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SEC Adopts Clearing Agency Standards

SEC Adopts Rule Establishing Minimum Requirements for Registered Central Counterparties and Central Security Depositories

SUMMARY

The Securities and Exchange Commission has adopted, substantially as proposed, Rule 17Ad-22 under the Securities Exchange Act. The new Rule, which only applies to registered clearing agencies, requires:

- Registered clearing agencies performing central clearing party services to:
 - establish, implement, maintain and enforce written policies and procedures reasonably designed to meet certain risk management and operational standards, and prohibit the use of certain criteria for membership eligibility; and
 - calculate and maintain a record of the financial resources necessary to withstand certain participant defaults on at least a quarterly basis.
- All registered clearing agencies to:
 - post annual audited financial statements on their websites; and
 - establish, implement, maintain and enforce written policies and procedures reasonably designed to meet certain objectives including imposing certain risk management requirements on participants, holding assets in a manner that minimizes risk of loss and delay of access to them in the event of default and publicly disclosing key aspects of default procedures.

Rule 17Ad-22 will become effective on January 2, 2013.

BACKGROUND AND IMPLEMENTATION SCHEDULE

On October 22, 2012, the SEC adopted Rule 17Ad-22 under the Securities Exchange Act of 1934 (the “Exchange Act”) pursuant to Sections 763 and 805 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), among other statutory provisions. Standards under the Rule will be applicable to registered clearing agencies offering central counterparty (“CCP”) services

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and/or central security depository (“CSD”) services,¹ imposing heightened requirements on those registered clearing agencies serving as CCPs to security-based swaps. The Rule does not apply to clearing agencies engaged in solely post-trade processing services or other clearing agencies exempt or conditionally and temporarily exempt from registration.² With respect to the registered clearing agencies to which the Rule applies, the Rule supplements tools for SEC oversight, including through the rule filing process for self-regulatory organizations (“SROs”) under Section 19b-4 and on-site examinations by SEC staff.

Rule 17Ad-22 represents the first step towards the implementation of regulatory changes affecting clearing agencies contemplated by Title VII and Title VIII of the Dodd-Frank Act. A number of rules governing clearing agencies that were proposed alongside Rule 17Ad-22 remain to be finalized:

- Proposed Rule 17Aj-1, which would require dissemination of pricing and valuation information by security-based swap CCPs;
- Proposed Rule 17Ad-23, which would require all clearing agencies to have adequate safeguards and procedures to protect the confidentiality of trading information of clearing agency participants;
- Proposed Rule 17Ad-24, which would exempt certain security-based swap-dealers and security-based swap execution facilities from the definition of clearing agency;
- Proposed Rule 17Ab2-1, which would amend an existing SEC rule concerning registration of clearing agencies to account for security-based swap clearing agencies;
- Proposed Rule 17Ad-25, which would require all clearing agencies to have procedures to identify and address conflicts of interest;
- Proposed Rule 17Ad-26, which would require clearing agencies to set standards for all members of their boards of directors or committees; and
- Proposed Rule 3Cj-1, which is modeled on Section 3C(j) of the Exchange Act and would require all clearing agencies to designate a chief compliance officer.

The SEC’s release adopting Rule 17Ad-22 (the “Adopting Release”) sets forth an implementation schedule, explaining that adoption of Rule 17Ad-22 is a “first stage”, to be followed by a “second stage” in which the SEC will consider Rules 17Aj-1, 17Ad-23, 17Ad-24, 17Ab2-1, 3Cj-1, 17Ad-25, 17Ad-26 and

¹ Today, there are only seven registered clearing agencies. The Depository Trust Company (“DTC”) is currently the only registered clearing agency that provides CSD services. Six entities are registered clearing agencies that provide CCP services: Fixed Income Clearing Corporation (“FICC”), National Securities Clearing Corporation (“NSCC”); The Options Clearing Corporation (“OCC”); CME Group (“CME”); ICE Clear Credit; and ICE Clear Europe.

² See, e.g., “Order Pursuant to Section 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions from Clearing Agency Registration Requirements under Section 17A(b) of the Exchange Act for Entities Providing Certain Clearing Services for Security-Based Swaps”, Exchange Act Release No. 34-64796 (July 1, 2011), 76 FR 39963 (July 7, 2011), available at <http://www.sec.gov/rules/exorders/2011/34-64796.pdf>.

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Regulation MC.³ In a “third stage”, the Commission will consider rules tailored to clearing agencies performing certain post-trade processing services.

