SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-90276; File No. S7-13-12)

October 28, 2020

Proposed Order Granting Conditional Exemptions under the Securities Exchange Act of 1934 in Connection with the Portfolio Margining of Swaps and Security-based Swaps that are Credit Default Swaps

AGENCY: Securities and Exchange Commission ("SEC" or "Commission")

ACTION: Notice of proposed exemptive order; request for comment.

SUMMARY: The Commission is proposing to grant exemptive relief, subject to certain conditions, from compliance with certain provisions of the Securities Exchange Act of 1934 in connection with a program to portfolio margin cleared swaps customer and affiliate positions in cleared credit default swaps that are swaps and security-based swaps in a segregated account established and maintained in accordance with Section 4d(f) of the Commodity Exchange Act (in the case of a cleared swaps customer) or a cleared swaps proprietary account (in the case of an affiliate). This proposed exemptive relief would supersede and replace the Commission's *Order Granting Conditional Exemptions under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-based Swaps* issued in December 2012.

DATES: Comments must be received on or before [insert date 30 days after publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/other.shtml); or
- Send an email to rule-comments@sec.gov. Please include File Number S7-13-12 on the subject line.

Paper comments:

- Send paper comments to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-13-12. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec/gov/rules/other.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change. Persons submitting comments are cautioned that the Commission does not redact or edit personal identifying information from comment submissions. Commenters should submit only information that they wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at (202) 551-5525; Thomas K. McGowan, Associate Director, at (202) 551-5521; Randall W. Roy, Deputy Associate Director, at (202) 551-5522; Raymond Lombardo, Assistant Director, at 202-551-5755; or Sheila Dombal Swartz, Senior Special Counsel, at (202) 551-5545, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, D.C. 20549-7010.

SUPPLEMENTARY INFORMATION:

I. Introduction

The Commission is proposing to issue an order granting conditional exemptive relief to SEC-registered clearing agencies also registered with the Commodity Futures Trading

Commission ("CFTC") as derivative clearing organizations ("clearing agency/DCOs") and SEC-registered broker-dealers also registered with the CFTC as futures commission merchants ("BD/FCMs"). The proposed order would exempt these entities from compliance with certain provisions of the Securities Exchange Act of 1934 ("Exchange Act") in connection with a program to portfolio margin cleared swaps customer and affiliate positions in cleared security-based swaps and swaps that are credit default swaps ("CDS") in a segregated account established and maintained in accordance with Section 4d(f) of the Commodity Exchange Act ("CEA") in the case of a cleared swaps customer ("CFTC cleared swaps customer account") or a cleared swaps proprietary account in the case of an affiliate ("CFTC cleared swaps proprietary account") (each a "CFTC cleared swaps account"), and to calculate margin requirements on a portfolio basis.[1]

The proposed order would supersede and replace the Commission's December 2012 order providing similar relief ("2012 Order"), and modify certain of its conditions, as discussed in more detail below.[2] In particular, it would eliminate conditions (a)(1) and (a)(2) in the 2012 Order pertaining to the exemptions for clearing agency/DCOs.[3] The requirements to adhere to these conditions are triggered on the compliance date for the final capital, margin, and segregation requirements for SBSDs: October 6, 2021. The Commission is seeking comment at this time on whether these and other conditions in the 2012 Order should be modified to provide

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1 The text of the proposed order is set forth in an appendix to this release and cited herein as the "Proposed Order."

2 *Order Granting Conditional Exemptions under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-based Swaps*, Exchange Act Release No. 68433 (Dec. 12, 2012) 77 FR 75211 (Dec. 19, 2012).

3 *See* 2012 Order, 77 FR at 75219-20.

time to consider comments and, if appropriate, issue a new order in advance of conditions (a)(1) and (a)(2) in the 2012 Order being triggered.

Conditions (a)(1) and (a)(2) in the 2012 Order are intended to provide an option for security-based swap customers to portfolio margin cleared security-based swaps and swaps that are CDS ("cleared CDS") in a security-based swap account in accordance with Section 3E of the Exchange Act ("SEC SBS account") as an alternative to a CFTC cleared swaps account.[4] The proposed order also would modify the conditions in paragraphs (b)(1)(ii) and (2)(ii) requiring subordination agreements to provide greater clarity that the scope of the subordination does not extend to the claims of general creditors. In addition, the proposed order would eliminate condition (b)(3) in the 2012 Order, which requires approval of a BD/FCM's margin methodology by the Commission or Commission staff. Instead, as a condition of the proposed order, a BD/FCM would need to have an internal risk management program that has been approved in advance by the Commission or the Commission staff. Further, as a condition of the proposed order, the internal risk management program would need to have certain standards drawn from the letters the staff of the Division of Trading and Markets ("Division staff") issued to BD/FCMs to approve their margin methodologies.[5] These staff letters would be withdrawn and the proposed order would provide that any BD/FCM that received a staff letter approving its margin

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4 The Commission has adopted capital, margin, and segregation requirements under the Exchange Act for security-based swaps dealers ("SBSDs"). *See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers*, Exchange Act Release No. 86175 (June 21, 2019), 84 FR 43872, 43956-57 (Aug. 22, 2019) ("Capital, Margin, and Segregation Adopting Release").

