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Division of Clearing and Risk

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CFTC Letter No. 16-26
No-Action
March 16, 2016
Division of Clearing and Risk

Re: No-Action Relief for EU-Based Registered Derivatives Clearing Organizations that are Authorized to Operate in the European Union, from Certain Requirements under Part 22 and Part 39 of Commission Regulations

Ladies and Gentlemen:

The Division of Clearing and Risk ("Division") of the Commodity Futures Trading Commission (the "Commission" or "CFTC") is issuing this letter to provide limited no-action relief from the following Commission requirements, on the terms and subject to the conditions below, for EU-based central counterparties ("CCPs") that are registered with the Commission as derivatives clearing organizations ("DCOs") (such EU-based CCPs referred to hereinafter as "DCO/CCPs") and are authorized to operate in the European Union ("EU"):

(1) CFTC Regulation 39.12(b)(6)'s requirement that, upon a DCO's acceptance of a swap for clearing, the original swap is extinguished and it is replaced by an equal and opposite swap between the DCO and each clearing member (acting as a principal for a house trade or an agent for a customer trade) will not apply in the context of a DCO/CCP where neither party is a U.S. clearing member or a futures commission merchant ("FCM") clearing member;

(2) Part 22 of CFTC Regulations and its "legally segregated but operationally commingled" ("LSOC") account model for cleared swaps customer accounts will not apply in the context of a DCO/CCP to clearing members that are not FCMs;

(3) CFTC Regulation 39.13(g)(8)(i)'s requirement that a DCO calculate and collect initial margin for customer accounts cleared by an FCM on a gross basis will not apply in the context of a DCO/CCP to non-FCM clearing member intermediaries;

(4) CFTC Regulation 39.13(g)(8)(ii)'s requirement that a DCO collect initial margin at a level that is greater than 100% of the DCO's initial margin requirements for the non-hedge positions of FCM customers will not apply in the context of a DCO/CCP to such positions of the customers of non-FCM clearing member intermediaries;

(5) CFTC Regulation 39.12(a)(2)(iii)'s prohibition that a DCO not set a minimum capital requirement of more than $50 million for any person that seeks to become a clearing member to clear swaps will not apply in the context of a DCO/CCP to non-U.S. clearing members or non-FCM clearing members;

(6) CFTC Regulation 39.12(b)(7)'s requirement that DCOs utilize "straight-through-processing" of swaps submitted for clearing will not apply to trades that are not executed on or subject to the rules of a designated contract market ("DCM") or a swap execution facility ("SEF") and for which neither clearing member is an FCM, a swap dealer, or a major swap participant;

(7) Regulation 39.13(h)(5)'s requirement that DCOs must require their clearing members to maintain written risk management policies and procedures and that DCOs must have the authority to obtain information and documents from clearing members regarding their risk will still apply; however, DCO/CCPs may implement different oversight programs for U.S./FCM clearing members and non-U.S. clearing members; and

(8) Regulation 39.11(f)'s and Regulation 39.19(c)(3)(ii)'s implicit requirements that DCOs submit to the CFTC quarterly financial resource reports and an audited year-end financial statement that are prepared in accordance with U.S. Generally Accepted Accounting Principles ("GAAP") will not apply in the context of a DCO/CCP; rather, the DCO/CCPs may submit financial statements prepared in accordance with International Financial Reporting Standards ("IFRS"), with periodic reconciliation to assist staff in reviewing the financial statements.

This no-action letter is being issued simultaneously with Federal Register Notice __ ("the Notice"), pursuant to which the Commission makes a comparability determination regarding the European Market Infrastructure Regulation ("EMIR").[1] In particular, the Notice concludes that certain laws and regulations applicable in the EU provide a sufficient basis for an affirmative finding of comparability with respect to certain regulatory obligations applicable to DCOs that are registered with the Commission and are authorized to operate as CCPs in the EU. Under the Notice, EU-based DCOs that are registered with the Commission and that are authorized to operate as CCPs in the EU may demonstrate compliance with certain Commission requirements for financial resources, risk management, settlement procedures, and default rules and procedures (as set forth in the Notice) by complying with the terms of corresponding requirements under the EMIR Framework, as defined in the Notice.

Background

The Commodity Exchange Act ("CEA") does not impose geographic limitations on the registration of DCOs. Nor does it mandate that clearing of futures traded on U.S. exchanges must take place in the United States.[2] To the contrary, it permits futures traded on exchanges in the United States to be cleared outside the United States. However, the CEA and CFTC regulations require that foreign-based CCPs that wish to clear such futures be registered with the Commission and comply with CFTC regulations.[3]

Under this regulatory framework, a number of foreign-based CCPs have been registered with the Commission for some time. LCH.Clearnet Ltd., which is based in London, for example, has been registered with the Commission since 2001, and thus has been subject to dual supervision by UK

[1] *See* Regulation (EU) No 648/2012 of the European Parliament and the Council on OTC derivatives, central counterparties and trade repositories of 4 July 2012 ("EMIR"), Art. 25(6).

[2] 7 USC § 7a-1(a).

