Davis Polk

Why the Market Should Care About Proposed Clearing Agency Requirements

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*On March 12, the SEC issued a 400-page rule proposal that, if adopted as proposed, would impose a multitude of new compliance requirements on The Options Clearing Corporation ("**OCC**"), The Depository Trust Company ("**DTC**"), National Securities Clearing Corporation ("**NSCC**"), Fixed Income Clearing Corporation ("**FICC**") and ICE Clear Europe. Since these clearing agencies play a fundamental role in the options, stock, debt, U.S. Treasuries, mortgage-backed securities and credit default swaps markets, the proposed requirements have important implications for banks, broker-dealers and other U.S. securities market participants, as well as securities exchanges, alternative trading systems and other trading venues.*

The Proposal

The proposed rule would impose new standards on any SEC-registered clearing agency that is deemed to be a "covered clearing agency," a designation that attaches largely by virtue of systemic importance. The proposal would apply new obligations on covered clearing agencies with respect to, among other things, their: default management, financial risk-management, transparency, governance, general business risk-management, and operational risk-management. The proposal was heavily influenced by the Principles for Financial Market Infrastructures developed by CPSS-IOSCO (the "**PFMIs**"), and represents the latest step by federal regulators to bring U.S. clearinghouse requirements in line with international standards. Last November, the CFTC adopted new rules that apply heightened standards to significantly important derivatives clearing organizations ("**DCOs**") and DCOs that voluntarily opt-in to comply with such requirements for Basel capital purposes. And earlier this year, the Board of Governors of the Federal Reserve System (the "**Board**") proposed new risk-management standards for certain financial market utilities. The SEC and Board proposals and the CFTC rules are all generally consistent with the PFMIs, although differences exist.

Many of the standards that the SEC proposes would simply be enhancements to requirements that already apply to registered clearing agencies and thus would necessitate only limited modifications to covered clearing agencies' existing policies and procedures. That said, several of the proposed standards would impose entirely new requirements and may require covered clearing agencies to develop new or extensively revised policies and procedures and in some cases redesign certain compliance processes.

Among other things, the SEC proposal would impose a new capital requirement on covered clearing agencies. In particular, it would require a covered clearing agency to hold sufficient liquid net assets funded by equity to cover either six months of the clearing agency's current operating expenses or another amount that the clearing agency's board has determined would ensure a recovery or orderly wind-down of the clearing agency's critical operations and services. These assets would be in addition to those which the clearing agency would need to hold to cover participant defaults or credit and liquidity risks. A covered clearing agency would also need to maintain a board-approved plan for raising additional equity should its capital fall close to or below the required level.

The proposal would also require a covered clearing agency to develop plans for its recovery and orderly wind-down. This aspect of the proposal differs from the PFMIs, CFTC rules and the Board proposal, each of which requires only the development of a plan for recovery or orderly wind-down. Like the Board's proposal and the CFTC rules, the SEC proposal does not provide any guidance or specific requirements concerning the content or format of such plans.

In addition, the proposal would require covered clearing agencies to satisfy significant new disclosure obligations. For example, a covered clearing agency would be required to publicly disclose, among other things: a description of its general organization, legal and regulatory framework and system design and operations; a standard-by-standard summary describing how it complies with each of the new applicable standards; and a summary of material changes since the last update of such disclosure.

The proposed rules would apply to any "covered clearing agency," which would be any SEC-registered clearing agency that:

- has been designated as systemically important by FSOC, for which the SEC acts as the supervisory agency under Title VIII of Dodd-Frank;
- provides central counterparty services for security-based swaps or is otherwise engaged in activities that the SEC deems to have a complex risk profile, unless the clearing agency has been designated as systemically important by FSOC and its supervisory agency under Title VIII is the CFTC; or
- the SEC determines to be a covered clearing agency.

The first prong would capture OCC, DTC, FICC and NSCC. The second prong would capture ICE Clearing Europe, which is registered to clear security-based swaps. CME and ICE Clear Credit, both of which are SEC-registered clearing agencies authorized to clear security-based swaps, would not be covered clearing agencies under prongs one or two, since they have both been designated as systemically important by FSOC and their supervisory agency is the CFTC. Nevertheless, CME and ICE Clear Credit are required to comply with generally analogous CFTC requirements.

Key Implications for Market Participants and Trading Venues

The requirements that would apply to covered clearing agencies would have important benefits and costs for market participants and trading venues.

For example, the development and maintenance of plans for recovery and orderly wind-down would presumably contribute to a better understanding by a covered clearing agency's management of the issues that it would face in a recovery or wind-down scenario and would help management anticipate and prepare for such challenges. The proposed capital requirement is similarly intended to help facilitate the clearing agency's orderly recovery or wind-down. These requirements are intended to help reduce the impact that a disruption to the clearing agency's operations would have on clearing participants and the stability of the financial markets generally. It is notable, however, that the SEC has not proposed guidance concerning the content or form of such plans.

The enhanced public information requirements, together with existing provisions that require clearing agencies to publicize key information including their rule changes, would provide regulators, market observers and the marketplace generally with a trove of information that could be used to gain a better understanding of the clearing agency's services and the risks associated with its use. That said, because many of the covered clearing agencies are the sole providers of their particular services, the practical value of this additional information is questionable, as market participants generally have no other choice but to use these entities.

The new SEC requirements would result in new costs. Although many of the clearing agencies have already taken steps to satisfy many of the proposed standards, there will still be significant new compliance costs, which likely will be passed on in the form of higher clearing fees. The SEC has provided preliminary estimates of the costs of the proposed requirements, some of which may be unrealistically low. For instance, the proposal would require a covered clearing agency to review and potentially make enhancements to its risk-management framework, including the development of recovery and wind-down plans. The SEC estimates that it would take each clearing agency only 57 total initial man hours to comply with this requirement.

Conclusion

While the SEC will likely adopt many aspects of its proposal in order to meet widely accepted international standards, commenters may be able to influence the degree to which the SEC refines or clarifies certain aspects of the rules. Also, more generally, market participants and trading venues will benefit by continuing to closely monitor this evolving regulatory area.

If you have any questions regarding the matters covered in this publication, please contact either of the lawyers listed below or your regular Davis Polk contact.

Annette L. Nazareth	**202 962 7075**	**annette.nazareth@davispolk.com**
Jeffrey T. Dinwoodie	**202 962 7132**	**jeffrey.dinwoodie@davispolk.com**