SPEECHES & TESTIMONY

Statement of Commissioner Dan M. Berkovitz on Proposed Amendments to Part 39: Derivatives Clearing Organization General Provisions and Core Principles

April 29, 2019

Introduction

I support issuing for public comment the notice of proposed rulemaking ("NPRM") to amend certain provisions of Part 39 of the Commission's regulations governing derivatives clearing organizations ("DCOs"). Part 39 generally covers registration and regulation of DCOs that centrally clear futures, options, and swaps regulated by the Commission.

The NPRM includes a number of beneficial provisions. I commend the staff of the Division of Clearing and Risk for this important effort to clarify and clean up some issues in the rules and staff guidance that have accumulated since Part 39 was substantively amended in 2011 and 2013. The NPRM also proposes several changes to the regulations that merit scrutiny as outlined below. I particularly look forward to comments on those provisions to help guide the Commission's deliberations on the proposed amendments.

Background

Central clearing of futures positions has been a fundamental risk mitigation measure for derivatives market participants in the United States for well over a hundred years. In more recent times, as futures and swap trading has grown dramatically,[1] central clearing of derivatives including swaps has become a critical element in risk management of the financial system as a whole. In response to the 2008 financial crisis, world leaders at the G20 summit in Pittsburgh established central clearing for derivatives as a core objective in mitigating systemic risk.[2] DCOs are a critical component of the clearing infrastructure, and effective clearinghouse registration and regulation is key to facilitating efficient, sound derivatives markets and preventing another financial crisis.

As described in the NPRM, the Commission adopted regulations in 2011 and 2013 to further implement DCO core principles and Title VIII of the Dodd-Frank Act. Based on experience in implementing these regulations and subsequent developments, including the establishment of international principles for clearing, the CFTC staff has provided guidance on the new regulations. It is now appropriate for the Commission to address this experience and these developments through amendments to our regulations.

Codification and Clarification

The NPRM includes numerous amendments that clarify, further define, or provide more explicit direction to market participants. Governance requirements are more fully developed and applied across all DCOs. The NPRM adds new regulations 39.24, 39.25, and 39.26 that establish governance requirements for DCOs to better ensure that DCOs are well managed.[3] These amendments provide greater certainty and uniform rules, and are important not only for fairness and consistency, but to improve risk management across the clearing space. The changes may help guard against risks from governance failures.

While the new governance regulations are beneficial, many of the provisions set out only general principles and do not provide specific guidance or prescriptive standards. I look forward to public comment on whether more explicit guidance or requirements would be appropriate for any specific provisions. In particular, I look forward to comments on whether members should play a larger role in governance.

Under the NPRM, regulation 39.16 would be amended to improve requirements around member default management.[4] The recent member default at NASDAQ Clearing reinforces the importance of default management mechanisms and information sharing when a default occurs.[5] The amendments explicitly require DCOs to have a default committee that must include clearing members. In addition, the amendments would require a DCO to include members in tests of the default management plan. I look forward to comments on how and when DCO members should be included in default management.

In addition to the above, the NPRM would provide a number of more discrete improvements, such as an explicit requirement for initial margin to cover concentration risk; a requirement for DCO personnel to certify certain reports; and several new reporting requirements around settlement bank arrangements, depositories, and liquidity funding arrangements. Clarifying these types of issues will help maintain consistent, objective, and transparent oversight of registered DCOs.

Issues Warranting Further Comment and Consideration

The NPRM includes several proposed amendments that, while beneficial in some respects, may also present additional issues for the Commission to consider in developing the final rule. Comments in these areas would be particularly helpful to inform the Commission in its deliberations.

Changes to regulation 39.13(g)(8) regarding calculation of initial margin and in particular, excess margin, attempt to incorporate in the regulation, and to clarify, staff guidance.[6] Getting initial margin calculations right is critical to providing sufficient resources to cover variation margin shortfalls that may occur when resolving a member's default. The proposed standard for margin to be "commensurate with the risk presented by each customer account," as a principle, seems appropriate. However, little guidance is provided on how that principle should be applied or the appropriate parameters for consideration. Given the importance of initial margin calculations, I look forward to comments on whether the Commission should provide a more detailed standard in the regulation or further guidance on the calculation.

New regulation 39.13(i) provides explicit procedures and requirements for filing DCO rules to implement a cross-margining program with other clearing organizations.[7] From a general policy perspective, establishing explicit procedures in regulation for evaluating such arrangements would facilitate consistent, objective reviews by the Commission.

