



## U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre  
1155 21st Street, NW, Washington, DC 20581  
Telephone: (202) 418-5430  
Facsimile: (202) 418-5547  
*pdietz@cftc.gov*

Division of  
Clearing and Risk

Phyllis Dietz  
Acting Director

CFTC Memorandum No. 15-50  
Interpretation  
Division of Clearing and Risk

### MEMORANDUM

TO: All Registered Derivatives Clearing Organizations

FROM: Phyllis Dietz

DATE: September 18, 2015

SUBJECT: Staff Interpretation Regarding Consistency between Part 39 and  
The Principles for Financial Market Infrastructures

---

#### **I. Introduction**

On December 2, 2013, the Commodity Futures Trading Commission (the “Commission” or “CFTC”) published final rules to establish additional standards for compliance with the derivatives clearing organization (“DCO”) core principles set forth in the Commodity Exchange Act (the “Act”) for systemically important DCOs (“SIDCOs”) and DCOs that elect to opt-in to the SIDCO regulatory requirements (“Subpart C DCOs”).<sup>1</sup> These additional requirements, as set forth in subpart C of Part 39 of the CFTC regulations,<sup>2</sup> are intended to harmonize CFTC regulations with the Principles for Financial Market Infrastructures (“PFMIs”).<sup>3</sup>

On February 26, 2015, the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions published the Level 2 assessment reports on the implementation of the PFMIs for central counterparties (CCPs) and trade repositories located in the European Union, Japan and the United States, respectively. The Level 2 report for

---

<sup>1</sup> See Derivatives Clearing Organizations and International Standards, 78 Fed. Reg. 72,476 (Dec. 2, 2013).

<sup>2</sup> 17 C.F.R. Part 39, subpart C.

<sup>3</sup> See Bank for International Settlements’ Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions, Principles for Financial Market Infrastructures, (April 2012) available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD377.pdf>.

The Committee on Payment and Settlement Systems changed its name to the Committee on Payments and Market Infrastructures on September 1, 2014.

the United States interpreted the CFTC SIDCO regime as completely and consistently implementing the majority of the Principles, and recommended that the CFTC provide clarity on the intended interpretation of certain Part 39 regulations in regards to their consistency with the PFMIIs.

The CFTC Division of Clearing and Risk (the “Division”) interprets Part 39 (subparts A, B and C) to incorporate all of the standards set forth in the PFMIIs and, indeed, to be fully consistent with the PFMIIs.<sup>4</sup> This position is supported by CFTC Regulation 39.40, which states that “[t]his subpart C is intended to establish standards which, together with subparts A and B of this part [Part 39 of CFTC regulations], are consistent with Section 5b(c) of the Act and the Principles for Financial Market Infrastructures... and should be interpreted in that context.”<sup>5</sup>

To the extent any uncertainty or ambiguity remains, the Division is issuing this interpretation to publicly clarify that certain Part 39 regulations, through the application of CFTC Regulation 39.40, encompass the standards set forth in the PFMIIs and require compliance by SIDCOs and Subpart C DCOs.

## **II. Division Staff Interpretation**

### **A. Risk Management**

CFTC Regulation 39.13, which applies to all DCOs, requires a comprehensive and integrated examination of all risks a DCO faces in its day-to-day operations. Specifically:

- CFTC Regulation 39.13(a) requires a DCO to ensure it has the requisite “ability to manage the risks associated with discharging the responsibilities of the DCO through the use of appropriate tools and procedures.”<sup>6</sup>
- CFTC Regulation 39.13(b) requires that a DCO “...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...”<sup>7</sup>
- CFTC Regulation 39.13(f) requires that a DCO utilize “risk control mechanisms [to] limit its exposure to potential losses from defaults by clearing members...”<sup>8</sup>

#### **(1) Risks Associated with Exchange-of-Value Settlement Services**

Principle 12 of the PFMIIs requires that “[i]f an FMI settles transactions that involve the settlement of two linked obligations (for example, securities or foreign exchange transactions), it

---

<sup>4</sup> See 17 C.F.R. § 39.1-39.42 (subparts A, B and C). The Commission notes that in order to register and maintain registration status with the Commission, all DCOs must comply with subparts A and B of Part 39 while only SIDCOs and Subpart C DCOs are required to comply with subpart C of Part 39.

<sup>5</sup> 17 C.F.R. § 39.40.

<sup>6</sup> 17 C.F.R. § 39.13(a).

<sup>7</sup> 17 C.F.R. § 39.13(b).

<sup>8</sup> 17 C.F.R. § 39.13(f).

should eliminate principal risk by conditioning the final settlement of one obligation upon the final settlement of the other.”<sup>9</sup>

If a SIDCO or Subpart C DCO performs exchange-of-value settlement services, then CFTC Regulation 39.13 requires the DCO to manage the risks associated with the performance of these services. This includes the DCO limiting its exposure to potential losses from defaults by ensuring that settlement of one obligation occurs if and only if the final settlement of the linked obligation also occurs, regardless of whether the SIDCO or Subpart C DCO settles on a gross or net basis and regardless of when finality occurs.<sup>10</sup> In this context, the appropriate risk control mechanisms include the use of a settlement system that ensures the final settlement of one obligation occurs if and only if the final settlement of the linked obligation also occurs.

Thus, in accordance with CFTC Regulation 39.40, the Division interprets CFTC Regulation 39.13 to require that a SIDCO or Subpart C DCO manage the risks arising from exchange-of-value settlement services consistent with Principle 12 of the PFMI.