5 The staff letters are available at https://www.sec.gov/rules/exorders/exordersarchive/exorders2012.shtml.

methodology prior to the issuance of the order would be deemed to have an approved internal risk management program for the purposes of the proposed order.

II. Background

A. 2012 Order

On December 14, 2012, in response to a request from ICE Clear Credit LLC,[6] the Commission issued the 2012 Order to provide relief so that clearing agency/DCOs and BD/FCMs could offer customers portfolio margining of cleared CDS in a CFTC cleared swaps account ("CDS portfolio margin program").[7] The 2012 Order exempts a clearing agency/DCO from Sections 3E(b), 3E(d) and 3E(e) of the Exchange Act and any rules thereunder, solely to perform the functions of a clearing agency/DCO under the CDS portfolio margin program, subject to five conditions.[8] It further exempts a BD/FCM from Sections 3E(b), 3E(d), 3E(e), and 15(c)(3) of the Exchange Act, and Rule 15c3-3, as well as from any requirement to treat an affiliate (as defined in association with the "cleared swaps proprietary account" definition in CFTC Rule 22.1) as a customer for purposes of Rules 8c-1 and 15c2-1, subject to six

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6 ICE Clear Credit formally petitioned the Commission to grant exemptive relief from the application of Section 15(c)(3) of the Exchange Act, Rule 15c3–3 and, related rules under the Exchange Act. *See* Letter from Michael M. Phillip, Partner, Winston & Strawn LLP (Nov. 7, 2011) (the petition 4-641 and comments received on the petition are available at https://www.sec.gov/rules/petitions.shtml).

7 The CFTC also issued a companion exemptive order on January 13, 2013 permitting ICE Clear Credit and its BD/FCM clearing members to provide for the portfolio margining of cleared swaps and security-based swaps that are CDS. *See* CFTC, *Order, Treatment of Funds Held in Connection with Clearing by ICE Clear Credit of Credit Default Swaps* (Jan. 13, 2013)("2013 CFTC Portfolio Margin Order"), *available at* https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/icecreditclearorder011413.pdf. *See also* CFTC, *Order, Treatment of Funds Held in Connection with Clearing by ICE Clear Europe of Credit Default Swaps* (Apr. 9, 2013), *available at* https://www.cftc.gov/sites/default/files/stellent/groups/public/@requestsandactions/documents/ifdocs/iceclearеurope4dfcds040913.pdf.

8 *See* Capital, Margin, and Segregation Adopting Release, 84 FR at 43954; *Cross-Border Application of Certain Security-Based Swap Requirements*, Exchange Act Release No. 87780 (Dec. 18, 2019), 85 FR 6270 (Feb. 4, 2020).

conditions.[9] The conditions applicable to clearing agency/DCOs and BD/FCMs are designed to: (1) protect money, securities, and property of security-based swap customers; (2) address certain differences in the statutory requirements of the Exchange Act and the CEA; and (3) promote appropriate risk management and disclosure.[10] The 2012 Order also sought comment on all aspects of the exemptions it provided.[11]

B. Division Staff Letters

On March 8, 2013, the Division staff issued temporary conditional approval letters to seven BD/FCMs pursuant to condition (b)(3) in the 2012 Order[12] permitting them to participate in the CDS portfolio margin program, subject to certain conditions (the "March 8, 2013 letters").[13] The conditions included a requirement to collect initial margin based on a multiplier

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9 *See* 2012 Order, 77 FR at 75213-14 (discussing these sections of the Exchange Act and the rules), 75216-19 (discussing the conditions), and 75220-21 (setting forth the conditions). *See also Order Extending Temporary Exemptions from Exchange Act Section 8 and Exchange Act Rules 8c-1, 10b-16, 15a-1, 15c2-1 and 15c2-5 in Connection with the Revision of the Definition of "Security" to Encompass Security-Based Swaps,* Exchange Act Release No. 87943 (Jan. 10, 2020), 85 FR 2763 (Jan. 16, 2020) (providing a temporary exemption from certain rules including Rules 8c-1 and 15c-1 in connection with the revision of the Exchange Act definition of "security" to encompass security-based swaps until Nov. 5, 2020).

10 *See* 2012 Order, 77 FR at 75214.

11 77 FR at 75219. Letters responding to this request for comment are available at https://www.sec.gov/comments/s7-13-12/s71312.shtml.

12 *See* Proposed Order, ¶ (b)(3) (providing that BD/FCM must require minimum margin levels with respect to any customer transaction in a program to commingle and portfolio margin CDS at least equal to the amount determined using a margin methodology established and maintained by the BD/FCM that has been approved by the Commission or the Commission staff).