[3] See generally 7 USC §§ 7(d)(9)(iii) and (11); 17 CFR 38.601.

authorities and the Commission since long before the EU adopted its current regulatory scheme – EMIR. This dual registration system has been a foundation on which the cleared swaps market grew to be a global market. In addition to LCH.Clearnet Ltd., there are currently five other registered foreign-based DCOs that are subject to the dual registration of the Commission and their home country regulator(s): Singapore Exchange Derivatives Clearing Limited (home country regulator is the Monetary Authority of Singapore), LCH.Clearnet SA (home country regulators are the Autorité de contrôle prudentiel et résolution, the Autorité des marchés financiers, and the Banque de France), ICE Clear Europe Ltd. (home country regulator is the Bank of England), Natural Gas Exchange (home country regulator is the Alberta Securities Commission) and Eurex Clearing AG (home country regulators are Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) and Deutsche Bundesbank). Two additional foreign-based CCPs have applications pending before the Commission for registration as DCOs (CME Clearing Europe Ltd. and Japan Securities Clearing Corporation).

Following the financial crisis of 2008, the United States and the EU undertook efforts to regulate over-the-counter ("OTC") derivatives markets and market participants. For swaps, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[4] amended the CEA to, among other things, establish a comprehensive statutory framework for the execution and clearing of swaps. Section 5b(a) of the CEA, as amended by the Dodd-Frank Act, establishes a comprehensive regulatory framework for clearing organizations that clear swaps, including (i) registration, operation, and compliance requirements for DCOs; and (ii) 17 core principles.[5] Applicants and registered DCOs are required to comply with the core principles as a condition of obtaining and maintaining their registration as a DCO. Thus, the registration of foreign-based CCPs clearing U.S. markets or serving U.S. persons is an important part of the Commission's regulatory scheme. Nevertheless, for the reasons discussed below in this letter, the Division has determined to provide limited and enumerated relief from the application of certain of the Commission regulations to discrete aspects of a DCO/CCP's non-U.S. clearing activities.

The European Parliament and the European Council passed EMIR on July 4, 2012, which entered into force on August 16, 2012. EMIR sets out standards regarding the registration and operation of CCPs and trade repositories; the clearing and regulatory reporting of OTC transactions; and risk mitigation techniques relating to uncleared OTC transactions. Pursuant to authority granted under EMIR, the European Securities and Markets Authority ("ESMA") developed technical standards that were adopted by the European Commission on December 19, 2012, published in the Official Journal on February 23, 2013 and generally entered into force on March 15, 2013.

Discussion of Limited No-Action Relief

The Division acknowledges that clearing organizations operate in different jurisdictions and under different regulatory regimes and that the differences between these various regimes may lead to regulatory arbitrage. Previously, the Commission provided exemptions to registration for foreign-based DCOs who clear proprietary swaps positions for their U.S. members and affiliates but that do not clear for

[4] Section 701 *et seq*. of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[5] 7 USC § 7a-1(a); 17 CFR 39.3; see also 7 U.S.C. § 2(i) (providing that the CEA's swap-related provisions shall not apply to activities outside the United States unless those activities "have a direct and significant connection with activities in, or effect on, commerce of the United States" or "contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [the CEA]").

U.S. customers generally. (These foreign-based DCOs also do not clear futures traded on DCMs.) These exemptions have been issued pursuant to Section 5b(h) of the CEA, which permits the Commission to exempt a clearing organization from DCO registration for the clearing of swaps where the Commission determines that such clearing organization is subject to comparable, comprehensive supervision by appropriate government authorities in the clearing organization's home country.[6] Pursuant to this authority, the Commission granted exemptions to clearing organizations in Australia, Japan, South Korea, and Hong Kong. Each of these exemptions required that each exempt CCP limit direct clearing by U.S. persons and FCMs to certain specified circumstances.[7]

Thus, consistent with the interests of comity and facilitating cross border regulatory coordination, the Division has determined to provide the following limited and enumerated relief from the application of Commission regulations to discrete aspects of a DCO/CCP's non-U.S. clearing activities, subject to the restrictions identified below. This letter, and the relief contained here, shall become effective when the Notice becomes effective.

1. Regulation 39.12(b)(6)

CFTC Regulation 39.12(b)(6) requires that, upon a DCO's acceptance of a swap for clearing, the original swap is extinguished and it is replaced by an equal and opposite swap between the DCO and each clearing member acting as a principal for a house trade or an agent for a customer trade.

For the reasons set forth above, the Division will not require DCO/CCPs to apply this "futures clearing model" to trades where neither party is a U.S. clearing member or an FCM clearing member.

2. Part 22 of CFTC Regulations

Part 22 of CFTC Regulations sets forth the LSOC account model for cleared swaps customer accounts.

For the reasons set forth above, the Division will not require DCO/CCPs to apply Part 22's LSOC account model to their clearing members that are not FCMs.

[6] 7 USC § 7a-1(h).