DEFINITIONS

Rule 17Ad-22 uses five defined terms:

- “Central counterparty” is defined as a clearing agency interposing itself between the counterparties to securities transactions, acting functionally as the buyer to every seller and the seller to every buyer.
- “Central securities depository services” is defined as services of a clearing agency that is a securities depository as described in Section 3(a)(23) of the Exchange Act.⁴
- “Participant family” includes any participant that directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with, another participant. For evaluating whether an entity is part of a participant family, the Adopting Release endorses the definition of “control” set forth in Rule 405 under the Securities Act of 1933 (the “Securities Act”).
- “Normal market conditions” is defined as “conditions in which the expected movement of the price of cleared securities would produce changes in a clearing agency’s exposures to its participants that would be expected to breach margin requirements or other risk control mechanisms only one percent of the time.”⁵
- “Net capital” is defined by reference to Rule 15c3-1 for broker-dealers and any similar risk adjusted capital calculation for all other prospective clearing members.

RISK MANAGEMENT REQUIREMENTS FOR CENTRAL COUNTERPARTIES

The Rule establishes standards relating to four areas of risk management practices by registered clearing agencies that perform CCP services (“registered CCPs”):

- measurement and management of credit exposures,
- margin requirements,
- annual evaluations of the performance of the registered CCP’s margin models, and
- financial resources.

³ For a discussion of proposed Regulation MC, see our Memorandum to Clients, dated October 20, 2010, entitled “Implementation of Title VII of Dodd-Frank”.

⁴ The definition of “clearing agency” in Section 3(a)(23)(A) of the Exchange Act includes “any person, such as a securities depository, who . . . acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates”. As indicated in footnote 1, DTC is currently the only registered clearing agency that provides CSD services.

⁵ The Adopting Release notes that the definition of “normal market conditions” comports with the international standard for bank capital requirements established by the Bank of International Settlements, which requires banks to measure market risks at a 99% confidence interval when determining regulatory capital requirements.

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Registered CCPs must establish, implement, maintain and enforce written policies and procedures reasonably designed to meet each of the standards in these four areas.

The first risk management standard requires each registered CCP to measure its credit exposures to its participants at least once a day and limit its exposures to potential losses from defaults by its participants under normal market conditions so that the operations of the clearing agency would not be disrupted and non-defaulting participants would not be exposed to losses they cannot anticipate or control. The SEC in the Adopting Release notes that:

- registered CCPs should measure credit exposures on an intraday basis depending on the individual risk characteristics of their members and businesses; and
- although the SEC agrees with commenters that expressed the view that a registered CCP should provide reductions in initial margin requirements based on offsetting or inversely correlated positions only if the registered CCP can demonstrate a robust correlation, the Rule was not modified in response to these comments, as the SEC believes that the determination of whether positions are sufficiently correlated to permit offset should be determined by the registered CCP as it implements its risk management procedures and submits them to the SEC for review and public comment as part of the SRO rule filing process.

The second risk management standard requires each registered CCP to use margin requirements to limit its credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin requirements and review such margin requirements and the related risk-based models and parameters at least monthly. In the Adopting Release, the Commission states that while some assumptions that underlie model parameters may be widely accepted by current convention, and those components therefore may be less likely to become outdated from month to month, registered CCPs will need to exercise discretion in how they administer their review of those components in light of constantly changing market conditions and risks. Notably, the SEC did not prescribe a particular confidence level for initial margin, stressing that each registered CCP will make that determination as part of its development of its margin parameters and risk-based models.

The third risk management standard requires each registered CCP to provide for an annual model validation consisting of evaluating the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who is free from influence from the persons responsible for the development or operation of the models being validated. Unlike the original proposal, the Rule does not prohibit a person who performs functions associated with the margin model or who is supervised by a person responsible for the margin model from performing the annual model valuation as long as he or she is free from the prohibited influence and can be candid in his or her assessment of the model. Significantly, the finalized standard does not require model valuation to be performed by an outside independent expert, model review to be separate from model development, the maintenance of two separate quantitative teams or specific qualifications or credentials for the persons performing the model validation.

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The fourth risk management standard requires each registered CCP to maintain sufficient financial resources to withstand, at a minimum, a default by the participant family⁶ to which it has the largest exposure in extreme but plausible market conditions, or in the case of a registered CCP for security-based swaps, the two participant families to which it has the largest exposures. According to the SEC, the “cover two” standard for security-based swap CCPs reflects the more complex risk profile of security-based swaps and, in particular, credit default swaps, which the SEC notes represent the vast majority of security-based swap transactions.