13 The March 8, 2013 letters and other staff letters to the BD/FCMs discussed below are available at: https://www.sec.gov/rules/exorders/exordersarchive/exorders2012.shtml. The temporary staff letters were responsive to a comment raising concerns about the first CFTC compliance date for mandatory swaps clearing (March 13, 2013). *See* Letter from Stuart J. Kaswell, Executive Vice President & Managing Director, Managed Funds Association (Feb. 11, 2013) ("MFA 2/11/13 Letter") (comment to the 2012 Order), *available at* https://www.sec.gov/comments/s7-13-12/s71312.shtml.

of the clearing agency/DCO margin requirement or to take a 100% capital charge for the difference.

On June 7, 2013, the Division staff issued updated temporary conditional letters to the seven BD/FCMs that received the March 8, 2013 letters, and to one additional BD/FCM, setting forth revised conditions for participation in the CDS portfolio margin program ("the June 7, 2013 letters"). The June 7, 2013 letters required the BD/FCMs to implement a required margin regime and establish minimum risk management standards by December 7, 2013. On December 6, 2013, the Division staff issued letters to the BD/FCMs extending the December 7, 2013 date to January 31, 2014. On January 31, 2014, the Division staff issued letters to the eight BD/FCMs permanently approving their margin methodologies, subject to the conditions in the June 7, 2013 letters ("January 31, 2014 letters"). Subsequent to the issuance of the January 31, 2014 letters, the Division staff approved the margin methodologies of two additional BD/FCMs, subject to the conditions in the June 7, 2013 letters.[14]

III. Discussion of Proposed Relief

Since the issuance of the 2012 Order, the SEC staff has monitored the operations of the BD/FCMs participating in the CDS portfolio margin program as well as the market for cleared CDS. The Commission believes it may be appropriate to issue a new portfolio margin order with modified conditions in light of: (1) the experience gained from this monitoring; and (2) comment letters addressing portfolio margining received in response to the 2012 Order and in the context of the SEC's recently finalized rulemaking adopting capital, margin and segregation

[14] The Division staff also issued an additional letter relating to the transfer of a CDS portfolio margin program using the same internal risk model and same internal risk management system from one broker-dealer affiliate to another. The June 7, 2013 letters and subsequent staff letters are collectively referred to below as the "BD/FCM staff letters."

requirements for security-based swap dealers ("SBSDs").[15] A modified order also may be appropriate because the CFTC has initiated the mandatory clearing of certain swaps, including broad-based index CDS.[16] The following discussion describes the conditions of the proposed order – many of which would be largely consistent with conditions in the 2012 Order. Proposed modifications to the conditions in the 2012 Order are noted and discussed.

A. Conditions for Clearing Agency/DCOs

1. Elimination of Conditions Relating to Expanding the CDS Portfolio Margin Program to Securities Accounts

The conditions in paragraphs (a)(1) and (a)(2) of the 2012 Order are intended to provide customers the option to portfolio margin cleared CDS in an SEC SBS account once the SEC's margin and segregation rules for SBSDs are in place.[17] In particular, paragraph (a)(1) requires that the clearing agency/DCO, by the later of six months after the adoption date of the final margin and segregation rules for security-based swaps or the compliance date of such rules, to take all necessary action within its control to *obtain any relief needed* to permit its BD/FCM clearing members to maintain customer money, securities, and property received by the BD/FCM to margin, guarantee, or secure customer positions in cleared CDS in an SEC SBS account for the purpose of the CDS portfolio margin program. Paragraph (a)(2) requires the clearing agency/DCO, within the same timeframe, to take all necessary action within its control,

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15 The comment letters received with respect to this rulemaking are available at https://www.sec.gov/comments/s7-08-12/s70812.shtml.

16 *See, e.g.*, *CFTC Announces that Mandatory Clearing Begins Today*, CFTC Press Release No. 6529-13 (Mar. 11, 2013) (announcing that swap dealers, major swap participants and private funds active in the swaps market are required to begin clearing certain index CDS); *CFTC Announces that Mandatory Clearing for Category 2 Entities Begins Today,* CFTC Press Release No. 6607-13 (June 13, 2013) (announcing the second phase of required clearing for certain CDS and interest rate swaps).

17 *See* 2012 Order, 77 FR at 75215-16 (discussing the conditions) and 75219-20 (setting forth the conditions).

to *establish rules and operational practices* to permit its BD/FCM clearing members to maintain customer money, securities, and property received by the BD/FCM to margin, guarantee, or secure customer positions in cleared CDS in an SEC SBS account for the purpose of the CDS portfolio margin program. Thus, the requirements to adhere to conditions in paragraphs (a)(1) and (2) of the 2012 Order are triggered on the compliance date for the final capital, margin, and segregation requirements for SBSDs: October 6, 2021.

