearing organization determines is necessary to assess whether participation requirements are met on an ongoing basis. A derivatives clearing organization shall require clearing members that are futures commission merchants to file the financial reports that are specified in § 1.10 of this chapter with the derivatives clearing organization. The derivatives clearing organization shall review all such financial reports for risk management purposes. A derivatives clearing organization shall also require clearing members that are not futures commission merchants to make such periodic financial reports available to

the Commission upon the Commission's request.

(ii) A derivatives clearing organization shall adopt rules that require clearing members to provide to the derivatives clearing organization, in a timely manner, information that concerns any financial or business developments that may materially affect the clearing members' ability to continue to comply with participation requirements.

(6) *Enforcement.* A derivatives clearing organization shall have the ability to enforce compliance with its participation requirements and shall establish procedures for the suspension and orderly removal of clearing members that no longer meet the requirements.

(b) *Product eligibility.* (1) A derivatives clearing organization shall establish appropriate requirements for determining the eligibility of agreements, contracts, or transactions submitted to the derivatives clearing organization for clearing, taking into account the derivatives clearing organization's ability to manage the risks associated with such agreements, contracts, or transactions. Factors to be considered in determining product eligibility include, but are not limited to:

(i) Trading volume;

(ii) Liquidity;

(iii) Availability of reliable prices;

(iv) Ability of market participants to use portfolio compression with respect to a particular swap product;

(v) Ability of the derivatives clearing organization and clearing members to gain access to the relevant market for purposes of creating and liquidating positions;

(vi) Ability of the derivatives clearing organization to measure risk for purposes of setting margin requirements; and

(vii) Operational capacity of the derivatives clearing organization and clearing members to address any unique risk characteristics of a product.

(2) A derivatives clearing organization shall adopt rules providing that all swaps with the same terms and conditions submitted to the derivatives clearing organization for clearing are economically equivalent within the derivatives clearing organization and may be offset with each other within the derivatives clearing organization. A derivatives clearing organization shall also provide for non-discriminatory clearing of a swap executed bilaterally or on or subject to the rules of an unaffiliated designated contract market or swap execution facility.

(3) A derivatives clearing organization shall select contract unit sizes that maximize liquidity, open access, and risk management. To the extent appropriate to further these objectives, a derivatives clearing organization shall select contract units for clearing purposes that are smaller than the contract units in which trades submitted for clearing were executed.

(4) A derivatives clearing organization that clears swaps shall have rules providing that, upon acceptance of a swap by the derivatives clearing organization for clearing:

(i) The original swap is extinguished;

(ii) The original swap is replaced by equal and opposite swaps between clearing members and the derivatives clearing organization;

(iii) All terms of the cleared swaps must conform to templates established under derivatives clearing organization rules; and

(iv) If a swap is cleared by a clearing member on behalf of a customer, all terms of the swap, as carried in the customer account on the books of the clearing member, must conform to the terms of the cleared swap established under the derivatives clearing organization's rules.

§ 39.13 Risk management.

(a) *In general.* A derivatives clearing organization shall ensure that it possesses the ability to manage the risks associated with discharging the responsibilities of the derivatives clearing organization through the use of appropriate tools and procedures.

(b) *Documentation requirement.* A derivatives clearing organization shall establish and maintain written policies, procedures, and controls, approved by its Board of Directors, which establish an appropriate risk management framework that, at a minimum, clearly identifies and documents the range of risks to which the derivatives clearing organization is exposed, addresses the monitoring and management of the entirety of those risks, and provides a mechanism for internal audit. The risk management framework shall be regularly reviewed and updated as necessary.

(c) *Chief risk officer.* A derivatives clearing organization shall have a chief risk officer who shall be responsible for implementing the risk management framework, including the procedures, policies and controls described in paragraph (b) of this section, and for making appropriate recommendations to the derivatives clearing organization's Risk Management Committee or Board of Directors, as applicable, regarding the derivatives clearing organization's risk management functions.

(d) [Reserved]

(e) *Measurement of credit exposure.* A derivatives clearing organization shall:

(1) Measure its credit exposure to each clearing member and mark to market such clearing member's open positions at least once each business day; and

(2) Monitor its credit exposure to each clearing member periodically during each business day.

(f) *Limitation of exposure to potential losses from defaults.* A derivatives clearing organization, through margin requirements and other risk control mechanisms, shall limit its exposure to potential losses from defaults by its clearing members to ensure that:

(1) The operations of the derivatives clearing organization would not be disrupted; and

(2) Non-defaulting clearing members would not be exposed to losses that nondefaulting clearing members cannot anticipate or control.

(g) *Margin requirements*—(1) *In general.* The initial margin that a derivatives clearing organization requires from each clearing member shall be sufficient to cover potential exposures in normal market conditions. Each model and parameter used in setting initial margin requirements shall be risk-based and reviewed on a regular basis.

(2) *Methodology and coverage.* (i) A derivatives clearing organization shall establish initial margin requirements that are commensurate with the risks of each product and portfolio, including any unique characteristics of, or risks associated with, particular products or portfolios. A derivatives clearing organization that clears credit default swaps shall appropriately address jump-to-default risk in setting initial margins.

(ii) A derivatives clearing organization shall use models that generate initial margin requirements sufficient to cover the derivatives clearing organization's potential future exposures to clearing members based on price movements in the interval between the last collection of variation margin and the time within which the derivatives clearing organization estimates that it would be able to liquidate a defaulting clearing member's positions (liquidation time); *provided, however,* that a derivatives clearing organization shall use a liquidation time that is a minimum of five business days for cleared swaps that are not executed on a designated contract market, whether the swaps are carried in a customer account subject to section 4d(a) or 4d(f) of the Act, or carried in a house account, and a liquidation time that is a minimum of one business day for all other products that it clears, and shall use longer

liquidation times, if appropriate, based on the unique characteristics of particular products or portfolios.

(iii) The actual coverage of the initial margin requirements produced by such models, along with projected measures of the models' performance, shall meet an established confidence level of at least 99%, based on data from an appropriate historic time period, for:

(A) Each product (that is margined on a product basis);

(B) Each spread within or between products for which there is a defined spread margin rate, as described in paragraph (g)(4) of this section;

(C) Each account held by a clearing member at the DCO, by customer origin and house origin; and

(D) Each swap portfolio, by beneficial owner.

(iv) A derivatives clearing organization shall determine the appropriate historic time period based on the characteristics, including volatility patterns, as applicable, of each product, spread, account, or portfolio.

(3) *Independent validation.* A derivatives clearing organization's systems for generating initial margin requirements, including its theoretical models, must be reviewed and validated by a qualified and independent party, on a regular basis.

(4) *Spread margins.* (i) A derivatives clearing organization may allow reductions in initial margin requirements for related positions (spread margins) if the price risks with respect to such positions are significantly and reliably correlated. The price risks of different positions will only be considered to be reliably correlated if there is a theoretical basis for the correlation in addition to an exhibited statistical correlation. That theoretical basis may include, but is not limited to, the following:

(A) The products on which the positions are based are complements of, or substitutes for, each other;

(B) One product is a significant input into the other product(s);

(C) The products share a significant common input; or

(D) The prices of the products are influenced by common external factors.

(ii) A derivatives clearing organization shall regularly review its spread margins and the correlations on which they are based.

(5) *Price data.* A derivatives clearing organization shall have a reliable source of timely price data in order to measure the derivatives clearing organization's credit exposure accurately. A derivatives clearing organization shall also have written procedures and sound valuation models for addressing circumstances where pricing data is not readily available or reliable.

(6) *Daily review.* On a daily basis, a derivatives clearing organization shall determine the adequacy of its initial margin requirements for each product (that is margined on a product basis).

(7) *Back tests.* A derivatives clearing organization shall conduct back tests, as defined in § 39.2 of this part, using historical price changes based on a time period that is equivalent in length to the historic time period used by the applicable margin model for establishing the confidence level described in paragraph (g)(2) of this section or a longer time period, unless another time period is specified by this paragraph.

(i) On a daily basis, a derivatives clearing organization shall conduct back tests with respect to products that are experiencing significant market volatility, to test the adequacy of its initial margin requirements and spread margin requirements for such products that are margined on a product basis.

(ii) On at least a monthly basis, a derivatives clearing organization shall conduct back tests to test the adequacy of its initial margin requirements and spread margin requirements for each product that is margined on a product basis.

(iii) On at least a monthly basis, a derivatives clearing organization shall conduct back tests to test the adequacy of its initial margin requirements for each account held by a clearing member at the DCO, by origin, house and customer, and each swap portfolio, by beneficial owner, over at least the previous 30 days.

(8) *Customer margin*—(i) *Gross margin.* A derivatives clearing organization shall collect initial margin on a gross basis for each clearing member's customer account equal to the sum of the initial margin amounts that would be required by the derivatives clearing organization for each individual customer within that account if each individual customer were a clearing member. A derivatives clearing organization may not net positions of different customers against one another. A derivatives clearing organization may collect initial margin for its clearing members' house accounts on a net basis.

(ii) *Customer initial margin requirements.* A derivatives clearing organization shall require its clearing members to collect customer initial margin, as defined in § 1.3 of this chapter, from their customers, for non-hedge positions, at a level that is greater than 100% of the derivatives clearing organization's initial margin requirements with respect to each product and swap portfolio. The derivatives clearing organization shall have reasonable discretion in determining the percentage by which customer initial margins must exceed the derivatives clearing organization's initial margin requirements with respect to particular products or swap portfolios. The Commission may review such percentage levels and require different percentage levels if the Commission deems the levels insufficient to protect the financial integrity of the clearing members or the derivatives clearing organization.

(iii) *Withdrawal of customer initial margin.* A derivatives clearing organization shall require its clearing members to ensure that their customers do not withdraw funds from their accounts with such clearing members unless the net liquidating value plus the margin deposits remaining in a customer's account after such withdrawal are sufficient to meet the customer initial margin requirements with respect to all products and swap portfolios held in such customer's account which are cleared by the derivatives clearing organization.

(9) *Time deadlines.* A derivatives clearing organization shall establish and enforce time deadlines for initial and variation margin payments to the derivatives clearing organization.

(h) *Other risk control mechanisms*—(1) *Risk limits.* (i) A derivatives clearing organization shall impose risk limits on each clearing member, by customer origin and house origin, in order to prevent a clearing member from carrying positions for which the risk exposure exceeds a specified threshold relative to the clearing member's and/or the derivatives clearing organization's financial resources. The derivatives clearing organization shall have reasonable discretion in determining:

(A) The method of computing risk exposure;

(B) The applicable threshold(s); and

(C) The applicable financial resources under this provision; *provided however,* that the ratio of exposure to capital must remain the same across all capital levels. The Commission may review such methods, thresholds, and financial resources and require the application of different methods, thresholds, or financial resources, as appropriate.

(ii) A derivatives clearing organization may permit a clearing member to exceed the threshold(s) applied pursuant to paragraph (h)(1)(i) of this section provided that the derivatives clearing organization requires the clearing member to post additional initial margin that the derivatives clearing organization deems sufficient to

appropriately eliminate excessive risk exposure at the clearing member. The Commission may review the amount of additional initial margin and require a different amount of additional initial margin, as appropriate.

(2) *Large trader reports.* A derivatives clearing organization shall obtain from its clearing members, copies of all reports that are required to be filed with the Commission by such clearing members pursuant to part 17 of this chapter. With respect to exclusively self-cleared contracts, a derivatives clearing organization shall obtain from the relevant reporting market, copies of all reports that are required to be filed with the Commission on behalf of such clearing members by the relevant reporting market, pursuant to § 17.00(i) of this chapter. A derivatives clearing organization shall review such reports on a daily basis to ascertain the risk of the overall portfolio of each large trader, including positions at all clearing members carrying accounts for each such large trader, and shall take additional actions with respect to such clearing members, when appropriate, as specified in paragraph (h)(6) of this section, in order to address any risks posed by any such large trader.