The Adopting Release clarifies the meaning of the phrase “extreme but plausible market conditions”, explaining that the phrase refers to “tail event conditions in which the price movement of a cleared security results in losses exceeding expectations at a 99% confidence interval, causing a clearing agency’s exposures to its participants to breach margin requirements or other risk controls.”⁷ As an example, the Adopting Release says “extreme but plausible market conditions” may include or exceed the worst historical price movement for a particular financial instrument over a specified time horizon. However, the SEC indicates in the Adopting Release that it agrees with commenters that industry professionals, not limited to clearing agency personnel, are likely to be in a position to contributing to a well-informed standard of “extreme but plausible market conditions”. To reflect this market understanding and to ensure consistency across registered CCPs, the SEC expects to review and publish for public comment rule proposals from clearing agencies that adopt definitions of “extreme but plausible market conditions” appropriate for the relevant markets.

PARTICIPANT ACCESS STANDARDS

The Rule establishes three standards governing access to clearing agency membership. The registered CCP must establish, implement, maintain and enforce written policies and procedures reasonably designed to:

- provide the opportunity for a person who does not perform any dealer or security-based swap dealer services to obtain membership at the clearing agency to clear securities for itself or on behalf of other persons,
- refrain from using minimum portfolio size and minimum volume transaction thresholds as conditions for membership, and
- provide the ability to obtain membership to persons who maintain net capital greater or equal to \$50 million.

The first standard governing member access requires a registered CCP to provide the opportunity for a person that does not perform any dealer or security-based swap dealer services to obtain membership on

⁶ This is one of only two provisions of Rule 17Ad-22 in which the “participant family” concept is used.

⁷ Clearing Agency Standards, 77 Fed. Reg. 66,220, 66,236 (November 2, 2012).

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fair and reasonable terms at the clearing agency to clear securities for itself or on behalf of other persons.⁸ The SEC believes that this requirement will promote competition on price and service as well as the practice of correspondent clearing by members without proprietary positions. According to the Adopting Release, the restriction applies where the clearing agency's sole reason for denying membership to a prospective participant would be the prospective participant's status as a non-dealer or non-security-based swap dealer, but the registered CCP may impose other standards of membership, such as requiring members to maintain financial resources, creditworthiness and operational capacity.

The second standard requires a registered CCP to have membership standards that do not require that participants maintain a portfolio of any minimum size or a minimum transaction volume. This standard does not prohibit a CCP from considering portfolio size and transaction volume as one of several factors when reviewing a potential participant's operations; rather, the rule prohibits the establishment of minimum portfolio sizes or transaction volumes that by themselves would act as barriers to participation by new participants.

The third standard generally limits net capital requirements that may be imposed by a registered CCP on its members. A registered CCP may not require a participant to maintain net capital equal to or greater than \$50 million, so long as such participant is able to comply with other reasonable membership standards. Any net capital requirements should be scalable so that they are proportional to the risks posed by the participant's activities to the clearing agency. A higher net capital requirement as a condition for membership would be permitted only if the registered CCP demonstrates to the SEC that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures, and the SEC approves the higher net capital requirement as part of an SRO rule filing or clearing agency registration application. The Adopting Release makes clear that registered CCPs retain flexibility to develop scalable policies and procedures to limit the activities of participants based on their level of net capital. For example, the Adopting Release provides that a registered CCP may place limits on potential exposure by participants operating at certain net capital levels by restricting the maximum size of the portfolio such participant may maintain at the CCP and may utilize tiered membership standards involving capital-related criteria to differentiate between types of participants.⁹

⁸ The Rule imposes the three open access standards in the form of requirements to establish, implement, maintain and enforce written policies and procedures reasonably designed to meet these standards rather than directly requiring these standards to be met.

⁹ The Adopting Release expressly acknowledges that capital-related tiers used by FICC remain permissible under this standard.

RECORDS OF FINANCIAL RESOURCES AND ANNUAL AUDITED FINANCIAL STATEMENTS

The Rule requires each registered clearing agency to prepare and disclose certain annual financial information. Within 60 days after the end of its fiscal year, each clearing agency is required to post on its website its audited financial statements, which must:

- include, for the clearing agency and its subsidiaries, consolidated balance sheets as of the end of the two most recent fiscal years and statements of income, changes in stockholders' equity and other comprehensive income and cash flows for each of the two most recent fiscal years;
- be prepared in accordance with U.S. generally accepted accounting principles (except that, for a clearing agency organized under non-U.S. law, the consolidated financial statements may be prepared in accordance with Internal Financial Reporting Standards as issued by the International Accounting Standards Board instead);
- be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with SEC rules applicable to public companies; and
- include a report of the registered public accounting firm that complies with SEC standards applicable to public companies.

In addition, each fiscal quarter (based on calculations made as of the last business day of that fiscal quarter), a registered CCP must calculate and maintain a record of the financial resources necessary to meet requirements of the Rule requiring maintenance of sufficient financial resources to withstand a default by the largest participant family (or in the case of CCPs clearing security-based swaps, the two largest participant families) and sufficient documentation to explain the methodology it uses to compute such financial resource requirements. This calculation and record would also have to be produced at any time if requested by the SEC.