In the 2012 Order, the Commission stated that it was important to ultimately provide market participants with the ability to select an account structure to manage their individual risks by taking into account the different regulatory provisions that may apply to different account types and any costs incurred.[18] Market participants have been clearing CDS under the CDS portfolio margin program since the initial BD/FCM staff letters were issued in 2013. The CDS portfolio margining program has allowed greater efficiencies in clearing, allowing the offset of positions and the ability to margin cleared CDS in a single account. Portfolio margining facilitates margin requirements that better reflect the overall risks presented by a CDS portfolio, which may result in decreased margin costs. Because of these greater efficiencies and potential cost reductions available under the current CDS portfolio margin program in a CFTC cleared swaps account, market participants have not expressed a desire to portfolio margin cleared CDS in an SEC SBS account. This lack of market interest in a securities account alternative also is consistent with: (1) the comments of ICE Clear Credit in 2011 that it received no indication in its discussions with market participants that they desired a securities account option with respect to

[18] *See* 2012 Order, 77 FR at 75216.

its petition for rulemaking to portfolio margin cleared CDS; and (2) the Division staff's experience in monitoring the CDS portfolio margin program.[19]

While portfolio margining cleared CDS in an SEC SBS account also would provide greater efficiencies and cost reductions, given the success of the current CDS portfolio margin program and the lack of market interest in a securities account alternative, the Commission preliminarily believes that it may be appropriate to eliminate these conditions. Removing them would avoid potentially unnecessary costs[20] to clearing agency/DCOs to implement systems and processes to accommodate SEC SBS accounts that may never be utilized. Moreover, their removal would not prohibit a clearing agency/DCO from offering an SEC SBS account option in the future, if market conditions change and the demand arises, subject to applicable regulatory approvals and relief.

2. Proposed Conditions

The three clearing agency/DCO conditions in the proposed order are largely consistent with the conditions in paragraphs (a)(3), (4), and (5) of the 2012 Order, respectively.[21] The first condition would require the clearing agency/DCO to *obtain any other relief* needed to permit a

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19 *See* Letter from Christopher S. Edmonds, President, ICE Clear Credit LLC (Dec. 22, 2011) ("ICE Letter") (comment to the ICE Clear Credit petition for rulemaking 4-641 (Nov. 7, 2011)), *available at* https://www.sec.gov/comments/4-641/4-641.shtml.

20 These costs may involve changes to trade processing systems (to designate account type), risk management processes (to capture and relate positions and margin held in multiple account types), and to treasury and banking processes, systems, and accounts. *See, e.g.,* ICE Letter.

21 *See* 2012 Order, 77 FR at 75216 (discussing the conditions) and 75220 (setting forth the conditions); Proposed Order, ¶¶ (a)(1), (2), and (3). The Commission made some technical changes to the DCO/clearing agency conditions in the proposed order to account for the elimination of conditions (a)(1) and (2) from the 2012 Order. These proposed changes include re-numbering the remaining clearing agency/DCO conditions and moving the definition of "BD/FCM" from condition (a)(1) in the 2012 Order (which would be eliminated) to condition (a)(1) in the proposed order (which parallels condition (a)(3) in the 2012 Order). Finally, the Commission is proposing to replace the term "shall" in two places with the term "will" and "must," respectively.

BD/FCM to maintain cleared swaps customer or affiliate money, securities, and property received to margin, guarantee, or secure cleared swaps customer or affiliate positions in cleared CDS in a CFTC cleared swaps customer account or a CFTC cleared swaps proprietary account, respectively, for the purpose of clearing such cleared swaps customer or affiliate positions under the CDS portfolio margin program.[22] This condition is designed to help ensure that the exemption would apply only in circumstances where the regulatory framework under the CEA and the CFTC's rules is applicable.

The second clearing agency/DCO condition would require the organization to have appropriate *rules and operational practices* to permit a BD/FCM to maintain cleared swaps customer or affiliate money, securities, and property received to margin, guarantee, or secure cleared swaps customer or affiliate positions in cleared CDS in a CFTC cleared swaps customer account or a cleared swaps proprietary account, respectively, for the purpose of clearing such cleared swaps customer or affiliate positions under the CDS portfolio margin program.[23] This condition also is designed to help ensure the exemption would apply only in circumstances where the regulatory framework under the CEA and the CFTC's rules is applicable.

The third clearing agency/DCO condition would require the organization to have rules mandating that each cleared swaps customer and affiliate of the BD/FCM participating in the CDS portfolio margin program must be an "eligible contract participant" as defined in Section

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22 *See* Proposed Order, ¶ (a)(1). The proposed order also would eliminate use of the generic term "customer" in the 2012 Order and instead use the more specific terms "cleared swaps customer," "affiliate," "security-based swap customer," and "securities customer". In addition, the proposed order would add specific language to clarify that cleared CDS positions of cleared swaps customers are held in CFTC cleared swaps customer accounts and affiliate positions are held in CFTC cleared swaps proprietary accounts. These proposed changes reflect the different treatment each type of person and account would receive under the CEA and rules thereunder, and applicable bankruptcy laws.

23 *See* Proposed Order, ¶ (a)(2). *See also* supra note 22.