(3) *Stress tests.* A derivatives clearing organization shall conduct stress tests, as defined in § 39.2 of this part, as follows:

(i) On a daily basis, a derivatives clearing organization shall conduct stress tests with respect to each large trader who poses significant risk to a clearing member or the derivatives clearing organization, including positions at all clearing members carrying accounts for each such large trader. The derivatives clearing organization shall have reasonable discretion in determining which traders to test and the methodology used to conduct such stress tests. The Commission may review the selection of accounts and the methodology and require changes, as appropriate.

(ii) On at least a weekly basis, a derivatives clearing organization shall conduct stress tests with respect to each clearing member account, by customer origin and house origin, and each swap portfolio, by beneficial owner, under extreme but plausible market conditions. The derivatives clearing organization shall have reasonable discretion in determining the methodology used to conduct such stress tests. The Commission may review the methodology and require changes, as appropriate.

(4) *Portfolio compression.* (i) A derivatives clearing organization shall offer multilateral portfolio compression exercises, on a regular basis, for its clearing members that clear swaps, to the extent that such exercises are appropriate for those swaps that it clears.

(ii) A derivatives clearing organization shall require its clearing members to participate in all such exercises, to the extent that any swap in the applicable portfolio is eligible for inclusion in the exercise, unless including the swap would be reasonably likely to significantly increase the risk exposure of the clearing member.

(iii) A derivatives clearing organization may permit clearing members participating in compression exercises to set risk tolerance limits for their portfolios, provided that the clearing members do not set such risk tolerances at an unreasonable level or use such risk tolerances to evade the requirements of this paragraph.

(5) *Clearing members' risk management policies and procedures.* (i) A derivatives clearing organization shall adopt rules that:

(A) Require its clearing members to maintain current written risk management policies and procedures;

(B) Ensure that it has the authority to request and obtain information and documents from its clearing members regarding their risk management policies, procedures, and practices, including, but not limited to, information and documents relating to the liquidity of their financial resources and their settlement procedures; and

(C) Require its clearing members to make information and documents regarding their risk management policies, procedures, and practices available to the Commission upon the Commission's request.

(ii) A derivatives clearing organization shall review the risk management policies, procedures, and practices of each of its clearing members on a periodic basis and document such reviews.

(6) *Additional authority.* A derivatives clearing organization shall take additional actions with respect to particular clearing members, when appropriate, based on the application of objective and prudent risk management standards including, but not limited to:

(i) Imposing enhanced capital requirements;

(ii) Imposing enhanced margin requirements;

(iii) Imposing position limits;

(iv) Prohibiting an increase in positions;

(v) Requiring a reduction of positions;

(vi) Liquidating or transferring positions; and

(vii) Suspending or revoking clearing membership.

§ 39.14 Settlement procedures.

(a) *Definitions*—(1) *Settlement.* For purposes of this section, "settlement" means:

(i) Payment and receipt of variation margin for futures, options, and swap positions;

(ii) Payment and receipt of option premiums;

(iii) Deposit and withdrawal of initial margin for futures, options, and swap positions;

(iv) All payments due in final settlement of futures, options, and swap positions on the final settlement date with respect to such positions; and

(v) All other cash flows collected from or paid to each clearing member, including but not limited to, payments related to swaps such as coupon amounts.

(2) *Settlement bank.* For purposes of this section, "settlement bank" means a bank that maintains an account either for the derivatives clearing organization or for any of its clearing members, which is used for the purpose of transferring funds and receiving transfers of funds in connection with settlements with the derivatives clearing organization.

(b) *Daily settlements.* A derivatives clearing organization shall effect a settlement with each clearing member at least once each business day, and shall have the authority and operational capacity to effect a settlement with each clearing member, on an intraday basis, either routinely, when thresholds specified by the derivatives clearing organization are breached, or in times of extreme market volatility.

(c) *Settlement banks.* A derivatives clearing organization shall employ settlement arrangements that eliminate or strictly limit its exposure to settlement bank risks, including the credit and liquidity risks arising from the use of such banks to effect settlements with its clearing members.

(1) A derivatives clearing organization shall have documented criteria with respect to those banks that are acceptable settlement banks for the derivatives clearing organization and its clearing members, including criteria addressing the capitalization, creditworthiness, access to liquidity, operational reliability, and regulation or supervision of such banks.

(2) A derivatives clearing organization shall monitor each approved settlement bank on an ongoing basis to ensure that such bank continues to meet the criteria established pursuant to paragraph (c)(1) of this section.

(3) A derivatives clearing organization shall monitor the full range and concentration of its exposures to its own and its clearing members' settlement banks and assess its own and its clearing members' potential losses and liquidity pressures in the event that the settlement bank with the largest share of settlement activity were to fail. A derivatives clearing organization shall:

(i) Maintain settlement accounts at additional settlement banks;

(ii) Approve additional settlement banks for use by its clearing members;

(iii) Impose concentration limits with respect to its own or its clearing members' settlement banks; and/or

(iv) Take any other appropriate actions, if any such actions are reasonably necessary in order to eliminate or strictly limit such exposures.

(d) *Settlement finality.* A derivatives clearing organization shall ensure that settlements are final when effected by ensuring that settlement fund transfers are irrevocable and unconditional when the derivatives clearing organization's accounts are debited or credited. A derivatives clearing organization's legal agreements with its settlement banks shall state clearly when settlement fund transfers will occur and a derivatives clearing organization shall routinely confirm that its settlement banks are effecting fund transfers as and when required by such legal agreements.

(e) *Recordkeeping.* A derivatives clearing organization shall maintain an accurate record of the flow of funds associated with each settlement.

(f) *Netting arrangements.* A derivatives clearing organization shall possess the ability to comply with each term and condition of any permitted netting or offset arrangement with any other clearing organization.

(g) *Physical delivery.* With respect to contracts, agreements, and transactions that are settled by physical transfers of the underlying instruments or commodities, a derivatives clearing organization shall:

(1) Establish rules that clearly state each obligation that the derivatives clearing organization has assumed with respect to physical deliveries, including whether it has an obligation to make or receive delivery of a physical instrument or commodity, or whether it indemnifies clearing members for losses incurred in the delivery process; and

(2) Ensure that the risks of each such obligation are identified and managed.

§ 39.15 Treatment of funds.

(a) *Required standards and procedures.* A derivatives clearing organization shall establish standards and procedures that are designed to protect and ensure the safety of funds and assets belonging to clearing members and their customers.

(b) *Segregation of funds and assets*—(1) *Segregation.* A derivatives clearing organization shall comply with the segregation requirements of section 4d of the Act and Commission regulations thereunder, or any other applicable Commission regulation or order requiring that customer funds and assets be segregated, set aside, or held in a separate account.

(2) *Commingling of futures, options on futures, and swaps positions*—(i) *Cleared swap account.* In order for a derivatives clearing organization and its clearing members to commingle customer positions in futures, options on futures, and swaps, and any money, securities, or property received to margin, guarantee or secure such positions, in an account subject to the requirements of section 4d(f) of the Act, the derivatives clearing organization shall file rules for Commission approval pursuant to § 40.5 of this chapter. Such rule submission shall include, at a minimum, the following:

(A) An identification of the futures, options on futures, and swaps that would be commingled, including contract specifications or the criteria that would be used to define eligible futures, options on futures, and swaps;

(B) An analysis of the risk characteristics of the eligible products;

(C) A description of whether the swaps would be executed bilaterally and/or executed on a designated contract market and/or a swap execution facility;

(D) An analysis of the liquidity of the respective markets for the futures, options on futures, and swaps that would be commingled, the ability of clearing members and the derivatives clearing organization to offset or mitigate the risk of such futures, options on futures, and swaps in a timely manner, without compromising the financial integrity of the account, and, as appropriate, proposed means for addressing insufficient liquidity;

(E) An analysis of the availability of reliable prices for each of the eligible products;

(F) A description of the financial, operational, and managerial standards or requirements for clearing members that would be permitted to commingle such futures, options on futures, and swaps;

(G) A description of the systems and procedures that would be used by the derivatives clearing organization to oversee such clearing members' risk management of any such commingled positions;

(H) A description of the financial resources of the derivatives clearing organization, including the composition and availability of a guaranty fund with respect to the futures, options on futures, and swaps that would be commingled;

(I) A description and analysis of the margin methodology that would be applied to the commingled futures, options on futures, and swaps, including any margin reduction applied to correlated positions, and any applicable margin rules with respect to both clearing members and customers;

(J) An analysis of the ability of the derivatives clearing organization to manage a potential default with respect to any of the futures, options on futures, or swaps that would be commingled;

(K) A discussion of the procedures that the derivatives clearing organization would follow if a clearing member defaulted, and the procedures that a clearing member would follow if a customer defaulted, with respect to any of the commingled futures, options on futures, or swaps in the account; and

(L) A description of the arrangements for obtaining daily position data from each beneficial owner of futures, options on futures, and swaps in the account.

(ii) *Futures account.* In order for a derivatives clearing organization and its clearing members to commingle customer positions in futures, options on futures, and swaps, and any money, securities, or property received to margin, guarantee or secure such positions, in an account subject to the requirements of section 4d(a) of the Act, the derivatives clearing organization shall file with the Commission a petition for an order pursuant to section 4d(a) of the Act. Such petition shall include, at a minimum, the information required under paragraph (b)(2)(i) of this section.

(iii) *Commission action.* (A) The Commission may request additional information in support of a rule submission filed under paragraph (b)(i) of this section, and may grant approval of such rules in accordance with § 40.5 of this chapter.

(B) The Commission may request additional information in support of a petition filed under paragraph (b)(ii) of this section, and may issue an order under section 4d of the Act in its discretion.

(c) *Holding of funds and assets.* A derivatives clearing organization shall hold funds and assets belonging to clearing members and their customers in a manner which minimizes the risk

of loss or of delay in the access by the derivatives clearing organization to such funds and assets.

(1) *Types of assets.* A derivatives clearing organization shall limit the assets it accepts as initial margin to those that are have minimal credit, market, and liquidity risks. A derivatives clearing organization may not accept letters of credit as initial margin.

(2) *Valuation.* A derivatives clearing organization shall use prudent valuation practices to value assets posted as initial margin on a daily basis.

(3) *Haircuts.* A derivatives clearing organization shall apply appropriate reductions in value to reflect market and credit risk (haircuts), including in stressed market conditions, to the assets that it accepts in satisfaction of initial margin obligations, and shall evaluate the appropriateness of such haircuts on at least a quarterly basis.

(4) *Concentration limits.* A derivatives clearing organization shall apply appropriate limitations on the concentration of assets posted as initial margin, as necessary, in order to ensure its ability to liquidate such assets quickly, with minimal adverse price effects, and shall evaluate the appropriateness of any such concentration limits, on at least a monthly basis.

(5) *Pledged assets.* If a derivatives clearing organization permits its clearing members to pledge assets for initial margin while retaining such assets in accounts in the names of such clearing members, the derivatives clearing organization shall ensure that such assets are unencumbered and that such a pledge has been validly created and validly perfected in the relevant jurisdiction.

(d) *Permitted investments.* Funds and assets belonging to clearing members and their customers that are invested by a derivatives clearing organization shall be held in instruments with minimal credit, market, and liquidity risks. Any investment of customer funds or assets by a derivatives clearing organization shall comply with § 1.25 of this part, as if all such funds and assets comprise customer funds subject to segregation pursuant to section 4d(a) of the Act and Commission regulations thereunder.