## (2) Risks Associated with DCO Link Arrangements

Principle 20 of the PFMI requires that “[a]n FMI that establishes a link with one or more FMIs should identify, monitor, and manage link-related risks.”<sup>11</sup>

If a SIDCO or Subpart C DCO engages in link arrangements with other FMIs, including central counterparties (“CCPs”), central securities depositories, or trade repositories, then CFTC Regulations 39.13, in conjunction with CFTC Regulation 39.40, requires the DCO to manage the risks that derive from these link arrangements by:

- identifying, monitoring and managing all potential sources of risk arising from the link arrangement both before entering into the link arrangement and on an ongoing basis once the link is established. The link arrangement should be designed such that all FMIs involved in the link are able to observe the PFMI;
- ensuring that the link has a well-founded legal basis in all relevant jurisdictions that supports its design and protects all FMIs involved in the link;
- ensuring that prior to entering into a link with another CCP, the SIDCO or Subpart C DCO identifies and manages the potential spill-over effects from the default of the linked CCP; and
- ensuring that, in the context of a link arrangement with another CCP, the SIDCO or Subpart C DCO is able to cover, at least on a daily basis, its current

---

<sup>9</sup> See Principle 12 of the PFMI.

<sup>10</sup> For example, the settlement of foreign exchange currencies requires the exchange of principal in two currencies which gives rise to a risk that one party will pay for the currency it sold but will not receive the currency it bought. A SIDCO or Subpart C DCO that clears foreign exchange contracts typically uses the services of CLS, a payment versus payment settlement service, to manage this type of settlement risk. Accordingly, a SIDCO or Subpart C DCO that uses CLS services may already be managing the risks associated with exchange-of-value services consistent with Principle 12.

<sup>11</sup> See Principle 20 of the PFMI.

and potential future exposures to the linked CCP and its participants, if any, fully with a high degree of confidence without reducing the SIDCO or Subpart C DCO's ability to fulfill its obligations to its own participants at any time.

Thus, in accordance with CFTC Regulation 39.40, the Division interprets CFTC Regulation 39.13 to require a SIDCO or Subpart C DCO to manage the risks arising from link arrangements with all types of FMIs consistent with Principle 20 of the PFMI.

#### B. Protection of Customer and Clearing Member Assets and Funds

CFTC Regulation 39.15, which applies to all DCOs, requires a DCO to protect the assets and funds of market participants by establishing standards and procedures to protect and ensure the safety of these assets and funds and to hold them in a manner to minimize the risk of loss. Specifically:

- CFTC Regulation 39.15(a) requires 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.”<sup>12</sup>
- CFTC Regulation 39.15(c) requires a DCO to “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 [DCO] to such funds and assets.”<sup>13</sup>

Additionally, CFTC Regulation 39.21(a), which also applies to all DCOs, requires a DCO to provide to market participants sufficient information to enable them to identify and evaluate accurately the risks and costs associated with using the services of the DCO.<sup>14</sup>

##### (1) Central Bank Services

Principle 7 of the PFMI requires, in relevant part, that “[a]n FMI should effectively measure, monitor, and manage its liquidity risk.”<sup>15</sup>

One of the most effective ways for a DCO to manage liquidity risk is to use central bank services. Thus, to the extent a SIDCO or Subpart C DCO has the opportunity to access central bank services, CFTC Regulation 39.15 requires the DCO do so when practicable.<sup>16</sup>

Thus, in accordance with CFTC Regulation 39.40, the Division interprets CFTC Regulation 39.15 to require a SIDCO or Subpart C DCO that has the ability to use central bank accounts, payment services, or custodial services, to do so consistent with Principle 7 of the PFMI.

---

<sup>12</sup> 17 C.F.R. § 39.15(a).

<sup>13</sup> 17 C.F.R. § 39.15(c).

<sup>14</sup> 17 C.F.R. § 39.21(a).

<sup>15</sup> See Principle 7 of the PFMI.

<sup>16</sup> In the United States, only SIDCOs may be authorized to establish accounts at the Federal Reserve Banks. In other jurisdictions, CCPs may be permitted or required to hold accounts at the jurisdiction's central bank.

## (2) Due Diligence on Custodian Banks

Principle 16 of the PFMI requires that “[a]n FMI should safeguard its own and its participants’ assets and minimise the risk of loss on and delay in access to these assets. An FMI’s investments should be in instruments with minimal credit, market, and liquidity risks.”<sup>17</sup>

When a SIDCO or Subpart C DCO conducts due diligence on its custodian banks, then CFTC Regulation 39.15 requires the DCO to evaluate and understand its exposures to each of its custodian banks and take into account the full scope of its relationships with each custodian. In addition, under CFTC Regulation 39.15, a SIDCO or a Subpart C DCO should ensure that its investment strategy is consistent with its overall risk management framework.

Further, CFTC Regulation 39.21 requires a SIDCO or Subpart C DCO to fully disclose its investment strategy to all market participants, including clearing members and their customers.

Thus, in accordance with CFTC Regulation 39.40, the Division interprets CFTC Regulations 39.15 and 39.21 to require a SIDCO or Subpart C DCO to (1) consider the full scope of its relationship with each custodian bank when evaluating its exposures; (2) ensure its investment strategy is consistent with its overall risk management framework; and (3) disclose its strategy to market participants all in a manner consistent with Principle 16 of the PFMI.

### **III. Conclusion**

This Staff Interpretation is intended to assist in the understanding and application of CFTC Part 39 regulations. This letter represents the position of the Division only and does not necessarily represent the views of the Commission or the views of any other division or office of the Commission.

Should you have any questions regarding this matter, please contact Robert Wasserman, Chief Counsel ([rwasserman@cftc.gov](mailto:rwasserman@cftc.gov), 202-418-5092) or Tracey Wingate, Special Counsel ([twingate@cftc.gov](mailto:twingate@cftc.gov), 202-418-5319).

---

<sup>17</sup> See Principle 16 of the PFMI.