1a(18) of the CEA.[24] Given that Congress determined it is appropriate to include these limitations in the Dodd-Frank Act with respect to eligible contract participants, the Commission preliminarily believes it is appropriate to limit the exemptions in this proposed order to cleared CDS entered into with eligible contract participants.[25]

B. Conditions for BD/FCMs

The first, second, fourth, fifth, and sixth BD/FCM conditions in the proposed order are largely consistent with the conditions in paragraphs (b)(1), (2), (4), (5) and (6) of the 2012 Order, respectively.[26] The first BD/FCM condition would consist of two requirements and apply with respect to transactions involving persons that *are not affiliates* of the BD/FCM (*i.e.*, cleared swaps customers).[27] Under the first requirement, the BD/FCM would need to maintain cleared swaps customer money, securities, and property received to margin, guarantee or secure cleared

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24 *See* Proposed Order, ¶ (a)(3). The 2012 order provided that each "customer" must be an eligible contract participant. 77 FR 75220. *See also* supra note 22.

25 The Dodd-Frank Act limits the swaps and security-based swaps transactions that may be entered into by parties that are not eligible contract participants. For example, under Section 6(l) of the Exchange Act, only an eligible contract participant may enter into security-based swaps that are not effected on a national securities exchange. 15 U.S.C. 78f(l). In addition, security-based swaps that are not registered pursuant to the Securities Act of 1933 ("Securities Act") can only be sold to eligible contract participants. 15 U.S.C. 77e(e). Section 5(e) of the Securities Act specifically provides that it shall be unlawful to for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell, offer to buy or purchase or sell a security-based swap to any person who is not an eligible contract participant, unless the transaction is registered under the Securities Act. *Id.*

26 *See* 2012 Order, 77 FR at 75216-19 (discussing the conditions) and 75220-21 (setting forth the conditions); Proposed Order, ¶¶ (b)(1), (2), (4), (5), and (6). The Commission made some technical and stylistic changes to these conditions, including replacing the term "shall" with "must" and capitalizing the first letter in each of the conditions (and their subparagraphs). Finally, the Commission inserted the phrase "Section 8 of the Exchange Act and" before "Exchange Act Rules 8c-1 and 15c2-1" in paragraph (b) of the proposed order to be consistent with the other rule references in the order, which refer to the relevant statute. *See* Proposed Order, ¶ (b).

27 *See* Proposed Order, ¶ (b)(1).

swaps customer positions consisting of cleared CDS in a CFTC cleared swaps customer account established and maintained for the purpose of the CDS portfolio margin program.[28] This condition is designed to help ensure that – in the absence of the security-based swap and securities customer protections afforded by the securities laws – collateral in the account is subject to the protections afforded by an alternative regulatory scheme (*i.e.*, the CEA and the CFTC's rules). The intent is to avoid having the assets in the account fall into a regulatory gap in which neither the federal securities laws nor the federal commodity futures laws apply. The condition also is designed to limit the relief to accounts that are established and maintained specifically for the purpose of the CDS portfolio margin program.

Under the second requirement, the BD/FCM would need to enter into a non-conforming subordination agreement with each non-affiliated cleared swaps customer that covers the customer's money, securities, or property held in a segregated account.[29] The non-conforming subordination agreement would need to contain: (1) a specific acknowledgment by the cleared swaps customer that such money, securities or property will not receive customer treatment under the Exchange Act or Securities Investor Protection Act of 1970 ("SIPA") or be treated as "customer property" as defined in 11 U.S.C. 741 in a liquidation of the BD/FCM ("stockbroker liquidation"), and that such money, securities or property will be subject to any applicable protections under Subchapter IV of Chapter 7 of Title 11 of the United States Code and rules and regulations thereunder ("commodity broker liquidation provisions"); and (2) an affirmation by the cleared swaps customer that claims to "customer property" as defined in SIPA or 11 U.S.C.

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28 *See* Proposed Order, ¶ (b)(1)(i). *See also* supra note 22 (discussing proposed change from the use of the generic term "customer" in the 2012 Order to "cleared swaps customer" in the proposed order).

29 *See* condition (b)(1)(ii) of 2012 Order.

741 against the BD/FCM will be subordinated to the claims of securities customers and security-based swap customers.

The 2012 Order required an affirmation by the customer that all of its claims with respect to such money, securities, or property against the BD/FCM will be subordinated to the claims of other securities customers and security-based swap customers not participating in the CDS portfolio margin program.[30] To better clarify that the cleared swaps customer is not subordinating claims to general creditors, the Commission is proposing to modify condition (b)(1)(ii) of the 2012 Order, as stated above, to provide that the cleared swaps customer must affirm that claims to "customer property" as defined in SIPA or the stockbroker liquidation provisions against the BD/FCM will be subordinated to the claims of securities customers and security-based swap customers. This modification is designed to more narrowly tailor the subordination to the portion of the debtor BD/FCM's estate that comprises "customer property" under SIPA and the stockbroker liquidation schemes.[31]

This proposed condition is designed to remove portfolio margin cleared swaps customers from the definitions of "customer" under Rule 15c3-3, SIPA, and the stockbroker liquidation provisions with respect to securities or cash held in CFTC cleared swaps accounts that otherwise would be subject to the segregation requirements of Rule 15c3-3 and the bankruptcy protections afforded by SIPA and the stockbroker liquidation provisions. The objective is to avoid a situation where the portfolio margin cleared swaps customers would be entitled to a ratable share of "customer property" and other protections afforded by SIPA or the stockbroker liquidation provisions even though their assets were held in CFTC cleared swaps customer accounts that

30 *See* 2012 Order, 77 FR at 75220.