§ 39.16 Default rules and procedures.

(a) *In general.* A derivatives clearing organization shall adopt rules and procedures designed to allow for the efficient, fair, and safe management of events during which clearing members become insolvent or default on the obligations of such clearing members to the derivatives clearing organization.

(b) *Default management plan.* A derivatives clearing organization shall maintain a current written default management plan that delineates the roles and responsibilities of its Board of Directors, its Risk Management Committee, any other committee that has responsibilities for default management, and the derivatives clearing organization's management, in addressing a default, including any necessary coordination with, or notification of, other entities and regulators. Such plan shall address any differences in procedures with respect to highly liquid contracts (such as certain futures) and less liquid contracts (such as certain swaps). A derivatives clearing organization shall conduct and document a test of its default management plan on at least an annual basis.

(c) *Default procedures.* (1) A derivatives clearing organization shall adopt procedures that would permit the derivatives clearing organization to take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a default on the obligations of a clearing member to the derivatives clearing organization.

(2) A derivatives clearing organization shall adopt rules that set forth its default procedures, including:

(i) The derivatives clearing organization's definition of a default;

(ii) The actions that the derivatives clearing organization may take upon a default, which shall include the prompt transfer, liquidation, or hedging of the customer or proprietary positions of the defaulting clearing member, as applicable, and which may include, in the discretion of the derivatives clearing organization, the auctioning or allocation of such positions to other clearing members;

(iii) Any obligations that the derivatives clearing organization imposes on its clearing members to participate in auctions, or to accept allocations, of a defaulting clearing member's positions, provided that any allocation shall be proportional to the size of the participating or accepting clearing member's positions at the derivatives clearing organization;

(iv) The sequence in which the funds and assets of the defaulting clearing member and the financial resources maintained by the derivatives clearing organization would be applied in the event of a default;

(v) A provision that customer margin posted by a defaulting clearing member shall not be applied in the event of a proprietary default;

(vi) A provision that proprietary margins posted by a defaulting clearing member shall be applied in the event of a customer default, if the relevant customer margin is insufficient to cover the shortfall; and

(3) A derivatives clearing organization shall make its default rules publicly available as provided in § 39.21 of this part.

(d) *Insolvency of a clearing member.*

(1) A derivatives clearing organization shall adopt rules that require a clearing member to provide prompt notice to the derivatives clearing organization if it becomes the subject of a bankruptcy petition, receivership proceeding, or the equivalent;

(2) Upon receipt of such notice, a derivatives clearing organization shall review the continuing eligibility of the clearing member for clearing membership; and

(3) Upon receipt of such notice, a derivatives clearing organization shall take any appropriate action, in its discretion, with respect to such clearing member or its positions, including but not limited to liquidation or transfer of positions, and suspension or revocation of clearing membership.

§ 39.17 [Reserved]

§ 39.18 System safeguards.

(a) *Definitions.* For purposes of this section and of § 39.30 of this part:

Relevant area means the metropolitan or other geographic area within which a derivatives clearing organization has physical infrastructure or personnel necessary for it to conduct activities necessary to the clearance and settlement of existing and new contracts. The term "relevant area" also includes communities economically integrated with, adjacent to, or within normal commuting distance of that metropolitan or other geographic area.

Recovery time objective means the time period within which an entity should be able to achieve recovery and resumption of clearing and settlement of existing and new contracts, after those capabilities become temporarily inoperable for any reason up to or including a wide-scale disruption.

Wide-scale disruption means an event that causes a severe disruption or destruction of transportation, telecommunications, power, water, or other critical infrastructure components in a relevant area, or an event that results in an evacuation or unavailability of the population in a relevant area.

(b) *In general*—(1) *Program of risk analysis.* Each derivatives clearing organization shall establish and

maintain a program of risk analysis and oversight with respect to its operations and automated systems to identify and minimize sources of operational risk through:

(i) The development of appropriate controls and procedures; and

(ii) The development of automated systems that are reliable, secure, and have adequate scalable capacity.

(2) *Resources.* Each derivatives clearing organization shall establish and maintain resources that allow for the fulfillment of each obligation and responsibility of the derivatives clearing organization in light of the risks identified pursuant to paragraph (b)(1) of this section.

(3) *Verification of adequacy.* Each derivatives clearing organization shall periodically verify that resources described in paragraph (b)(2) are adequate to ensure daily processing, clearing, and settlement.

(c) *Elements of program.* A derivatives clearing organization's program of risk analysis and oversight with respect to its operations and automated systems, as described in paragraph (b) of this section, shall address each of the following categories of risk analysis and oversight:

(1) Information security;

(2) Business continuity and disaster recovery planning and resources;

(3) Capacity and performance planning;

(4) Systems operations;

(5) Systems development and quality assurance; and

(6) Physical security and environmental controls.

(d) *Standards for program.* In addressing the categories of risk analysis and oversight required under paragraph (c) of this section, a derivatives clearing organization shall follow generally accepted standards and industry best practices with respect to the development, operation, reliability, security, and capacity of automated systems.

(e) *Business continuity and disaster recovery*—(1) *Plan and resources.* A derivatives clearing organization shall maintain a business continuity and disaster recovery plan, emergency procedures, and physical, technological, and personnel resources sufficient to enable the timely recovery and resumption of operations and the fulfillment of each obligation and responsibility of the derivatives clearing organization following any disruption of its operations.

(2) *Responsibilities and obligations.* The responsibilities and obligations described in paragraph (e)(1) shall include, without limitation, daily processing, clearing, and settlement of transactions cleared.

(3) *Recovery time objective.* The derivatives clearing organization's business continuity and disaster recovery plan described in paragraph (e)(1) of this section shall have the objective of, and the physical, technological, and personnel resources described therein shall be sufficient to, enable the derivatives clearing organization to resume daily processing, clearing, and settlement no later than the next business day following the disruption.

(f) *Location of resources; outsourcing.* A derivatives clearing organization may maintain the resources required under paragraph (e)(1) of this section either:

(1) Using its own employees as personnel, and property that it owns, licenses, or leases (own resources); or

(2) Through written contractual arrangements with another derivatives clearing organization or other service provider (outsourcing).

(i) *Retention of responsibility.* A derivatives clearing organization that enters into such a contractual arrangement shall retain complete liability for any failure to meet the responsibilities specified in paragraph (e) of this section, although it is free to seek indemnification from the service provider. The outsourcing derivatives clearing organization must employ personnel with the expertise necessary to enable it to supervise the service provider's delivery of the services.

(ii) *Testing.* The testing referred to in paragraph (j) of this § 39.18 and § 39.30(c) of this part shall include all own and outsourced resources, and shall verify that all such resources will work effectively together.

(g) *Notice of exceptional events.* A derivatives clearing organization shall notify staff of the Division of Clearing and Intermediary Oversight promptly of:

(1) Any hardware or software malfunction, cyber security incident, or targeted threat that materially impairs, or creates a significant likelihood of material impairment, of automated system operation, reliability, security, or capacity; or

(2) Any activation of the derivatives clearing organization's business continuity and disaster recovery plan.

(h) *Notice of planned changes.* A derivatives clearing organization shall give staff of the Division of Clearing and Intermediary Oversight timely advance notice of all:

(1) Planned changes to automated systems that are likely to have a significant impact on the reliability, security, or adequate scalable capacity of such systems; and

(2) Planned changes to the derivatives clearing organization's program of risk analysis and oversight.

(i) *Recordkeeping.* A derivatives clearing organization shall maintain, and provide to Commission staff promptly upon request, pursuant to § 1.31 of this chapter, current copies of its business continuity plan and other emergency procedures, its assessments of its operational risks, and records of testing protocols and results, and shall provide any other documents requested by Commission staff for the purpose of maintaining a current profile of the derivatives clearing organization's automated systems.

(j) *Testing*—(1) *Purpose of testing.* A derivatives clearing organization shall conduct regular, periodic, and objective testing and review of:

(i) Its automated systems to ensure that they are reliable, secure, and have adequate scalable capacity; and

(ii) Its business continuity and disaster recovery capabilities, using testing protocols adequate to ensure that the derivatives clearing organization's backup resources are sufficient to meet the requirements of paragraph (e) of this section.

(2) *Conduct of testing.* Testing shall be conducted by qualified, independent professionals. Such qualified independent professionals may be independent contractors or employees of the derivatives clearing organization, but shall not be persons responsible for development or operation of the systems or capabilities being tested.

(3) *Reporting and review.* Reports setting forth the protocols for, and results of, such tests shall be communicated to, and reviewed by, senior management of the derivatives clearing organization. Protocols of tests which result in few or no exceptions shall be subject to more searching review.

(k) *Coordination of business continuity and disaster recovery plans.* A derivatives clearing organization shall, to the extent practicable:

(1) Coordinate its business continuity and disaster recovery plan with those of its clearing members, in a manner adequate to enable effective resumption of daily processing, clearing, and settlement following a disruption;

(2) Initiate and coordinate periodic, synchronized testing of its business continuity and disaster recovery plan and the plans of its clearing members; and

(3) Ensure that its business continuity and disaster recovery plan takes into account the plans of its providers of essential services, including telecommunications, power, and water.

§ 39.19 Reporting.

(a) [Reserved]

(b) [Reserved]

(c) (1) [Reserved]

(i) [Reserved]

(ii) [Reserved]

(iii) [Reserved]

(iv) End-of-day positions for each clearing member, by customer origin and house origin.

(2) [Reserved]

(3)(i) [Reserved]

(ii) [Reserved]

(iii) The annual verification required by § 39.24(b)(4) of this part.

(iv) *Time of report.* The reports required by this paragraph (c)(3) shall be submitted concurrently to the Commission not more than 90 days after the end of the derivatives clearing organization's fiscal year; *provided that,* a derivatives clearing organization may request from the Commission an extension of time to submit either report, provided the derivatives clearing organization's failure to submit the report in a timely manner could not be avoided without unreasonable effort or expense. Extensions of the deadline will be granted at the discretion of the Commission.

(4) (i)–(xv) [Reserved]

(xvi) *Action of Board of Directors or Risk Management Committee.* A report when (A) the Board of Directors of a derivatives clearing organization rejects a recommendation or supersedes an action of the Risk Management Committee; or

(B) The Risk Management Committee rejects a recommendation or supersedes an action of its subcommittee, as required by § 39.25(b) of this part.

(xvii) *Election of Board of Directors.* A report after each election of its Board of Directors in accordance with § 40.9(b)(1)(iii) of this chapter.

(xviii) *System safeguards.* A report of (A) exceptional events as required by § 39.18(g) of this part; or

(B) Planned changes as required by § 39.18(h) of this part.

§ 39.20 [Reserved]

§ 39.21 Public information.

(a) [Reserved]

(b) [Reserved]

(c)(1)–(5) [Reserved]

(6) The derivatives clearing organization's rules and procedures for defaults in accordance with § 39.16 of this part;

(7) Governance and conflicts of interest in accordance with § 39.24(a)(2) of this part and § 40.9(d) of this chapter; and

(8) Any other matter that is relevant to participation in the clearing and settlement activities of the derivatives clearing organization.

§ 39.22 [Reserved]

§ 39.23 [Reserved]

§ 39.24 Governance fitness standards.