[7] In particular, the Commission required that each CCP maintain rules that limit clearing services for U.S. persons and FCMs to the following circumstances: (1) "A U.S. person that is a clearing member of [the exempt CCP] may clear swaps for itself and those persons identified in the Commission's definition of 'proprietary account' set forth in Regulation 1.3(y)"; (2) "A non-U.S. person that is a clearing member of [the exempt CCP] may clear swaps for any affiliated U.S. person identified in the definition of 'proprietary account' set forth in Regulation 1.3(y)"; and (3) "An entity that is registered with the Commission as an FCM may be a clearing member of [the exempt CCP], or otherwise maintain an account with an affiliated broker that is a clearing member, for the purpose of clearing swaps for itself and those persons identified in the definition of 'proprietary account' set forth in Regulation 1.3(y)." *See* In re Petition of ASX Clear (Futures) Pty Limited for Exemption from Registration as a Derivatives Clearing Organization (Aug. 18, 2015); In re Petition of Japan Securities Clearing Corp. for Exemption from Registration as a Derivatives Clearing Organization (Oct. 26, 2015); In re Petition of Korea Exchange, Inc. for Exemption from Registration as a Derivatives Clearing Organization (Oct. 26, 2015); In re Petition of OTC Clearing Hong Kong Ltd. for Exemption from Registration as a Derivatives Clearing Organization (Dec. 21, 2015).

3. CFTC Regulation 39.13(g)(8)(i)

CFTC Regulation 39.13(g)(8)(i) requires that initial margin for customer accounts cleared by an FCM must be calculated and collected on a gross basis. Regulation 39.13(g)(8)(i) further prohibits a DCO from permitting FCM clearing members to net customer positions.

For the reasons set forth above, the Division will not require DCO/CCPs to apply this regulation to non-FCM clearing member intermediaries.

4. CFTC Regulation 39.13(g)(8)(ii)

CFTC Regulation 39.13(g)(8)(ii) requires a DCO to collect initial margin at a level that is greater than 100% of the DCO's initial margin requirements for the non-hedge positions of FCM customers.

For the reasons set forth above, the Division will not require DCO/CCPs to apply this regulation to such non-hedge positions of the customers of non-FCM clearing member intermediaries.

5. Regulation 39.12(a)(2)(iii)

CFTC Regulation 39.12(a)(2)(iii) prohibits a DCO from setting a minimum capital requirement of more than $50 million for any person that seeks to become a clearing member to clear swaps. Regulation 39.12(a)(2)(iii) 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 member.

For the reasons set forth above, the Division will not require DCO/CCPs to apply this requirement to non-U.S. clearing members or non-FCM clearing members.

6. Regulation 39.12(b)(7)

CFTC Regulation 39.12(b)(7) requires "straight-through-processing" of swaps submitted for clearing.

For the reasons set forth above, the Division will not require DCO/CCPs to apply straight-through-processing requirements to trades that are not executed on or subject to the rules of a DCM or a SEF and for which neither clearing member is an FCM, a swap dealer, or a major swap participant.

7. Regulation 39.13(h)(5)

Regulation 39.13(h)(5) requires DCOs to require that their clearing members maintain written risk management policies and procedures and further requires that DCOs must have the authority to obtain information and documents from clearing members regarding their risk.

For the reasons set forth above, although Regulation 39.13(h)(5) will still apply, the Division will permit DCO/CCPs to implement different oversight programs for U.S./FCM clearing members and non-U.S. clearing members.

8. Regulation 39.11(f) and Regulation 39.19(c)(3)(ii)

Regulation 39.11(f) requires DCOs to submit to the CFTC quarterly financial resource reports that include a quarterly financial statement. Similarly, Regulation 39.19(c)(3)(ii) requires DCOs to submit to

the CFTC an audited year-end financial statement. Although not explicitly stated in the text of either regulation, it is implicit that the financial statements will be prepared in accordance with U.S. GAAP.

For the reasons set forth above and because the Division recognizes that foreign-based CCPs may not have financial statements prepared in U.S. GAAP, absent Commission registration, the Division will permit DCO/CCPs to submit financial statements prepared in accordance with IFRS, with periodic reconciliation to assist staff in reviewing the financial statements.

Conclusion

The relief provided in this letter does not excuse any DCO/CCP from any obligation under the CEA or Commission regulations, other than those mentioned explicitly herein.

The position taken in this letter concerns enforcement action only and does not represent a legal conclusion with respect to the applicability of any provision of the CEA or the Commission's regulations. In addition, the Division's position does not necessarily reflect the views of the Commission or any other division or office of the Commission.

This letter, and the relief contained herein, is based upon the Division's understanding of the regulatory provisions applicable in the EU. Any different, changed, or omitted material facts or circumstances might render the relief void. Finally, as with all no-action letters, the Division retains the authority to condition further, modify, suspend, terminate, or otherwise restrict the terms of the no-action relief provided in this letter, in its discretion.

Should you have any questions concerning this correspondence, please contact Robert B. Wasserman, Chief Counsel, 202-418-5092, rwasserman@cftc.gov; Tracey Wingate, Special Counsel, 202-418-5319, twingate@cftc.gov; or Michael H. Margolis, Special Counsel, 312-596-0576, mmargolis@cftc.gov.

Sincerely,

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