31 *See supra* note 22.

were not subject to the segregation requirements of Rule 15c3-3. Assets held in a CFTC cleared swaps customer account would instead be afforded the protections of the rules of the CFTC governing the treatment of customer margin held by BD/FCMS and DCOs as well as the protections of the CEA and commodity broker liquidation provisions. The proposed condition is not intended to undermine these protections.

The proposed condition also is not intended to require portfolio margin cleared swaps customers to subordinate their claims, in the event that their claims as cleared swaps customers are not fully satisfied by the distribution of assets held in CFTC cleared swaps customer accounts, to assets that may be included in the debtor's general estate. In summary, this condition, along with the proposed disclosure conditions discussed below, is intended to help ensure that cleared swaps customers clearly understand that any security-based swap or securities customer protection treatment otherwise available with respect to securities transactions under the Exchange Act, SIPA, or the stockbroker liquidation provisions will not be available for cleared CDS held in a CFTC cleared swaps customer account.

The second BD/FCM condition in the proposed order would apply with respect to transactions involving *affiliates* of the BD/FCM and would consist of three requirements.[32] Under the first requirement, the BD/FCM would need to maintain money, securities, and property of affiliates received to margin, guarantee, or secure positions consisting of cleared CDS in a "cleared swaps proprietary account" as defined in CFTC Rule 22.1 for the purpose of clearing such positions under the CDS portfolio margin program.[33] The purpose of this requirement is that under the CFTC regulatory framework certain affiliates are not treated as

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32 *See* Proposed Order, ¶ (b)(2).

33 *See* Proposed Order, ¶ (b)(2)(i).

cleared swaps customers and their assets are held in proprietary accounts as distinct from CFTC cleared swaps customer accounts.[34]

Under the second requirement, the BD/FCM would need to enter into a non-conforming subordination agreement with an affiliate.[35] The non-conforming subordination agreement would need to contain: (1) a specific acknowledgment by the affiliate that such money, securities or property will not receive customer treatment under the Exchange Act or SIPA or be treated as customer property in a stockbroker liquidation of the BD/FCM, and that such money, securities or property will be held in a proprietary account in accordance with the CFTC requirements and will be subject to any applicable protections under the commodity broker liquidation provisions; and (2) an affirmation by the affiliate that claims to "customer property" as defined in SIPA or 11 U.S.C. 741 against the BD/FCM will be subordinated to the claims of securities customers and security-based swap customers.

For the reasons discussed above, the Commission is proposing to modify the text of the affirmation by an affiliate from the 2012 Order to more narrowly tailor the subordination to the portion of the debtor BD/FCM's estate that comprises "customer property" under SIPA and the stockbroker liquidation schemes.[36] This requirement is designed to help ensure that affiliates

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34 *See* 17 CFR 22.1. The Commission preliminarily believes that this condition is appropriate because affiliates of a BD/FCM that are not otherwise excluded from the definition of "customer" in Exchange Act Rules 8c-1 and 15c2-1 are customers whose securities positions cannot be commingled with the broker-dealer's own proprietary securities positions and therefore could not be held in a cleared swaps account.

35 *See* Proposed Order, ¶ (b)(2)(ii).

36 *See* Proposed Order, ¶ (b)(2)(ii). The 2012 Order required an affirmation by the affiliate that all of its claims with respect to such money, securities, or property against the BD/FCM will be subordinated to the claims of other securities customers and security-based swap customers not operating under a program to commingle and portfolio margin CDS. 77 FR at 75220. *See also supra* note 22. The modification would require the affiliate to affirm that that all of its claims to "customer property" as defined in SIPA or 11 U.S.C. 741 against the BD/FCM will be subordinated to the claims of securities customers and security-based swap customers.

clearly understand that any customer protection treatment otherwise available with respect to securities transactions under the Exchange Act, SIPA, or the stockbroker liquidation provisions will not be available and the account would be treated as a proprietary account (and not a CFTC cleared swaps customer account) under the CEA. Consistent with the proposed condition above with respect to cleared swaps customers that are not affiliates, this condition is intended to remove affiliates from the definitions of "customer" under Rule 15c3-3, SIPA, and the stockbroker liquidation provisions with respect to securities or cash held in cleared swaps proprietary accounts that otherwise would be subject to the segregation requirements of Rule 15c3-3 and the bankruptcy protections afforded by SIPA and the stockbroker liquidation provisions.

Under the third requirement, the BD/FCM would need to obtain from the affiliate an opinion of counsel that the affiliate is legally authorized to subordinate all of its claims against the BD/FCM to those of securities customers and security-based swap customers.[37] This condition is designed to help ensure that affiliates of the BD/FCM do not place any assets in the proprietary account that the affiliate is not legally authorized to subordinate.