(a) [Reserved]

(b)(1)–(3) [Reserved]

(4) *Verification.* Each derivatives clearing organization must collect and verify information that supports compliance with the standards in paragraphs (b)(2) and (3) of this section, and provide that information to the Commission on an annual basis in accordance with the requirements of § 39.19(c)(3)(iv) of this part. Such information may take the form of a certification based on verifiable information, an affidavit from the general counsel of the derivatives clearing organization, registration information, or other substantiating information.

§ 39.25 Conflicts of interest.

(a) [Reserved]

(b) *Reporting to the Commission.* In the event that:

(1) The Board of Directors of a derivatives clearing organization rejects a recommendation or supersedes an action of the Risk Management Committee, or

(2) The Risk Management Committee rejects a recommendation or supersedes an action of its subcommittee (as described in § 39.13(d)(5) of this part), the derivatives clearing organization shall submit a written report to the Commission within 30 days of such a rejection or supersession detailing:

(i) The recommendation or action of the Risk Management Committee (or subcommittee thereof);

(ii) The rationale for such recommendation or action;

(iii) The rationale of the Board of Directors (or the Risk Management Committee, if applicable) for rejecting such recommendation or superseding such action; and

(iv) The course of action that the Board of Directors (or the Risk Management Committee, if applicable) decided to take contrary to such recommendation or action.

9. Add subpart C to read as follows:

Subpart C—Provisions applicable to systemically important derivatives clearing organizations.

Sec.
39.28 Scope.
39.29 [Reserved]
39.30 System safeguards.
30.31 Special enforcement authority.

Subpart C—Provisions applicable to systemically important derivatives clearing organizations.

§ 39.28 Scope.

(a) The provisions of this subpart C apply to any derivatives clearing organization, as defined in section 1a(15) of the Act and § 1.3(d) of this chapter,

(1) Which is registered or deemed to be registered with the Commission as a derivatives clearing organization, is required to register as such with the Commission pursuant to section 5b(a) of the Act, or which voluntarily registers as such with the Commission pursuant to section 5b(b) or otherwise; and

(2) Which is a systemically important derivatives clearing organization as defined in § 39.2 of this part.

(b) A systemically important derivatives clearing organization is subject to the provisions of subparts A and B of this part 39 except to the extent different requirements are imposed by provisions of this subpart C.

(c) A systemically important derivatives clearing organization shall provide notice to the Commission in advance of any proposed change to its rules, procedures, or operations that could materially affect the nature or level of risks presented by the systemically important derivatives clearing organization, in accordance with the requirements of § 40.10 of this chapter.

§ 39.29 [Reserved]

§ 39.30 System safeguards.

(a) Notwithstanding § 39.18(e)(3) of this part, the business continuity and disaster recovery plan described in § 39.18(e)(1) for each systemically important derivatives clearing organization shall have the objective of enabling, and the physical, technological, and personnel resources described in § 39.18(e)(1) shall be sufficient to enable, the derivatives clearing organization to recover its operations and resume daily processing, clearing, and settlement no later than two hours following the disruption, for any disruption including a wide-scale disruption.

(b) To ensure its ability to achieve the recovery time objective specified in paragraph (a) of this section in the event of a wide-scale disruption, each systemically important derivatives clearing organization must maintain a degree of geographic dispersal of physical, technological and personnel resources consistent with the following:

(1) Physical and technological resources, sufficient to enable the entity

to meet the recovery time objective after interruption of normal clearing by a wide-scale disruption, must be located outside the relevant area of the infrastructure the entity normally relies upon to conduct activities necessary to the clearance and settlement of existing and new contracts, and must not rely on the same critical transportation, telecommunications, power, water, or other critical infrastructure components the entity normally relies upon for such activities;

(2) Personnel, sufficient to enable the entity to meet the recovery time objective after interruption of normal clearing by a wide-scale disruption affecting the relevant area in which the personnel the entity normally relies upon to engage in such activities are located, must live and work outside that relevant area;

(3) The provisions of § 39.18(f) of this part shall apply to these resource requirements.

(c) Each systemically important derivatives clearing organization must conduct regular, periodic tests of its business continuity and disaster recovery plans and resources and its capacity to achieve the required recovery time objective in the event of a wide-scale disruption. The provisions of § 39.18(j) of this part apply to such testing.

(d) The requirements of this section shall apply to a derivatives clearing organization not earlier than one year after such derivatives clearing organization is designated as systemically important.

§ 39.31 Special enforcement authority.

For purposes of enforcing the provisions of Title VIII of the Dodd-Frank Act, a systemically important derivatives clearing organization shall be subject to, and the Commission has authority under the provisions of subsections (b) through (n) of section 8 of, the Federal Deposit Insurance Act (12 U.S.C. 1818) in the same manner and to the same extent as if the systemically important derivatives clearing organization were an insured depository institution and the Commission were the appropriate Federal banking agency for such insured depository institution.

10. Revise appendix A to read as follows:

Appendix A to Part 39—Form DCO Derivatives Clearing Organization Application for Registration

BILLING CODE 6351–01–P

UNITED STATES COMMODITY FUTURES TRADING COMMISSION

FORM DCO

DERIVATIVES CLEARING ORGANIZATION APPLICATION FOR REGISTRATION

GENERAL INSTRUCTIONS

Intentional misstatements or omissions of fact may constitute federal criminal violations (7 U.S.C. § 13 and 18 U.S.C. § 1001) or grounds for disqualification from registration.

DEFINITIONS

Unless the context requires otherwise, all terms used in this Form DCO have the same meaning as in the Commodity Exchange Act ("Act"), and in the General Rules and Regulations of the Commodity Futures Trading Commission ("Commission") thereunder. All references to Commission regulations are found at 17 CFR Ch. 1.

GENERAL INSTRUCTIONS

1. This Form DCO, which includes a Cover Sheet and required Exhibits (together, "Form DCO" or "application"), is to be filed with the Commission by all applicants for registration as a derivatives clearing organization, including applicants when amending a pending application, and by any registered derivatives clearing organization applying for an amendment to its registration, pursuant to Section 5b of the Act and the Commission's regulations thereunder. Upon the filing of an application for registration or registration amendment, the Commission will publish notice of the filing and afford interested persons an opportunity to submit written data, views and comments concerning such application. No application for registration or registration amendment will be effective unless the Commission, by order, grants such registration or amended registration.

2. For the purposes of this Form DCO, the term "Applicant" shall include any applicant for registration as a derivatives clearing organization or any registered derivatives clearing organization that is applying for an amendment to its derivatives clearing organization registration.

3. Individuals' names, except the executing signature, shall be given in full (Last Name, First Name, Middle Name).

4. With respect to the executing signature, it must be manually signed by a duly authorized representative of the Applicant as follows: If the Form DCO is filed by a limited liability company, it must be signed in the name of the limited liability company by a manager or member duly authorized to sign on the limited liability company's behalf; if filed by a corporation, it must be signed in the name of the corporation by a principal officer duly authorized; if filed by a partnership, it must be signed in the name of the partnership by a general partner duly authorized; if filed by an unincorporated organization or association which is not a partnership, it must be signed in the name of such organization or association by the managing agent, i.e., a duly authorized person who directs or manages or who participates in the directing or managing of its affairs.

5. If this Form DCO is being filed as an application for registration, all applicable items must be answered in full. If any item or Exhibit is inapplicable, this response must be affirmatively indicated by the designation "none," "not applicable," or "N/A," as appropriate.

6. Under Section 5b of the Act and the Commission's regulations thereunder, the Commission is authorized to solicit the information required to be supplied by this Form DCO from any Applicant seeking registration as a derivatives clearing organization and from any registered derivatives clearing organization. Disclosure by the Applicant of the information specified in this Form DCO is mandatory prior to the start of the processing of an application for, or amendment to, registration as a derivatives clearing organization. The information provided in this Form DCO will be used for the principal purpose of determining whether the Commission should grant or deny registration to an Applicant.

The Commission may determine that additional information is required from the Applicant in order to process its application. An Applicant is therefore encouraged to supplement this Form DCO with any additional information that may be significant to its operation as a derivatives clearing organization and to the Commission's review of its application. A Form DCO which is not prepared and executed in compliance with applicable requirements and instructions may be returned as not acceptable for filing. Acceptance of this Form DCO, however, shall not constitute a finding that the Form DCO has been filed as required or that the information submitted is true, current or complete.

7. Except as provided in 17 CFR 39.3(a)(5), in cases where the Applicant submits a request for confidential treatment with the Secretary of the Commission pursuant to the Freedom of Information Act and 17 CFR 145.9, information supplied in this application will be included routinely in the public files of the Commission and will be available for inspection by any interested person.

APPLICATION AMENDMENTS

1. 17 CFR 39.3(a)(4) requires an Applicant to promptly amend its application if it discovers a material omission or error in the application, or if there is a material change in the information contained in the application, including any supplement or amendment thereto.

2. Applicants, when filing this Form DCO for purposes of amending an application, must re-file a cover sheet, amended if necessary and including an executing signature, and attach thereto revised Exhibits or other materials marked to show changes, as applicable. The submission of an amendment represents that the remaining items and Exhibits that are not amended continue to be true, current and complete as previously filed.

WHERE TO FILE

This Form DCO must be filed electronically with the Secretary of the Commission in the form and manner provided by the Commission.

UNITED STATES COMMODITY FUTURES TRADING COMMISSION

FORM DCO

DERIVATIVES CLEARING ORGANIZATION
APPLICATION FOR REGISTRATION

COVER SHEET

_____

Exact name of Applicant as specified in charter

_____

Address of principal executive offices

☐ If this is an **APPLICATION** for registration, complete in full and check here.

☐ If this is an **AMENDMENT** to an application, list below all items that are being amended and check here.

☐ If this is an **APPLICATION FOR AN AMENDMENT** to an existing registration, list below all items to be amended and check here.

_____

_____

_____

_____

GENERAL INFORMATION

- Name under which business is conducted, if different than name specified above (include acronyms, if any):

_____

- If name of derivatives clearing organization is being amended, state previous derivatives clearing organization name:

_____

- Mailing address, if different than address specified above:

_____

Number and Street

_____

City State Country Zip Code

- Additional contact information:

_____

Website URL Main Phone Number

- List of principal office(s) and address(es) where derivatives clearing organization activities are/will be conducted:

Office	Address
_____	_____
_____	_____
_____	_____

BUSINESS ORGANIZATION

- Applicant is a:

☐ Corporation

☐ Partnership (specify whether general or limited)

☐ Limited Liability Company

☐ Other form of organization (specify) _____

- Date of formation _____
- Jurisdiction of organization: _____
- List all other jurisdictions in which Applicant is qualified to do business (including non-US jurisdictions):

_____

_____

- List all other regulatory licenses or registrations of Applicant (or exemptions from any licensing requirement) including with non-US regulators:

_____

_____

- FEIN or other Tax ID# _____
- Fiscal Year End _____

CONTACT INFORMATION

- Provide contact information specifying name, title, phone numbers, mailing address and e-mail address for the following individuals:

a. The primary contact for questions and correspondence regarding the application

Name and Title

Office Phone Number | Mobile Phone Number

Mailing address | E-mail Address

b. The individual responsible for handling questions regarding the Applicant's financial statements

Name and Title

Office Phone Number | Mobile Phone Number

Mailing address | E-mail Address

c. The individual responsible for serving as the Chief Risk Officer of the Applicant pursuant to § 39.13 of the Commission's regulations

Name and Title

Office Phone Number | Mobile Phone Number

Mailing address | E-mail Address

d. The individual responsible for serving as the Chief Compliance Officer of the Applicant pursuant to § 39.10 of the Commission's regulations

Name and Title

Office Phone Number | Mobile Phone Number

Mailing address | E-mail Address

e. The individual responsible for serving as the chief legal officer of the Applicant

Name and Title

Office Phone Number Mobile Phone Number

Mailing address E-mail Address

- Outside Service Providers: Provide contact information specifying name, title, phone number, mailing address and e-mail address for any outside service provider retained by the Applicant as follows:

a. Certified Public Accountant

Name and Title

Office Phone Number Mobile Phone Number

Mailing address E-mail Address

b. Legal Counsel

Name and Title

Office Phone Number Mobile Phone Number

Mailing address E-mail Address

c. Records Storage or Management

Name and Title

Office Phone Number Mobile Phone Number

Mailing address E-mail Address

d. Business Continuity/Disaster Recovery

Name and Title

Office Phone Number Mobile Phone Number

Mailing address E-mail Address

e. Other (specify any other outside service providers, such as consultants, providing services related to this application)

_____

Name and Title

_____

Office Phone Number Mobile Phone Number

_____

Mailing address E-mail Address

- Applicant agrees and consents that the notice of any proceeding before the Commission in connection with this application may be given by sending such notice by certified mail to the person named below at the address given.

