Global Market Structure Subcommittee Recommendation

Objective:

Authorize a central counterparty that meets the definition of a covered clearing agency under SEC Rule 17-Ad-22(a)(5)[1] to be designated a "permitted counterparty" pursuant to CFTC Rule 1.25(d)(2).[2]

Recommendation:

The Subcommittee requests that the Commission amend CFTC Rule 1.25(d)(2) to permit derivatives clearing organizations ("DCOs") and futures commission merchants ("FCMs") to invest customer funds pursuant to repos cleared by a covered clearing agency registered with the Securities and Exchange Commission ("SEC") under section 17A of the Securities Exchange Act.

Background and Current Status:

CFTC Rule 1.25(d) permits an FCM or DCO to invest customer funds by buying and selling the permitted investments listed in Regulation 1.25(a)(1)(i) through (vii) pursuant to a repo, provided that the FCM and DCO complies with the requirements set forth in CFTC Rule 1.25(d). Paragraph (d)(2) requires that an FCM or DCO enter into a repo only opposite a "permitted counterparty." Currently, a clearing agency is not a permitted counterparty.

Such entities are limited to the following:

(i) a bank as defined in Section 3(a)(6) of the Securities Exchange Act of 1934,
(ii) a domestic branch of a foreign bank insured by the Federal Deposit Insurance Corporation,
(iii) a securities broker or dealer, or
(iv) a government securities broker or government securities dealer registered with the Securities and Exchange Commission or which has filed notice pursuant to section 15C(a) of the Government Securities Act of 1986.

As a result of the exclusion of clearing agencies from the types of permitted counterparties, FCMs and DCOs can invest customer funds in repos with a dealer or bank on a bilateral basis, but they cannot participate in the cleared market for these investments, even through one of FICC's various client clearing models (e.g., Sponsored Service, Prime Brokerage Clearing Service or Correspondent Clearing Service).

Supporting Rationale for Recommendation

FCM / DCO Access to cleared markets

A clearing agency novates transactions between two counterparties, becoming the buyer to every seller and seller to every buyer, and guarantees the settlement of the novated transactions. Thus, when two counterparties bilaterally execute a repo and elect to submit the repo for clearing, the clearing agency becomes the counterparty to each side of the repo transaction. However, as described above, because clearing agencies are not a permitted counterparty under CFTC Rule 1.25(d)(2), FCMs and DCOs are effectively prohibited from accessing the cleared market for repo investments. The exclusion of clearing agencies also serves to deny the benefits of clearing to these entities' counterparties.

[1] 17 CFR 240.17Ad-22(a)(5).

[2] 17 CFR § 1.25(d)(2).

Permitting FCMs and DCOs to access the cleared market for repo investments would provide them with access to a larger liquidity pool during a stress scenario, and decreased settlement and operational risk by making a greater number of transactions eligible to be netted and subject to guaranteed settlement, novation, and independent risk management through a central counterparty. In addition, cleared transactions in the repo market receive greater protection against fire sale risk because of a central counterparty's ability to centralize and control the liquidation of a greater portfolio of a failed counterparty's portfolio.

Satisfaction of the risk reduction requirements applicable to a "permitted counterparty"

A clearing agency's ability to meet the risk-reducing requirements necessary to be considered a permitted counterparty were acknowledged by the DCR and the Commission in their letter granting no-action relief permitting an FCM to enter into repos cleared by a clearing agency registered with the SEC (the "No-Action Letter").[3] In the No-Action Letter, the Commission stated that, "As an SEC-registered clearing agency [Y] is a regulated financial institution that can be expected to present no greater credit risk than banks or broker dealers that are permitted counterparties. Indeed, clearing can reduce credit risk to [X] (the FCM) by eliminating the risks presented by individual counterparties that are subject to financial stress associated with their activities in the financial markets. DCR therefore believes that it is consistent with the purpose of Regulation 1.25(d)(2) for [X] to be permitted to invest customer funds in a repo that is cleared by [Y] and for which [Y] becomes the counterparty."

Protection of Customer Funds

The Subcommittee recognizes that a crucial principle underlying Regulation 1.25, is that "customer segregated funds must be invested in a manner that minimizes their exposure to credit, liquidity, and market risks."[4] As a result, to further assure protection of customer funds that are invested by a CFTC-regulated entity, we recommend that clearing agencies authorized as permitted counterparties be those that are registered with the SEC and meet the definition of a covered clearing agency under SEC's regulations. This is because a covered clearing agency is subject to comprehensive oversight and supervision by the SEC and an enhanced regulatory framework under SEC Rule 17Ad-22(e)[5] that is aligned with the global Principles for Financial Market Infrastructures, which is substantively similar to the requirements for systemically important derivatives clearing organizations under Part 39 of the CFTC's regulations.[6]

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[3] See CFTC No-Action Letter No.12-34, Division of Clearing and Risk, Nov. 19, 2012.

[4] Rules Relating to Intermediaries of Commodity Interest Transactions, 65 Fed. Reg. 77,993, 78,001 (Dec. 13, 2000) and Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 76 Fed. Reg. 78,776 (Dec. 19, 2011).

[5] 17 CFR 240.17Ad-22(e).

[6] 17 CFR Part 39, Subpart C.