The condition in paragraph (b)(3) of the 2012 Order provides that the BD/FCM must require minimum margin levels with respect to any customer transaction in the CDS portfolio margin program at least equal to the amount determined using a margin methodology established and maintained by the BD/FCM that has been approved by the Commission or the Commission staff.[38] A commenter responding to the issuance of the 2012 Order supported the requirement

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37 *See* Proposed Order, ¶ (b)(2)(iii). The 2012 Order required that the BD/FCM obtain from the affiliate an opinion of counsel that the affiliate is legally authorized to subordinate all of its claims against the BD/FCM to those of customers. 77 FR at 75220. *See also supra* note 22.

38 *See* condition (b)(3) of 2012 Order.

for a BD/FCM to assess the credit risk of counterparties based on the BD/FCM's own risk management standards, but argued that requiring a unique margin model beyond the BD/FCM's own credit risk assessment is unwarranted.[39] This commenter also stated that this condition "deters" efficiency, capital formation, and competition.[40] Another commenter responding to the issuance of the 2012 Order argued that the condition undermines a fundamental benefit of central clearing: the ability of market participants to rely on clearing agency/DCO margin requirements.[41] This commenter believes that this condition reduces transparency and the ability to anticipate and verify margin calls, and that it discourages entities from entering the cleared CDS market.[42]

In the context of the SEC's capital, margin and segregation rulemaking for SBSDs, another commenter expressed concern that the conditions in the 2012 Order have proven too restrictive to support a robust market for cleared CDS.[43] More specifically, this commenter

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39 *See* Letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association; Carl B. Wilkerson, Vice President & Chief Counsel, Securities & Litigation, American Council of Life Insurers; and Jiří Krol, Director of Government and Regulatory Affairs, Alternative Investment Management Association (Dec. 27, 2013) ("MFA/ACLI/AIMA 12/27/2013 Letter") (comment to the 2012 Order), *available at* https://www.sec.gov/comments/s7-13-12/s71312.shtml; *see also* Letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association; Carl B. Wilkerson, Vice President & Chief Counsel, Securities & Litigation, American Council of Life Insurers; and Jiří Krol, Director of Government and Regulatory Affairs, Alternative Investment Management Association (May 10, 2013) (comment to the 2012 Order), *available at* https://www.sec.gov/comments/s7-13-12/s71312.shtml.

40 MFA/ACLI/AIMA 12/27/2013 Letter.

41 *See* Letter from Adam C. Cooper, Senior Managing Director and Chief Legal Officer, Citadel LLC (Feb. 2, 2016) ("Citadel 2/2/16 Letter") (comment to the 2012 Order), *available at* https://www.sec.gov/comments/s7-13-12/s71312.shtml.

42 Citadel 2/2/16 Letter; Letter from Laura Harper Powell, Associate General Counsel, Managed Funds Association, and Adam Jacobs-Dean, Managing Director, Global Head of Markets Regulation, Alternative Investment Management Association (Nov. 19, 2018) (comment to the Commission's capital, margin, and segregation rulemaking for SBSDs), *available at* https://www.sec.gov/comments/s7-08-12/s70812.shtml.

43 *See* Letter from Walt L. Lukken, President and Chief Executive Office, Futures Industry Association (Nov. 29, 2018) ("FIA 11/29/18 Letter") (comment to the Commission's capital,

recommended that both the CFTC and SEC recognize a harmonized portfolio margin approach for cleared CDS that defers to the clearing agency/DCO margin methodologies.[44] Finally, a commenter expressed concern that the margin requirements imposed by the Commission have delayed voluntary buy-side clearing of single-name CDS, with resulting adverse effects on trading volume and liquidity.[45]

The vast majority of the BD/FCM clearing members of ICE Clear Credit have obtained approval of their margin methodologies from Commission staff.[46] Furthermore, each BD/FCM that has received approval of its margin methodology already had existing margin models in place prior to applying to the Commission. Therefore, the firms needed to make some adjustments to their models in order to meet the minimum qualitative and quantitative standards set forth in the BD/FCM staff letters, but did not need to develop new margin models. To date, all BD/FCMs that have submitted applications to Commission staff to approve their internal margin methodologies have received approval.

The Commission preliminarily believes that it would not be prudent for a BD/FCM to simply defer to the margin methodology of the clearing agency/DCO in terms of measuring and managing the risk of cleared CDS in a portfolio margin account, as requested by commenters.

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margin, and segregation rulemaking for SBSDs), *available at* https://www.sec.gov/comments/s7-08-12/s70812.shtml.

44 Letter from Walt L. Lukken, President and Chief Executive Office, Futures Industry Association (Nov. 19, 2018) (comment to the Commission's capital, margin, and segregation rulemaking for SBSDs), *available at* https://www.sec.gov/comments/s7-08-12/s70812.shtml; FIA 11/29/18 Letter.