_____

Print Name and Title

_____

Number and Street

_____

City State Zip Code

SIGNATURE/REPRESENTATION

- The Applicant has duly caused this application to be signed on its behalf by its duly authorized representative as of the _____ day of _____, 20_____. The Applicant and the undersigned represent hereby that all information contained herein is true, current and complete. It is understood that all required items and Exhibits are considered integral parts of this Form DCO and that the submission of any amendment represents that all items and Exhibits that are not amended, remain true, current, and complete as previously filed.

_____

Name of Applicant

By:_____

Manual Signature of Duly Authorized Officer

_____

Print Name and Title of Signatory

UNITED STATES COMMODITY FUTURES TRADING COMMISSION

FORM DCO

DERIVATIVES CLEARING ORGANIZATION APPLICATION FOR REGISTRATION

EXHIBIT INSTRUCTIONS

1. The following Exhibits must be filed with the Commission by each Applicant seeking registration as a derivatives clearing organization or applying for an amendment to an existing derivatives clearing organization registration, pursuant to Section 5b of the Act and the Commission's regulations thereunder.

2. The application must include a Table of Contents listing each Exhibit required by this Form DCO and indicating which, if any, Exhibits are inapplicable. For any Exhibit that is inapplicable, next to the Exhibit letter specify "none," "not applicable," or "N/A," as appropriate.

3. The Exhibits must be labeled as specified in this Form DCO. If any Exhibit requires information that is related to, or may be duplicative of, information required to be included in another Exhibit, Applicant may summarize such information and provide a cross-reference to the Exhibit that contains the required information.

4. If the information required in an Exhibit involves computerized programs or systems, Applicant must submit descriptions of system test procedures, tests conducted, or test results in sufficient detail to demonstrate the Applicant's ability to comply with the core principles specified in Section 5b of the Act and the Commission's regulations thereunder (the "Core Principles"). With respect to each system test, Applicant must identify the methodology used and provide the computer software, programs, and data necessary to enable the Commission to duplicate each system test as it relates to the applicable Core Principle.

5. If Applicant seeks confidential treatment of any Exhibit or a portion of any Exhibit, Applicant must clearly label the relevant material as being "SUBJECT TO A REQUEST FOR CONFIDENTIAL TREATMENT" and file a confidentiality request with the Secretary of the Commission in accordance with 17 CFR 145.9.

BILLING CODE 6351–01–C

Description of Exhibits

Exhibit A—General Information/Compliance

• Attach as Exhibit A–1, a regulatory compliance chart setting forth each Core Principle and providing citations to the Applicant's relevant rules, policies, and procedures that address each Core Principle, and a brief summary of the manner in which Applicant will comply with each Core Principle.

• Attach as Exhibit A–2, a current copy of Applicant's rulebook. The rulebook must consist of all the rules necessary to carry out Applicant's role as a derivatives clearing organization. Applicant must certify that its rules constitute a binding agreement between Applicant and its clearing members and, in addition to the separate clearing member agreements, establish rights and obligations between Applicant and its clearing members.

• Attach as Exhibit A–3, a narrative summary of Applicant's proposed clearing activities including (i) the anticipated start date of clearing products (or, if Applicant is already clearing products, the anticipated start date of activities for which Applicant is seeking an amendment to its registration) and (ii) a description of the scope of Applicant's proposed clearing activities (*e.g.,* clearing for a designated contract market; clearing for a swap execution facility; clearing over-the-counter ("OTC") products).

• Attach as Exhibit A–4, a detailed business plan setting forth, at a minimum, the nature of and rationale for Applicant's activities as a derivatives clearing organization, the context in which it is beginning or expanding its activities, and the nature, terms, and conditions of the products it will clear.

• Attach as Exhibit A–5, a list of the names of any person (i) who owns 5% or more of Applicant's stock or other ownership or equity interests; or (ii) who, either directly or indirectly, through agreement or otherwise, may control or direct the management or policies of Applicant. Provide as part of Exhibit A–5 the full name and address of each such person, indicate the person's ownership percentage, and attach a copy of the agreement or, if there is no agreement, an explanation of the basis upon which such person exercises or may exercise such control or direction.

• Attach as Exhibit A–6, a list of Applicant's current officers, directors, governors, general partners, LLC managers, and members of all standing committees (including any committee referenced in Section (a)(2) of Exhibit P herein), as applicable, or persons performing functions similar to any of the foregoing, indicating for each:

a. Name and Title (with respect to a director, such title must include participation on any committee of Applicant);

b. Phone number (both work and mobile) and e-mail contact information;

c. Dates of commencement and, if appropriate, termination of present term of office or position;

d. Length of time each such person has held the same office or position;

e. Brief description of the business experience of each person over the last ten years;

f. Any other current business affiliations in the financial services industry;

g. If such person is not an employee of Applicant, list any compensation paid to the person as a result of his or her position at Applicant. For a director, describe any performance-based compensation;

h. A certification for each such person that the individual would not be disqualified under Section 8a(2) of the Act or § 1.63; and

i. With respect to a director, whether such director is a public director or a clearing member customer, and the basis for such a determination as to the director's status.

If another entity "operates" Applicant, attach for such entity all of the items indicated in Exhibit A–6. For this purpose, the term "operate" shall be as defined in § 40.9(b)(2)

• Attach as Exhibit A–7, a diagram of the entire corporate organizational structure of Applicant including the legal name of all entities within the organizational structure and the applicable percentage ownership among affiliated entities. Additionally, provide (i) a list of all jurisdictions in which Applicant or its affiliated entities are doing business; (iii) the registration status of Applicant and its affiliated entities, including pending applications or exemption requests and whether any applications or exemptions have been denied (*e.g.,* country, regulator, registration category, date of registration or request for exemption, date of denial, if applicable); and (ii) the address for

legal service of process for Applicant (which cannot be a post office box) for each applicable jurisdiction.

• Attach as Exhibit A–8, a copy of the constituent documents, articles of incorporation or association with all amendments thereto, partnership or limited liability agreements, and existing bylaws, operating agreement, and rules or instruments corresponding thereto, of Applicant. Provide a certificate of good standing or its equivalent for Applicant for each jurisdiction in which Applicant is doing business, including any foreign jurisdiction, dated within one month of the date of the Form DCO.

• Attach as Exhibit A–9, a brief description of any material pending legal proceeding(s) or governmental investigation(s) to which Applicant or any of its affiliates is a party or is subject, or to which any of its or their property is at issue. Include the name of the court or agency where the proceeding(s) is pending, the date(s) instituted, the principal parties involved, a description of the factual allegations in the complaint(s), the laws that were allegedly violated, and the relief sought. Include similar information as to any such proceeding(s) or any investigation known to be contemplated by any governmental agency.

• If Applicant intends to use the services of an outside service provider (including services of its clearing members or market participants), to enable Applicant to comply with any of the Core Principles, Applicant must submit as Exhibit A–10 all agreements entered into or to be entered into between Applicant and the outside service provider, and identify (1) the services that will be provided; (2) the staff who will provide the services; and (3) the Core Principles addressed by such arrangement. If a submitted agreement is not final and executed, the Applicant must submit evidence that constitutes reasonable assurance that such services will be provided as soon as operations require.

• Attach as Exhibit A–11, documentation that demonstrates compliance with the Chief Compliance Officer ("CCO") requirements set forth in § 39.10(c), including but not limited to:

a. Evidence of the designation of an individual to serve as Applicant's CCO with full responsibility and authority to develop and enforce appropriate compliance policies and procedures;

b. A description of the background and skills of the person designated as the CCO and a certification that the individual would not be disqualified under Section 8a(2) of the Act or § 1.63;

c. To whom the CCO reports (*i.e.,* the senior officer or the Board of Directors);

d. Any plan of communication or regular or special meetings between the CCO and the Board of Directors or senior officer as appropriate;

e. A job description setting forth the CCO's duties;

f. Procedures for the remediation of noncompliance issues; and

g. A copy of Applicant's Compliance Manual (including a code of ethics and conflict of interest policy).

Exhibit B—Financial Resources

• Attach as Exhibit B, documents that demonstrate compliance with the financial resources requirements set forth in § 39.11, including but not limited to:

a. *General*—Provide as Exhibit B–1:

(1) The most recent set of audited financial statements of Applicant or of its parent company, including the balance sheet, income statement, statement of cash flows, notes to the financial statements, and accountant's opinion;

(2) If the audited financial statements are not dated within 1 month of the date of filing of the Form DCO, Applicant must provide a set of unaudited financial statements current within 1 month of the date of filing of the Form DCO;

(3) If Applicant does not have audited financial statements, Applicant must provide a balance sheet as of a date within 1 month of the date of filing of the Form DCO and an income statement and statement of cash flows reflecting the period since Applicant's formation and a date that is within 1 month of the date of filing of the Form DCO. These statements must be accompanied by an independent certified public accountant's review report; and

(4) Evidence of ability to satisfy the requirements of Exhibits B–2 and B–3 below which may include (i) pro forma financial statements setting forth all projections and assumptions used therein, and (ii) a narrative description of how Applicant will fund its financial resources obligations on the first day of its operation as a derivatives clearing organization.

b. *Default Resources*—Provide as Exhibit B–2:

(1) A calculation of the financial resources needed to enable Applicant to meet its requirements under § 39.11(a)(1). Applicant must provide hypothetical default scenarios designed to reflect a variety of market conditions, and the assumptions and variables underlying the scenarios must be explained. All results of the analysis must be included. This calculation requires a start-up enterprise to estimate its largest anticipated financial exposure. A start-up must be able to explain the basis for its estimate;

(2) Proof of unencumbered assets sufficient to satisfy § 39.11(a)(1). This may be demonstrated by a copy of a bank balance statement(s) in the name of Applicant and may be combined with the types of financial resources set forth in § 39.11(b)(1). If relying on § 39.11(b)(1)(vi), such other resources must be thoroughly explained. If relying on § 39.11(b)(1)(ii) and/or (vi), Applicant cannot also count these assets when demonstrating its compliance with its operating resources requirement under § 39.11(a)(2) and Applicant must detail the amounts or percentages of such assets that apply to each financial resource requirement;

(3) A demonstration that Applicant can perform the monthly calculations required by § 39.11(c)(1);

(4) A demonstration that Applicant's financial resources are sufficiently liquid as required by § 39.11(e)(1);

(5) A demonstration of how Applicant will be able to maintain, at all times, the level of resources required by § 39.11(a)(1); and

(6) A demonstration of how default resources financial information will be updated and reported to clearing members and the public under § 39.21, and to the Commission as required by § 39.11(f)(1) and § 39.19.