However, multi-entity cross-margining – which could cross borders and involve multiple regulatory regimes of different regulators – creates additional layers of legal, operational, and financial risk that may be difficult to evaluate. The members of the DCO could be affected in ways not previously contemplated and that may be more obscure to the members and difficult for them to assess. The information that the DCO would be required to provide to the Commission under the NPRM is fashioned from less complex portfolio margining evaluation requirements and is general in nature. Will a bankruptcy involving a member of one of the clearing organizations, the DCO, or the other clearing organization affect the other entity and its members in ways that are not anticipated? Are there margin model risks, such as greater concentration risk across both entities, that are not properly accounted for in the proposed regulations? Do members of the DCO have other concerns and do they have appropriate mechanisms to voice those concerns through the DCO rules, governance structures, and/or CFTC review procedures? I look forward to reviewing the comments on these and other issues regarding the proposed multi-entity cross margining regulations.

Finally, the NPRM would establish regulation 40.5 as the mechanism for Commission review of certain DCO rule sets including: (1) a request to transfer a DCO's open interest – in many cases its entire open interest, (2) cross-margining programs among different clearing organizations – including across borders and for entities subject to different regulators, and (3) commingling of futures, options, and swaps positions in a section 4d(a) futures account. These rule reviews could involve consideration of novel issues, customer protections, and other factors. Accordingly, I have some concern that regulation 40.5 may not provide sufficiently robust review procedures or the Commission with adequate authority to require a DCO to mitigate risks arising from the proposed actions.

Section 40.5 was intended to address voluntary submission of DCO rule changes pursuant to section 5c(c) of the Commodity Exchange Act. While the process for submission and Commission review is more detailed under regulation 40.5 than under regulation 40.6, regulation 40.5 provides for automatic approval after 45 days if that period is not extended by the Commission and a narrow standard of review; namely, the Commission shall approve a DCO rule under review unless it "is inconsistent with the [Commodity Exchange] Act or Commission's regulations." However, the DCO activities to which this review procedure would be applied under the NPRM are significant actions that likely will raise customer protection concerns, entail a sophisticated risk management analysis, and call for a more nuanced review and response than can be accomplished under the blunt "inconsistent with the CEA" standard that governs the Commission under regulation 40.5.

Accordingly, I encourage comments on whether regulation 40.5 is the appropriate mechanism to review these proposed DCO actions or whether a more balanced procedure should be employed that would provide the Commission more flexibility to ensure the proposed actions adequately address issues involving customer protection, potential risks to FCMs, and market integrity.

Conclusion

In conclusion, I commend the staff of the Division of Clearing and Risk for their efforts in preparing the NPRM to codify practices that are currently addressed through staff guidance and to conform our regulations to developments that have occurred since the regulations were issued. The NPRM will help clarify and provide explicit rules for clearing organizations that provide a vital service to derivatives markets. Finally, I look forward to the public comments on the NPRM, particularly on the proposed amendments discussed above.

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[1] A CFTC study published in 1998 noted that an estimated 272 million futures and options contracts were traded globally in 1986, while recent Futures Industry Association data indicates that 30.28 billion futures and options contracts were traded globally in 2018. *See* CFTC, Division of Economic Analysis, The Global Competitiveness of U.S. Futures Markets Revisited (November 1999); available at https://www.cftc.gov/sites/default/files/idc/groups/public/@swaps/documents/file/plstudy_53_cftc.pdf; FIA Releases Annual Trading Statistics showing Record [Exchange Traded Derivatives] Volume in 2018; available at https://fia.org/articles/fia-releases-annual-trading-statistics-showing-record-etd-volume-2018. Similarly, the trading of over-the-counter derivatives expanded from about $72 trillion in notional amount in 1998 to about $595 trillion in 2018. *See* Bank of International Settlements, OTC derivatives notional amount outstanding by risk category; available at https://stats.bis.org/statx/srs/tseries/OTC_DERIV/H:A:A:A:5J:A:5J:A:TO1:TO1:A:A:3:C?t=D5.1&p=20172&x=DER_RISK.3.CL_MARKET_RISK.T:B:D:A&o=w:19981.,s:line.nn,t:Derivatives%20risk%20category.

[2] *See* G20, Leaders' Statement: The Pittsburgh Summit (Sept. 24-25, 2009); available at https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

[3] *See* NPRM section IV.J.

[4] *See* NPRM section IV.F.

[5] *See* Luke Clancy, *Margin or membership? Regulators react to Nasdaq default*, Risk.net (Feb. 7, 2019) available at: https://www.risk.net/regulation/6366441/margin-or-membership-regulators-react-to-nasdaq-default.

[6] *See* NPRM section IV.D.3.f.

[7] *See* NPRM section IV.D.5.