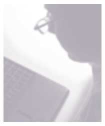

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# The Key to Regulating Derivatives Clearing Organizations

Recently, a number of articles and white papers have focused on central clearing parties (CCPs) and have renewed market and regulatory interest in these often large and globally interconnected financial institutions. Derivatives clearing entities have gained enormous importance since the G-20 at its Pittsburgh Summit in September 2009 agreed that over-the-counter (OTC) derivatives should be cleared; this agreement gave rise to new derivatives clearing requirements both under The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and the European Market Infrastructure Regulation (EMIR). As more derivatives go through clearing houses, it is imperative that clearing entities not only be adequately regulated, but also that regulators conduct risk-based supervision of these entities (and not just a compliance-based approach) to ensure that they have an adequate capital cushion to sustain unexpected losses.

#### What Is a Designated Clearing Entity?

When market participants or journalists are talking about CCPs, they are referring to what the CFTC, SEC, and the Federal Reserve call Designated Clearing Entities (DCEs). DCEs are either Derivatives Clearing Organizations (DCOs) registered with the CFTC under Section V of the Commodities Exchange Act or a Clearing Agency (CA) registered with the SEC under Section 17A of the Securities Exchange Act, 1934.

In the derivatives world, a central clearing party is usually a DCO. According to the CFTC, a DCO is "a clearinghouse, clearing association, clearing corporation, or similar entity that enables each party to an agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the DCO for the credit of the parties; arranges or provides, on a multilateral basis, for the settlement or netting of obligations; or otherwise provides clearing services or arrangements that mutualize or transfer credit risk among participants."

As of the end of November 2012, 14 companies are registered as DCOs in the US, according to the CFTC:

- Cantor Clearinghouse, L.P.
- Chicago Mercantile Exchange, Inc.
- Clearing Corporation
- ICE Clear Credit
- ICE Clear Europe Limited
- ICE Clear US, Inc.
- Kansas City Board of Trade Clearing Corporation
- LCH.Clearnet LLC
- LCH.Clearnet Ltd.
- MGE Clearing House
- Natural Gas Exchange Inc.
- New York Portfolio Clearing, LLC
- North American Derivatives Exchange, Inc.
- Options Clearing Corporation

#### Regulation

Designated Clearing Entities are regulated by the CFTC or the SEC. Dodd-Frank's Title VIII, Section 813, requires the SEC and CFTC to coordinate with the Board of Governors of the Federal Reserve to develop joint risk management supervision programs for clearing entities designated as systemically important, such as the CME or ICE, by the Financial Stability Oversight Council.

In the US, just about any type of financial institution can apply to become a DCO. Any DCO comes under the CFTC's core principles, which require that they have:

- Adequate financial, operational, and managerial resources.
- Appropriate standards for participant and product eligibility.
- Adequate and appropriate risk management capabilities.
- Ability to complete settlements on a timely basis under varying circumstances.
- Standards and procedures to protect member and participant funds.
- Efficient and fair default rules and procedures.
- Adequate rule enforcement and dispute resolution procedures.
- Adequate and appropriate systems safeguards, emergency procedures, and plans for disaster recovery.
- Obligation to provide necessary reports to allow the CFTC to oversee clearinghouse activities.
- Maintenance of all business records for five years in a form acceptable to the CFTC.
- Publication of clearinghouse rules and operating procedures.

- Participation in appropriate domestic and international information-sharing agreements.
- Avoidance of actions that are unreasonable restraints of trade or that impose anti-competitive burdens.
- Governance arrangements and fitness standards.
- Rules to minimize conflicts of interest in the DCO's decision-making process, and a process for resolving any conflicts.
- Composition of governing boards to include market participants.
- Well founded legal framework for the activities of the DCO.

**DCOs and Risk-Based Supervision**

It is tremendously important that the CFTC not simply examine DCOs using a compliance based approach that is just making sure that clearing entities follow rules and principles. The CFTC should strengthen how they conduct risk-based on- and off-site supervisions of DCOs, particularly given their increasing role as systemically important financial institutions. A risk-based supervision approach entails that the CFTC would evaluate how a DCO identifies, measures, controls, and monitors its macro risks (country and economic) and its financial risks (credit, market, operational, liquidity, legal, and reputational) across all legal entities and geographic locations. Risk-based supervision allows regulators to focus on an organization's problem areas and on those entities that have higher risks.

The CFTC increasingly has professionals coming from varied backgrounds, which is a great asset for risk-based exams. The best exam teams have expertise in risk-based supervision, finance, legal matters, accounting, derivatives, and risk measurement models. Examiners should be evaluating carefully the background of DCOs' board of directors and senior management for signs of their risk philosophy, policies, and procedures and how they communicate them to all staff members. It is critical that examiners analyze the financial safeguards and account segregation at DCOs.

Moreover, evaluating the way that DCOs credit risk committees conduct due diligence on potential and existing members' credit quality is very important. These credit groups should not just look at members' financials, but when possible also their market signals, such as credit spreads and stock prices. Given the confluence of Basel III, Dodd-Frank, and EMIR, the pressure to have highly marketable, liquid, and unencumbered collateral is critical. Examiners need to make sure that DCOs accept only the highest-quality collateral and that if anything else – such as corporate bonds, stocks, or gold -- is accepted, that DCOs make transparent how they calculate haircuts.

DCOs have great exposure to operational risk -- a breach in the day-to-day running of the business due to people, processes, technology and external threats. As DCO volumes rise, there is more scope for operational risk simply by the virtue of the fact that people and systems need to keep up with the changing nature of the business. CFTC examiners need very detailed information from DCO senior management as to what type of data they collect for low-probability, high-adverse-impact events and need to see if DCOs use that information to measure if they are adequately capitalized to sustain unexpected losses.

CFTC examiners should also be analyzing how DCOs conduct stress tests; what liquidity, credit, market, and operational risks they use as inputs in their models; and what DCOs do with stress test results. Additionally, CFTC professionals want to evaluate the quality of business continuity, liquidity plans, and living wills that DCOs draw up.

Importantly, CFTC examiners need to be given resources and tools to undertake their expanded roles. Financial institutions cannot lobby congress to hinder or cut the CFTC's budget and then complain that the CFTC is not finalizing Dodd-Frank rules fast enough or that they are not regulating and supervising the many entities under their purview. Dodd-Frank is here to stay, and the market, not to mention the global economy, will be helped enormously if derivatives clearing organizations are properly regulated and supervised. DCOs can aid enormously in making the derivatives market more transparent, liquid, and efficient, but only if they are properly supervised as systemically important organizations.

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**3 Comments to "The Key to Regulating Derivatives Clearing Organizations":**

**shamlet76**
28 December 2012

agree, agree, agree

**crammond1964**
02 January 2013

totally agree ........... however will exchanges big clients accept it ?

**mrv123**
02 January 2013

It is in the interest of exchanges' clients to have DCOs well regulated and supervised. Otherwise, we risk simply transferring bilateral credit and operational risks and centralizing them in 'too big too fail' type entities.