c. *Operating Resources*—Provide as Exhibit B–3:

(1) A calculation of the financial resources needed to enable Applicant to meet its requirements under § 39.11(a)(2);

(2) Proof of assets sufficient to satisfy the amount required under § 39.11(a)(2). This may be demonstrated by a copy of a bank balance statement(s) in the name of Applicant and may be combined with the types of financial resources set forth in § 39.11(b)(2). If relying on § 39.11(b)(2)(ii), such other resources must be thoroughly explained. If relying on § 39.11(b)(2)(i) or (ii), Applicant cannot also count these assets when demonstrating its compliance with meeting its default resources requirement under § 39.11(a)(1) and Applicant must detail the amounts or percentages of such assets that apply to each financial resource requirement;

(3) Proof of adequate physical infrastructure to carry out business operations, which includes an office(s) (separate from any personal dwelling) with a U.S. street address (not merely a post office box number) that has electricity, HVAC, and running water and meets all local building and fire codes. This location must be the same as the principal executive offices address identified on the cover sheet of the Form DCO;

(4) Proof of adequate technological systems necessary to carry out operations including properly working computers, networks, appropriate software, telephones, fax machines, Internet access, and photocopiers;

(5) A calculation pursuant to § 39.11(c)(2), including the total projected operating costs for Applicant's first year of operation, calculated on a monthly basis with an explanation of the basis for calculating each cost and a discussion of the type, nature, and number of the various costs included;

(6) A demonstration that Applicant's financial resources are sufficiently liquid and unencumbered, as required by § 39.11(e)(2);

(7) A demonstration of how Applicant will maintain, at all times, the level of resources required by § 39.11(a)(2) with an explanation of asset valuation methodology and calculation of projected revenue, if applicable; and

(8) A demonstration of how operating resources financial information will be updated and reported to clearing members and the public under § 39.21, and to the Commission as required by § 39.11(f)(1) and § 39.19.

d. *Human Resources*—Provide as Exhibit B–4:

(1) An organizational chart showing Applicant's current and planned staff by position and title, including key personnel (as such term is defined in § 39.2) and, if applicable, managerial staff reporting to key personnel.

(2) A discussion and description of the staffing requirements needed to fulfill all operations and associated functions, tasks,

services, and areas of supervision necessary to operate Applicant on a day-to-day basis; and

(3) The names and qualifications of individuals who are key personnel or other managerial staff who will carry out the operations and associated functions, tasks, services, and supervision needed to run the Applicant on day-to-day basis. In particular, Applicant must identify such individuals who are responsible for risk management, treasury, clearing operations and compliance (and specify whether each such person is an employee or consultant/agent).

Exhibit C—Participant and Product Eligibility

• Attach as Exhibit C, documents that demonstrate compliance with the participant and product eligibility requirements set forth in § 39.12 of the Commission's regulations, including but not limited to:

a. *Participant Eligibility*—Provide as Exhibit C–1, an explanation of the requirements for becoming a clearing member and how those requirements satisfy § 39.12 and, where applicable, support Applicant's compliance with other Core Principles. Applicant must address how its participant eligibility requirements comply with the core principles and regulations thereunder for financial resources, risk management and operational capacity. The explanation also must include:

(1) A final version of the membership agreement between Applicant and its clearing members that sets forth the full scope of respective rights and obligations;

(2) A discussion of how Applicant will monitor for and enforce compliance with its eligibility criteria, especially minimum financial requirements;

(3) An explanation of how the eligibility criteria are objective and allow for fair and open access to Applicant. Applicant must include an explanation of the differences between various classes of membership or participation that might be based on different levels of capital and/or creditworthiness. Applicant must also include information about whether any differences exist in how Applicant will monitor and enforce the obligations of its various clearing members including any differences in access, privilege, margin levels, position limits, or other controls;

(4) If Applicant allows intermediation, Applicant must describe the requirements applicable to those who may act as intermediaries on behalf of customers or other market participants;

(5) A description of the program for monitoring the financial status of the clearing members on an ongoing basis;

(6) The procedures that Applicant will follow in the event of the bankruptcy or insolvency of a clearing member, which did not result in a default to Applicant;

(7) A description of whether and how Applicant would adjust clearing member participation under continuing eligibility criteria based on the financial, risk, or operational status of a clearing member;

(8) A discussion of whether Applicant's clearing members will be required to be registered with the Commission; and

(9) A list of current or prospective clearing members. If a current or prospective clearing member is a Commission registrant, Applicant must identify the member's designated self-regulatory organization.

b. *Product Eligibility*—Provide as Exhibit C–2, an explanation of the criteria for instruments acceptable for clearing including:

(1) The regulatory status of each market on which a contract to be cleared by Applicant is traded (*e.g.,* DCM, SEF, not a registered market), and whether the market for which Applicant clears intends to join the Joint Audit Committee. For OTC agreements, contracts, or transactions not traded on a registered market, Applicant must describe the nature of the OTC market and its interest in having the particular OTC agreement, contract, or transaction cleared;

(2) The criteria, and the factors considered in establishing the criteria, for determining the types of products that will be cleared;

(3) An explanation of how the criteria for deciding what products to clear take into account the different risks inherent in clearing different agreements, contracts, or transactions and how those criteria affect maintenance of assets to support the guarantee function in varying risk environments;

(4) A precise list of all the agreements, contracts, or transactions to be covered by Applicant's registration order, including the terms and conditions of all agreements, contracts, or transactions;

(5) A forecast of expected volume and open interest at the outset of clearing operations, after six months, and after one year of operation; and

(6) The mechanics of clearing the contract, such as reliance on exchange for physical, exchange for swap, or other substitution activity; whether the contracts are matched prior to submission for clearing or after submission; and other aspects of clearing mechanics that are relevant to understanding the products that would be eligible for clearing.

Exhibit D—Risk Management

• Attach as Exhibit D, documents that demonstrate compliance with the risk management requirements set forth in § 39.13 of the Commission's regulations, including but not limited to:

a. *Risk Management Framework*—Provide as Exhibit D–1, a copy of Applicant's written policies, procedures, and controls, as approved by Applicant's Board of Directors, that establish Applicant's risk management framework as required by § 39.13(b). Applicant must also provide a description of the composition and responsibilities of Applicant's Risk Management Committee.

b. *Measuring Risk*—Provide as Exhibit D–2, a narrative explanation of how Applicant has projected and will continue to measure its counterparty risk exposure, including:

(1) A description of the risk-based margin calculation methodology;

(2) The assumptions upon which the methodology was designed, including the risk analysis tools and procedures employed in the design process;

(3) An explanation as to why a particular methodology was chosen over other methodologies that might have been suitable, including a comparison of margin levels calculated using other margin methodologies;

(4) A demonstration of the margin methodology as applied to real or hypothetical clearing scenarios;

(5) A description of the data sources for inputs used in the methodology, *e.g.* historical price data reflecting market volatility over various periods of time;

(6) A description of the sources of price data for the measurement of current exposures and the valuation models for addressing circumstances where pricing data is not readily available or reliable;

(7) The frequency and circumstances under which the margin methodology will be reviewed and the criteria for deciding how often to review and whether to modify a margin methodology;

(8) An independent validation of Applicant's systems for generating initial margin requirements, including its theoretical models;

(9) The frequency of measuring counterparty risk exposures (mark to market), whether counterparty risk exposures are routinely measured on an intraday basis, whether Applicant has the operational capacity to measure counterparty risk exposures on an intraday basis, and the circumstances under which Applicant would conduct a non-routine intraday measurement of counterparty risk exposures;

(10) Preliminary forecasts regarding future counterparty risk exposure and assumptions upon which such forecasts of exposure are based;

(11) A description of any systems or software that Applicant will require clearing members to use in order to margin their positions in their internal bookkeeping systems, and whether and under what terms and conditions Applicant will provide such systems or software to clearing members; and

(12) A description of the extent to which counterparty risk can be offset through the clearing process (*i.e.,* the limitations, if any, on Applicant's duty to fulfill its obligations as the buyer to every seller and the seller to every buyer).

c. *Limiting Risk*—Provide as Exhibit D–3, a narrative discussion addressing the specifics of Applicant's clearing activities, including:

(1) How Applicant will collect financial information about its clearing members and other traders or market participants, monitor price movements, and mark to market, on a daily basis, the products and/or portfolios it clears;

(2) How Applicant will monitor accounts carried by clearing members, the accumulation of positions by clearing members and other market participants, and compliance with position limits; and how it will use large trader information;

(3) How Applicant will determine variation margin levels and outstanding initial margin due;

(4) How Applicant will identify unusually large pays on a proactive basis before they occur;

(5) Whether and how Applicant will compare price moves and position information to historical patterns and to the

financial information collected from its clearing members; how it will identify unusually large pays on a daily basis;

(6) How Applicant will use various risk tools and procedures such as: (i) value-at-risk calculations; (ii) stress testing; (iii) back testing; and/or (iv) other risk management tools and procedures;

(7) How Applicant will communicate with clearing members, settlement banks, other derivatives clearing organizations, designated contract markets, swap execution facilities, major swap participants, swap data repositories, and other entities in emergency situations or circumstance that might require immediate action by the Applicant;

(8) How Applicant will monitor risk outside business hours;

(9) How Applicant will review its clearing members' risk management practices;

(10) Whether Applicant will impose credit limits and/or employ other risk filters (such as automatic system denial of entry of trades under certain conditions);

(11) Plans for handling "extreme market volatility" and how Applicant defines that term;

(12) An explanation of how Applicant will be able to offset positions in order to manage risk including: (i) ensuring both Applicant and clearing members have the operational capacity to do so; and (ii) liquidity of the relevant market, especially with regard to OTC products and OTC markets;

(13) Plans for managing accounts that are "too big" to liquidate and for conducting "what if" analyses on these accounts;

(14) If options are involved, how Applicant will manage the different and more complex risk presented by these products;

(15) If Applicant intends to clear swaps, whether and how often Applicant will offer multilateral portfolio compression exercises for its clearing members; and

(16) If Applicant intends to clear credit default swaps, how Applicant will manage the unique risks associated with clearing these products, such as jump-to-default risk.

d. *Existence of collateral (funds and assets) to apply to losses resulting from realized risk*—Provide as Exhibit D–4:

(1) An explanation of the factors, process, and methodology used for calculating and setting required collateral levels, the required inputs, the appropriateness of those inputs, and an illustrative example;

(2) An analysis supporting the sufficiency of Applicant's collateral levels for capturing all or most price moves that may take place in one settlement cycle;

(3) A description of how Applicant will value open positions and collateral assets;

(4) A description and explanation of the forms of assets allowed as collateral, why they are acceptable, and whether there are any haircuts or concentration limits on certain kinds of assets, including how often any such haircuts and concentration limits are reviewed;

(5) An explanation of how and when Applicant will collect collateral, whether and under what circumstances it will collect collateral on an intraday basis, and what will happen if collateral is not received in a timely manner. Include a proposed collateral collection schedule based on changes in market positions and collateral values; and

(6) If options are involved, a full explanation of how it will manage the associated risk through the use of collateral including, if applicable, a discussion of its option pricing model, how it establishes its implied volatility scan range, and other matters related to the complex matter of managing the risk associated with the clearing of option contracts.

