**U.S. COMMODITY FUTURES TRADING COMMISSION**
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Division of Clearing and Risk

# MEMORANDUM

TO: All Registered Derivatives Clearing Organizations (DCOs)

FROM: Clark Hutchison

DATE: March 29, 2021

SUBJECT: Guidance Regarding Regulation 39.13(g)(8)(ii)

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The Division of Clearing and Risk ("DCR") recently received several inquiries regarding the implementation of amendments to Regulation 39.13(g)(8)(ii)[1] that the Commission adopted on January 27, 2020 with a compliance date of January 27, 2021.[2] In particular, some market participants asked whether it would be permissible under Regulation 39.13(g)(8)(ii) as revised for a futures commission merchant (FCM) to assess whether a customer account presents a "heightened risk profile," and is therefore subject to additional initial margin requirements, based on whether the account is a hedging or speculative account if the FCM concludes that is an appropriate method of assessing risk. For the reasons explained below, DCR is confirming that it would be permissible for an FCM to do so, provided that the FCM maintains policies and procedures that demonstrate this is the risk analysis the FCM will use when determining whether to collect additional initial margin from a given customer.

## Background

Regulation 39.13(g)(8)(ii) provides that a DCO must require its clearing members to collect from their customers initial margin at a level that is at least equal to the DCO's own initial margin requirements with respect to each product and portfolio and commensurate with the risk presented by each customer account. The regulation requires that a DCO set both (1) a baseline level of initial margin ("clearing initial margin"), which serves as the minimum amount its clearing members must in turn collect from their customers; and (2) an increased level of initial

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[1] 17 C.F.R. 39.13(g)(8)(ii).
[2] *See* 85 Fed. Reg. 4800 (Jan. 27, 2020).

margin ("customer initial margin") for categories of customers determined by a clearing member to have a "heightened risk profile."

When originally adopted in 2011, Regulation 39.13(g)(8)(ii) required clearing members to collect customer initial margin for "non-hedge positions."[3] In 2012, DCR issued guidance ("2012 Interpretive Guidance") interpreting Regulation 39.13(g)(8)(ii) in a manner that provided DCOs with flexibility to define their criteria for assessing customer margin requirements based on the type of customer account, so long as the DCO applied "prudential standards that result in FCMs collecting customer initial margin at levels commensurate with the risk presented by each type of customer account."[4] Specifically, DCR clarified that while many DCOs distinguished customer risk profiles by designating them as "hedge" or "non-hedge," a DCO may choose to use a different set of risk-based criteria.[5]

In 2020, the Commission amended the text of Regulation 39.13(g)(8)(ii) ("2020 Amendments") to incorporate this aspect of the 2012 Interpretive Guidance. Specifically, the 2020 Amendments replaced the term "non-hedge" with "heightened risk profile" and clarified that the clearing member is responsible for determining which categories of customers have a "heightened risk profile."[6]

**<u>Definition of "Heightened Risk Profile"</u>**

The Commission replaced "non-hedge" with "heightened risk profile" to more closely align the terminology of Regulation 39.13(g)(8)(ii) with the substantive nature of the requirement. FCMs may reference the hedging or speculative nature of an account in determining whether it presents a heightened risk profile, and may choose to use the terms "hedge" and "non-hedge" (or "spec") as shorthand for the account categories even if its risk profile analysis involves other considerations.

**<u>Impact on Margin Levels</u>**

DCR is aware of market participant concerns that requiring FCM clearing members to determine which customers present a "heightened risk profile," rather than which are "non-hedge" customers, could result in FCMs collecting less margin. Specifically, some market participants have argued that the "non-hedge" designation is well understood by DCOs, FCMs, and customers, and is largely uniform across the industry, whereas FCMs may seek competitive advantage by applying "heightened risk profile" narrowly to offer lower margin requirements to more customers. They argue this could cause other FCMs to lower their standards in response, resulting in a market-wide reduction in customer margin.

The 2020 Amendments should not lead to this result. While the terminology in Regulation 39.13(g)(8)(ii) has changed, the underlying concept is the same as that in the 2012 Interpretive

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[3] *See* 76 Fed. Reg. 69334, 69379 (Nov. 8, 2011); 17 C.F.R. 1.3.
[4] CFTC Letter No. 12–08 (Sept. 14, 2012).
[5] *Id*. at p.8.
[6] *Supra* n.2 at 4812.

Guidance that DCOs have followed for years.[7] Therefore, DCR does not expect to see significant changes in margining practices in response to the change in the rule.

Commission regulations prevent an FCM or DCO from improperly changing its customer margining practices. To comply with a DCO's rules required by Regulation 39.13(g)(8)(ii), its clearing members must analyze the risk profile of each of their customers to determine if they present a heightened risk profile. An FCM can only categorize an account as "non-HRP" that was previously categorized as a "non-hedge" (or "spec") account if it can demonstrate that it is warranted based on the risk profile of the customer. An FCM that fails to establish and maintain appropriate margin requirements based on a customer's risk profile may violate the risk management requirements of Regulation 1.11.[8] In addition, if a DCO were to improperly set customer account type margin levels, Regulation 39.13(g)(8)(ii) permits the Commission to require different levels if necessary to protect the financial integrity of the DCO or its clearing members.

In assessing compliance with Regulation 39.13(g)(8)(ii), DCR will evaluate whether a DCO via its risk review process pursuant to 39.13(h)(5)(ii) is reviewing its clearing members' policies and procedures to ensure that they are reasonably designed to determine which categories of customers have heightened risk profiles, and that they result in clearing members collecting customer initial margin commensurate with the risk presented to the FCM.

This memo represents the position of DCR only and does not necessarily represent the views of the Commission or those of any other division or office of the Commission.

If you have questions regarding this matter, please contact Joe Opron, Special Counsel, Division of Clearing and Risk (jopron@cftc.gov, (312) 596-0653) or Theodore Polley, Associate Director, Division of Clearing and Risk (tpolley@cftc.gov, (312) 596-0551).

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[7] In the 2012 Interpretive Guidance, DCR stated that it interprets Regulation 39.13(g)(8)(ii) "in a manner that preserves the historical customer margining practices applicable to FCMs . . . [noting that] FCMs are expected to continue the practice of collecting customer initial margin at a higher level than the minimum required, if such action is warranted based on the unique risk profile of an individual customer." *Supra* n. 4 at p.6.

[8] FCMs are required by Regulation 1.11 to establish, maintain, and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with its activities as an FCM.