MINIMUM STANDARDS FOR REGISTERED CLEARING AGENCIES

The Rule requires each registered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:

- (1) Provide for a well-founded, transparent and enforceable legal framework for each aspect of its activities in all relevant jurisdictions.
- (2) Require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency; have procedures in place to monitor that participation requirements are met on an ongoing basis; and have participation requirements that are objective and publicly disclosed, and permit fair and open access. The SEC rejected a proposal to prohibit participants from using credit facilities to meet financial resource requirements. Instead, the SEC indicated that it expects each registered clearing agency to establish rules, policies and procedures that properly reflect the extent to which credit facility arrangements are appropriate for participants at the particular clearing agency based on the particular clearance and settlement services it provides.
- (3) Hold assets in a manner that minimizes risk of loss or of delay in its access to them; and invest assets in instruments with minimal credit, market and liquidity risks.

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- (4) Identify sources of operational risk and minimize them through the development of appropriate systems, controls and procedures; implement systems that are reliable, resilient and secure, and have adequate, scalable capacity; and have business continuity plans that allow for timely recovery of operations and fulfillment of a clearing agency's obligations. In the Adopting Release, the SEC explained that, in order to determine "appropriate" systems, controls and procedures, a registered clearing agency may consider the relevant trade-offs between cost and risk reduction and need not eliminate all operational risk.
- (5) Employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants; and require funds transfers to the clearing agency to be final when effected.
- (6) Be cost-effective in meeting the requirements of participants while maintaining safe and secure operations.
- (7) Evaluate the potential sources of risks that can arise when the clearing agency establishes links either cross-border or domestically to clear or settle trades, and ensure that the risks are managed prudently on an ongoing basis.
- (8) Have governance arrangements that are clear and transparent to fulfill the public interest, support the objectives of owners and participants, and promote the effectiveness of the clearing agency's risk management procedures.¹⁰
- (9) Provide market participants with sufficient information for them to identify and evaluate the risks and costs associated with using its services. In particular, the SEC noted "disclosure of the clearing agency rulebook, the costs of its services, a description of netting and settlement activities it provides, participants' rights and obligations, information regarding its margin methodology, and information regarding the extreme but plausible scenarios that the clearing agency uses to stress tests its margin requirements are among the categories of information that participants could use to identify and evaluate risks and costs associated with use of the clearing agency."¹¹
- (10) Immobilize¹² or dematerialize¹³ securities certificates and transfer them by book entry to the greatest extent possible when the clearing agency provides CSD services.
- (11) In order to increase the possibility that defaults by participants will proceed in an orderly and transparent manner and place a clearing agency in a better position to continue providing its services in a manner that promotes accurate clearance and settlement during times of market stress, make key aspects of the clearing agency's default procedures publicly available and establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default.
- (12) Ensure that final settlement occurs no later than the end of the settlement day; and require that intraday or real-time finality be provided where necessary to reduce risks.¹⁴

¹⁰ The SEC indicated that it is continuing to review the appropriateness of more prescriptive corporate governance and conflicts of interest standards in connection with Proposed Rules 17Ad-25, 17Ad-26 and Regulation MC. See our Memorandum to Clients, dated October 20, 2010, entitled "Implementation of Title VII of Dodd-Frank" (October 20, 2010).

¹¹ Clearing Agency Standards, 77 Fed. Reg. 66,220, 66,253 (November 2, 2012).

¹² Immobilization refers to any circumstance where an investor does not receive a physical certificate upon the purchase of securities or is not required to physically deliver a certificate upon the sale of securities.

¹³ Dematerialization is the process of eliminating physical certificates as a record of security ownership.

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- (13) Eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment (“DVP”). A settlement process achieves DVP when the mechanism facilitating settlement ensures that delivery occurs if and only if payment occurs.
- (14) Institute risk controls, including collateral requirements and limits to cover the clearing agency’s credit exposure to each participant family exposure fully, ensuring timely settlement in the event that the participant with the largest payment obligation is unable to settle when the clearing agency provides CSD services and extends intraday credit to participants.
- (15) State to its participants the clearing agency’s obligations with respect to physical deliveries and identify and manage the risks from these obligations.

The SEC indicated that registered clearing agencies are expected to update their rules and procedures to meet the minimum standards set forth in the Rule as market conditions evolve. The SEC further indicated that it intends to observe clearing agency practices as they develop and may modify the rules, adopt additional rules as appropriate or issue further guidance.

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(...footnote continued)

¹⁴ The SEC noted that the Rule does not require clearing agencies to implement intraday settlement at this time, but stated that it plans to study the issue further.

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