Exhibit E—Settlement Procedures

• Attach as Exhibit E, documents that demonstrate compliance with the settlement procedures requirements set forth in § 39.14 of the Commission's regulations, including but not limited to:

a. *Settlement*—Provide as Exhibit E–1, a full description of the daily process of settling financial obligations on all open positions being cleared. This must include:

(1) Procedures for completing settlements on a timely basis during normal market conditions (and no less frequently than once each business day);

(2) Procedures for completing settlements on a timely basis in varying market circumstances including in the event of a default by the clearing member creating the largest financial exposure for Applicant in extreme but plausible market conditions;

(3) A description of how contracts will be marked to market on at least a daily basis;

(4) Identification of the settlement banks used by Applicant (including identification of the lead settlement bank, if applicable) and a copy of Applicant's settlement bank agreement(s). Such settlement bank agreements must (i) outline daily cash settlement procedures, (ii) state clearly when settlement fund transfers will occur, (iii) provide procedures for settlements on bank holidays when the markets are open, and (iv) ensure that settlements are final when effected;

(5) Identification of settlement banks that Applicant will allow its clearing members to use for margin calls and variation settlements;

(6) A description of the criteria and review process used by Applicant when selecting settlement banks; procedures for monitoring the continued appropriateness of all settlement banks including a description of how Applicant monitors its concentration risk or exposure to each settlement bank;

(7) The specific means by which settlement instructions are communicated from Applicant to the settlement bank(s);

(8) A timetable showing the flow of funds associated with the settlement of products for a 24-hour period or such other settlement timeframe specified by a particular product; this may be presented in the form of a chart, as in the following example:

FORM DCO - SAMPLE SETTLEMENT CYCLE CHART [Specify U.S. Dollar or other currency as applicable]	
TRADE DATE = T [INSERT TIME ZONE] [INSERT EXACT TIMES BELOW]	**EXAMPLE OF SETTLEMENT ACTIVITY FOR WHICH TIMES SHOULD BE PROVIDED**
T: _____ pm	Last market closes (end of regular trading hours).
T: Approx. ____ pm	DCO/DCM/SEF establishes daily settlement price for each product based on information generated by its [INSERT NAME OF APPLICABLE CLEARING SYSTEM].
T: By _____ pm	Clearing members' position information for intraday settlement is obtained from DCO's clearing system.
T+1: Approx. ____ am	DCO provides daily performance bond (PB) and settlement variation/option premium (SVOP) amounts to clearing members and banks.
T+1: By ____ am	Banks commit to pay daily PB and SVOP amounts.
T+1: Approx. ____ am	Banks pay daily PB and SVOP amounts from clearing members to DCO.
T+1: Approx. __ am	Banks pay daily PB and SVOP amounts from DCO to clearing members.
T: Approx. ____ pm	DCO/DCM/SEF determines prices for intraday settlement.
T: Approx. ____ pm	Clearing members' position information for intraday settlement is obtained from DCO's clearing system.
T: By approx. ____ pm	DCO provides intraday PB and SVOP amounts to banks and clearing members.
T: By ____ pm	Banks commit to pay intraday PB and SVOP amounts.
T: Approx. ____ pm	Banks pay intraday PB and SVOP amounts from clearing members to DCO.
T: Approx. ____ pm	Banks pay intraday PB and SVOP amounts from DCO to clearing members.

(9) A description of what happens in the event that there are insufficient funds in a clearing member's settlement account;

(10) An explanation of how and when Applicant will collect variation margin, whether and under what circumstances it will collect variation margin on an intraday basis, what will happen if variation margin is not received in a timely manner, and a proposed variation margin collection schedule based on changes in market prices;

(11) All the information above, to the extent relevant, for any products cleared that may be denominated in a foreign currency; and

(12) With respect to physical settlements, identify Applicant's rules that clearly state each obligation of Applicant with respect to physical deliveries, and explain how Applicant intends to identify and manage risks arising from physical settlement.

b. *Recordkeeping*—Provide as Exhibit E–2, a full description of the following:

(1) The nature and quality of the information collected concerning the flow of funds involved in clearing and settlement; and

(2) How such information will be recorded, maintained, and accessed.

c. *Interfaces with other clearing organizations*—Provide as Exhibit E–3, a description of Applicant's relationships with other derivatives clearing organizations, clearing agencies, financial market utilities or foreign entities that perform similar functions including how compliance with the terms and conditions of agreements or arrangements with such other entities will be satisfied, *e.g.,* any netting or offset arrangements, cross-margining, portfolio margining, linkage, common banking, common clearing programs or limited guaranty agreements or arrangements.

Exhibit F—Treatment of Funds

• Attach as Exhibit F, documents that demonstrate compliance with the treatment of funds requirements set forth in § 39.15 of the Commission's regulations, including but not limited to:

a. *Safe custody*—Provide as Exhibit F–1, documents that demonstrate:

(1) How Applicant will ensure the safekeeping of funds and collateral in depositories and how Applicant will minimize the risk of loss or of delay in accessing such funds and collateral;

(2) The depositories that will hold the funds and collateral and any written agreements between or among such depositories, Applicant or its clearing members regarding the legal status of the funds and collateral and the specific conditions or prerequisites for movement of the funds and collateral; and

(3) How Applicant will limit the concentration of risk in depositories where funds and collateral are deposited.

b. *Segregation of customer and proprietary funds*—Provide as Exhibit F–2, documents that demonstrate:

(1) The appropriate segregation of customer funds and associated acknowledgement documentation; and

(2) Requirements or restrictions regarding commingling customer funds with proprietary funds, obligating customer funds for any purpose other than to purchase, clear, and settle the products Applicant is clearing, procedures regarding customer funds which are subject to cross-margin or similar agreements, and any other aspects of customer fund segregation.

c. *Investment standards*—Provide as Exhibit F–3, documents that demonstrate:

(1) How customer funds would be invested in instruments with minimal credit, market, and liquidity risks, and in compliance with the requirements of § 1.25; and

(2) How Applicant will obtain and keep associated records and data regarding the details of such investments.

Exhibit G—Default Rules and Procedures

• Attach as Exhibit G, documents that demonstrate compliance with the default rules and procedures requirements set forth in § 39.16 of the Commission's regulations, including but not limited to:

a. *Default Management Plan*—Applicant must provide a copy of its written default management plan which must contain all of the information required by § 39.16(b), along with Applicant's most recently documented results of a test of its default management plan.

b. *Definition of default*—Applicant must describe or otherwise document:

(1) The events (activities, lapses, or situations) that will constitute a clearing member default;

(2) What action Applicant can take upon a default and how Applicant will otherwise enforce the rules applicable in the event of default, including the steps and the sequence of the steps that will be followed. Identify whether a Default Management Committee exists and, if so, its role in the default process; and

(3) An example of a hypothetical default scenario and the results of the default management process used in the scenario.

c. *Remedial action*—Applicant must describe or otherwise document:

(1) The authority and methods by which Applicant may take appropriate action in the event of the default of a clearing member which may include, among other things, liquidating positions, hedging, auctioning, allocating (including any obligations of clearing members to participate in auctions or to accept allocations), and transferring of customer accounts to another clearing member (including an explanation of the movement of positions and collateral on deposit); and

(2) Actions taken by a clearing member or other events that would put a clearing member on Applicant's "watch list" or similar device.

d. *Process to address shortfalls*—Applicant must describe or otherwise document:

(1) Procedures for the prompt application of Applicant and/or clearing member financial resources to address monetary shortfalls resulting from a default;

(2) How Applicant will make publicly available its default rules including a description of the priority of application of financial resources in the event of default (*i.e.,* the "waterfall"); and

(3) How Applicant will take timely action to contain losses and liquidity pressures and to continue to meet each obligation of Applicant.

e. *Use of cross-margin programs*—Describe or otherwise document, as applicable, how cross-margining programs will provide for fair and efficient means of covering losses in the event of a default of any clearing member participating in the program.

f. *Customer priority rule*—Describe or otherwise document rules and procedures regarding priority of customer accounts over proprietary accounts of defaulting clearing members and, where applicable, specifically in the context of specialized margin reduction programs such as cross-margining or common banking arrangements with other derivatives clearing organizations, clearing agencies, financial market utilities or foreign entities that perform similar functions.

Exhibit H—Rule Enforcement

• Attach as Exhibit H, documents that demonstrate compliance with the rule enforcement requirements set forth in § 39.17 of the Commission's regulations, including but not limited to:

a. *Surveillance*—Describe or otherwise document arrangements and resources for the effective monitoring and enforcement of compliance with Applicant's rules and the resolution of disputes.

b. *Enforcement*—Applicant must describe or otherwise document:

(1) Arrangements and resources for the effective enforcement of rules and authority and ability to discipline and limit or suspend a member's activities pursuant to clear and fair standards;

(2) Arrangements for enforcing compliance with its rules and addressing instances of non-compliance, including: Disciplinary tools such as limiting, suspending, or terminating a clearing member's access or member privileges;

(3) How Applicant will address situations related to, but which may not constitute an event of default, such as a clearing member's failure to comply with certain rules or to maintain eligibility standards, or actions taken by other regulatory bodies;

(4) The standards and any procedural protections Applicant will follow in imposing any such enforcement measure; and

(5) Processes for reporting to the Commission Applicant's rule enforcement activities and possible sanctions that could be imposed against clearing members.

c. *Dispute resolution*—Describe or otherwise document arrangements and resources for resolution of disputes between customers and clearing members, and between clearing members.

Exhibit I—System Safeguards

• Attach as Exhibit I, documents that demonstrate compliance with the system safeguards requirements set forth in § 39.18 of the Commission's regulations, including but not limited to:

a. A description of Applicant's program of risk analysis and oversight with respect to its operations and automated systems. This program must be designed to ensure daily processing, clearing, and settlement of transactions and address each of the following categories of risk:

(1) Information security;

(2) Business continuity-disaster recovery planning and resources;

(3) Capacity and performance planning;

(4) Systems operations;

(5) Systems development and quality assurance; and

(6) Physical security and environmental controls.

b. An explanation of how Applicant will establish and maintain resources that allow for the fulfillment of its program of risk analysis and oversight with respect to its operations and automated systems, and a description of such resources, including:

(1) A description of how Applicant will periodically verify that its resources are adequate to ensure daily processing, clearing, and settlement;

(2) A demonstration that Applicant's automated systems are reliable, secure, and have (and will continue to have) adequate scalable capacity;

(3) A description of the physical, technological and personnel resources and procedures used by Applicant as part of its business continuity and disaster recovery plan, and support for the conclusion that these resources are sufficient to enable the Applicant to resume daily processing, clearing and settlement no later than the next business day following a disruption; and

(4) A statement identifying which such resources are Applicant's own resources and which are provided by a service provider (outsourced). For resources that are outsourced, provide (i) all contracts governing the outsourcing arrangements, including all schedules and other supplemental materials, and (ii) a demonstration that Applicant employs personnel with the expertise necessary to enable them to supervise the service provider's delivery of the services.

c. An explanation of how Applicant will ensure the proper functioning of its systems, including its program for the periodic objective testing and review of its systems and back-up facilities (including all of its own and outsourced resources), and verification that all such resources will work effectively together;

d. Identification of the persons conducting the testing, including information as to their qualifications and independence;

e. A description of Applicant's emergency procedures, including a copy of its written plan for business continuity and disaster recovery and a description of how Applicant will coordinate its business continuity and disaster recovery plan (including testing) with those of its clearing members and providers of essential services such as telecommunications, power and water; and

f. A description of how Applicant will report exceptional events and planned changes to the Commission as required by §§ 39.18(g) and 39.18(h).

Exhibit J—Reporting

• Attach as Exhibit J, documents that demonstrate compliance with the reporting requirements set forth in § 39.19 of the Commission's regulations including but not limited to:

a. How Applicant will make available to Commission staff all the information Commission staff need in order to carry out effective oversight. This must include a discussion of what will be made available on a routine basis, how often it will be made available, and the method of its transmission. The same items must be addressed for information it will make available on a non-routine basis and what events would precipitate the generation of such data or information. Applicant must also address the manner in which any information will be made available to clearing members, customers, market participants and/or the general public. If not part of an initial application, Applicant must provide a representation that it will provide the

following when initially generated or when content changes occur:

(1) A list of current members/market participants;

(2) A list of all products currently eligible for clearing;

(3) The initial margin collection schedule;

(4) Information on any disciplinary actions (such as suspensions, etc.);

(5) Information concerning any physical or other emergencies;

(6) All information concerning any default by a member and the impact of the default on Applicant's financial resources;

(7) A copy of any examination/evaluation/compliance report of any regulatory body other than the Commission that oversees Applicant;

(8) A copy of any internal examination/evaluation/compliance reports such as, but not limited to, those related to stress testing and systems testing;

(9) Key personnel that have particular knowledge of the market(s) for which Applicant clears and any changes in those personnel, especially those to be contacted in case of market volatility or to respond to inquiries and emergencies;

(10) Copies of audited financial statements of Applicant; and

(11) Information regarding counterparties and their positions, stress test results, internal governance, legal proceedings, and other clearing activities.

b. Forms or templates to be used to satisfy the daily, quarterly, annual, and event-specific reporting requirements specified in § 39.19(c) of the Commission's regulations.

Exhibit K—Recordkeeping

• Attach as Exhibit K, documents that demonstrate compliance with the recordkeeping requirements set forth in § 39.20 of the Commission's regulations including but not limited to:

a. Applicant's recordkeeping and record retention policies and procedures;

b. The different activities related to the entity as a derivatives clearing organization for which it must maintain records;

c. The manner in which records relating to swaps and swap data are gathered and maintained; and

d. How Applicant will satisfy the performance standards of § 1.31 as applicable to derivatives clearing organizations, including:

(1) What "full" or "complete" will encompass with respect to each type of book or record that will be maintained;

(2) The form and manner in which books or records will be compiled and maintained with respect to each type of activity for which such books or records will be kept;

(3) Confirmation that books and records will be open to inspection by any representative of the Commission or of the U.S. Department of Justice;

(4) How long books and records will be readily available and how they will be made readily available during the first two years; and

(5) How long books and records will be maintained (and confirmation that, in any event, they will be maintained as required in § 1.31).

Exhibit L—Public Information

• Attach as Exhibit L, documents that demonstrate compliance with the public information requirements set forth in § 39.21 of the Commission's regulations including but not limited to:

a. Applicant's procedures for making its rulebook, a list of all current clearing members, and the information listed in § 39.21(c) readily available to the general public, in a timely manner, by posting such information on Applicant's Web site no later than the business day following the day to which the information pertains;

b. Any other information routinely made available to the public by Applicant;

c. How Applicant will make information available to clearing members and market participants in order to allow such persons to become familiar with Applicant's procedures before participating in clearing operations; and

d. How clearing members will be informed of their specific rights and obligations preceding a default and upon a default, and of the specific rights, options and obligations of Applicant preceding and upon a clearing member's default.

Exhibit M—Information Sharing

• Attach as Exhibit M, documents that demonstrate compliance with the information sharing requirements set forth in § 39.22 of the Commission's regulations, including but not limited to:

a. The appropriate and applicable information sharing agreements to which Applicant is, or intends to be, a party including any domestic or international information-sharing agreements or arrangements, whether formal or informal, which involve or relate to Applicant's operations, especially as it relates to measuring and addressing counterparty risk;

b. A description of the types of information expected to be shared and how that information will be shared;

c. An explanation as to how information obtained pursuant to any information-sharing agreements or arrangements would be used to further the objectives of Applicant's risk management program and any of its surveillance programs including financial surveillance and continuing eligibility of its clearing members; and

d. An explanation as to how Applicant expects to obtain accurate information pursuant to the information-sharing agreement or arrangement and the mechanisms or procedures which would allow for timely use and application of all information.

Exhibit N—Antitrust Considerations

• Attach as Exhibit N, documents that demonstrate compliance with the antitrust considerations requirements set forth in § 39.23 of the Commission's regulations, including but not limited to policies or procedures to ensure compliance with the antitrust considerations requirements.

Exhibit O—Governance Fitness Standards

• Attach as Exhibit O, documents that demonstrate compliance with the governance fitness standards requirements set forth in § 39.24 of the Commission's regulations, including but not limited to:

a. The manner in which its governance arrangements permit consideration of the views of Applicant's owners, whether voting or non-voting, and its participants (clearing members and customers) including (i) the general method by which Applicant will learn of the views of Applicant's owners, other than through their exercise of voting power, or the views of participants, other than through representation on the Board of Directors or any committee of Applicant, and (ii) the manner in which Applicant will consider such views;

b. The fitness standards applicable to members of the Board of Directors, members of any Disciplinary Panel, members of any Disciplinary Committee, clearing members, any individual or entity with direct access to settlement or clearing activities, and any party affiliated with any of the above individuals or entities, as well as natural persons who, directly or indirectly, own greater than 10% of any one class of equity interest in Applicant; including a description or other documentation explaining how Applicant will collect and verify information that supports compliance with the fitness standards; and

c. The manner in which Applicant will condition clearing member access and other direct access to its settlement and clearing activities on agreement to be subject to the jurisdiction of Applicant.

Exhibit P—Conflicts of Interest

• Attach as Exhibit P, documents that demonstrate compliance with the conflicts of interest requirements set forth in §§ 39.13(d), 39.25, and 40.9 of the Commission's regulations, including but not limited to:

a. A copy of:

(1) The charter (or mission statement) of Applicant (if not attached as Exhibit A–8).

(2) The charter (or mission statement) of Applicant's Board of Directors, each committee with a composition requirement (including any Executive Committee), as well as each other committee that has the authority to amend or constrain actions of Applicant's Board of Directors (if not attached as Exhibit A–8).

(3) If another entity "operates" the Applicant, the charter (or mission statement) of such entity's Board of Directors (if not attached as Exhibit A–8); and a description of the manner in which the Applicant will ensure that the entity complies with § 40.9(b)(2)(ii)(B) and (C) (Officers and Directors; Books and Records).

(4) An internal organizational chart showing the lines of responsibility and accountability for each operational unit.

b. Describe or otherwise document:

(1) Applicant's rules and procedures for ensuring compliance with the requirements of § 39.25(b) (including ensuring parent compliance with § 39.25(b)(4)), including through remediation as detailed in § 39.25(b)(5);

(2) Applicant's nominations process for the Board of Directors and the process for assigning members of the Board of Directors or other persons to any committee referenced in item a.(2) above;

1. The manner in which the Board of Directors reviews its performance and the

performance of its members on an annual basis; and

2. The procedures for removing a member of the Board of Directors, including where the conduct of such member is likely to be prejudicial to the sound and prudent management of Applicant;

(3) The composition of its Nominating Committee, including the number or percentage of public directors, and the identity of the Chairman of the Committee;

(4) The composition of any Executive Committee, including the number or percentage of public directors;

(5) The composition of the Risk Management Committee, including the number or percentage of public directors, the number or percentage of customer representatives, and the identity of the Chairman of the committee;

1. Whether the Risk Management Committee is an executive committee or an advisory committee; and

2. Whether the Risk Management Committee has delegated certain functions to the Risk Management Subcommittee, including a description or other documentation of the functions so delegated;

(6) The form of report to be used in reporting to the Commission those instances in which the Board rejects a recommendation or supersedes an action of the Risk Management Committee, or the Risk Management Committee rejects a recommendation or supersedes an action of its subcommittee;

(7) The manner in which Applicant will ensure compliance with § 39.13(d)(6) (Discretion); and the manner in which Applicant will ensure compliance with § 40.9(c)(ii)(A) and (B) (Prohibition on Domination of and Recusal Procedures with respect to the Disciplinary Panel), and § 40.9(c)(iii) (Appeals), including whether the Board of Directors has delegated the functions of the Disciplinary Panel to any other committee;

(8) The manner in which Applicant will record and summarize "significant decisions," as such term is described in § 40.9(d);

(9) The manner in which Applicant will ensure that all information required under § 40.9(d) is current, accurate, clear, and readily accessible to both the Commission and the public;

(10) Any written procedures that Applicant intends to adopt to identify, on an ongoing basis, existing and potential conflicts of interest;

(11) Applicant's process for making fair and non-biased decisions in the event of a conflict of interest; and

(12) Applicant's written policies or procedures on safeguarding non-public information, and the manner in which such policies or procedures fulfill the minimum standards set forth in § 40.9(f)(2).

Exhibit Q—Composition of Governing Boards

• Attach as Exhibit Q, documents that demonstrate compliance with the composition of governing boards requirements set forth in § 39.26, including but not limited to documentation describing the composition of Applicant's Board of Directors, including the number or percentage of public directors and customer representatives.

Exhibit R—Legal Risk Considerations

• Attach as Exhibit R, documents that demonstrate compliance with the legal risk considerations requirements set forth in § 39.27 of the Commission's regulations, including but not limited to:

a. A discussion of how Applicant operates pursuant to a well-founded, transparent, and enforceable legal framework that addresses each aspect of the activities of Applicant. The framework must provide for Applicant to act as a counterparty, including, as applicable:

(1) Novation;

(2) Netting arrangements;

(3) Applicant's interest in collateral (including margin);

(4) The steps that Applicant can take to address a default of a clearing member, including but not limited to, the unimpeded ability to liquidate collateral and close out or transfer positions in a timely manner;

(5) Finality of settlement and funds transfers that are irrevocable and unconditional when effected (when Applicant's accounts are debited and credited); and

(6) Other significant aspects of Applicant's operations, risk management procedures, and related requirements.

b. If Applicant provides, or will provide, clearing services outside the United States, Applicant must (i) provide a memorandum from local counsel analyzing insolvency issues in the foreign jurisdiction where Applicant is based and (ii) describe or otherwise document:

(1) How Applicant has identified and addressed any conflict of law issues;

(2) Which jurisdiction's law is intended to apply to each aspect of Applicant's operations;

(3) The enforceability of Applicant's choice of law in relevant jurisdictions; and

(4) That its rules, procedures, and products are enforceable in all relevant jurisdictions.

Issued in Washington, DC, on December 16, 2010, by the Commission.

Sauntia S. Warfield,

Assistant Secretary of the Commission.

Appendices to Risk Management Requirements for Derivatives Clearing Organizations—Commission Voting Summary and Statements of Commissioners

Note: The following appendices will not appear in the Code of Federal Regulations.

Appendix 1—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Dunn, Sommers, Chilton and O'Malia voted in the affirmative; no Commissioner voted in the negative.

Appendix 2—Statement of Chairman Gary Gensler

I support the proposed rulemaking for risk management requirements for derivatives clearing organizations (DCOs). The proposal establishes robust risk management standards, which is particularly important as more swaps are moved into central clearinghouses. The proposed rule meets or exceeds international standards and recommendations. It establishes methodologies for clearinghouses to set margin with regard to swaps contracts.

The proposed regulations will enhance legal certainty for DCOs, clearing members and market participants by providing a regulatory framework to support DCO risk management practices. This will help strengthen the financial integrity of the futures and swap markets. The proposed participant eligibility requirements will promote fair and open access to clearing. Importantly, the proposal addresses rules of how a futures commission merchant can become a member of a swaps clearinghouse. The proposal promotes more inclusiveness while allowing the clearinghouses to scale a member's participation and risk based upon its capital.

The proposal would establish a registration application form to bring about greater uniformity and transparency in the DCO application process and facilitate greater efficiency and consistency in processing submissions.

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