45 *See* Letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association (May 18, 2017) (comment to the Commission's capital, margin, and segregation rulemaking for SBSDs), *available at* https://www.sec.gov/comments/s7-08-12/s70812.shtml.

46 *See* ICC membership, *available at* https://www.theice.com/clear-credit/participants. Based on Division staff experience in monitoring the CDS portfolio margin program, the vast majority of positions are being cleared through ICE Clear Credit, and to a lesser extent, ICE Clear Europe.

Prudent firms establish and maintain integrated internal risk management programs that include management policies and procedures designed to help ensure an awareness of, and accountability for, the risks taken throughout the firm and to develop tools to address those risks. For example, there may be idiosyncratic risk factors with respect to a cleared swaps customer, an affiliate, or the BD/FCM's financial condition that are not covered by the margin methodology of the clearing agency/DCO.

At the same time, the Commission also preliminarily believes that it can promote the prudent operation of the BD/FCMs through a process of approving their internal risk management programs (rather than their internal margin methodologies), as discussed below. This may increase transparency for market participants in terms of being able to anticipate margin requirements generated by their cleared CDS portfolios, as the clearing agency/DCO margin methodology will generate the regulatory margin requirement across all the BD/FCMs.[47] Accordingly, the Commission is proposing to modify the condition in paragraph (b)(3) of the 2012 Order to eliminate the requirement that the Commission or Commission staff approve the BD/FCM's margin methodology. Instead, the proposed order would require the BD/FCM to adopt an internal risk management program that is reasonably designed to identify, measure, and manage the risks arising from its participation in the CDS portfolio margin program that has been approved in advance by the Commission or the Commission staff and that meets the standards described below ("internal risk management program").[48]

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47 Nothing in the proposed order would preclude a BD/FCM from setting higher "house" margin requirements for some or all of its customers. *See* 17 CFR 39.13(g)(8).

48 *See* Proposed Order, ¶ (b)(3). The proposed order would contain a provision finding that the BD/FCMs that have received previous approval of their internal margin methodology from the Division staff would be deemed to have approved internal risk management programs for purposes of paragraph (b)(3) of the proposed order. These BD/FCMs would no longer be required to have minimum margin levels with respect to any customer transaction in a CDS portfolio margin program at least equal to the amount determined using a margin methodology

An internal risk management program would facilitate the identification, measurement, and management of a broader range of risks than those covered by the clearing agency/DCO margin methodology and, consequently, help ensure that the BD/FCMs operate in a prudent manner with respect to the CDS portfolio margin program. Further, an internal risk management program entails a more comprehensive set of measures to mitigate risk than a margin methodology.[49] Consequently, based on the Commission staff's experience gained in monitoring the CDS portfolio margin program, approving a firm's internal risk management program (rather than its internal margin methodology) may foster a more robust approach to managing risk by BD/FCMs. This approach to managing risk also will promote consistency with the Commission's final capital, margin, and segregation rules for SBSDs, which require such firms to be subject to a risk management rule, as well as with the regulatory approach adopted by the CFTC with respect to the portfolio margining of cleared CDS.[50] The proposed requirement to have an internal risk management program also is a condition in the BD/FCM staff letters and all the firms operating under the 2012 Order have implemented such programs.

The requirement that a BD/FCM independently measure risk by developing and using its own internal model is not designed to impose a margin collection requirement (or capital charge)

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approved by the Commission or the Commission staff, as required by the 2012 Order. They would instead comply the internal risk management program standards under condition (b)(3) of the proposed order.

49 *See, e.g.*, 17 CFR 240.15c3-1e(d)(1) ("The VaR model used to calculate market and credit risk for a position must be integrated into the daily internal risk management system of the broker or dealer[.]").

50 *See* Capital, Margin, and Segregation Adopting Release, 84 FR at 43905 ("The Commission proposed that nonbank SBSDs be required to comply with Rule 15c3-4 to promote the establishment of effective risk management control systems by these firms."); and 2013 CFTC Portfolio Margin Order (requiring participants to "take appropriate measures to identify, measure, and monitor financial risk associated with carrying the Security-Based CDS in a cleared swaps account and implement risk management procedures to address those financial risks").

or diminish the role of the clearing agency/DCO margin methodology. Rather, it is intended to require the BD/FCM to independently measure the potential future credit risk to cleared swaps customers and affiliates participating in the CDS portfolio margin program under a different stress scenario in order to better understand risks and address them as the firm deems appropriate (*e.g.*, through risk limits, threshold triggers, house margin, heightened monitoring, or other controls).

Under this proposed condition, a BD/FCM seeking approval of its internal risk management program would need to submit sufficient information for the Commission or Commission staff to be able to make a determination whether its program meets the proposed standards described below.[51] In reviewing this information, the Commission or the Commission staff would be guided by these standards. If a BD/FCM's internal risk management program is approved for purposes of this proposed order, the program would be subject to ongoing supervision and monitoring by the Commission.[52]

The first standard for the internal risk management program is that the BD/FCM would need to calculate a future credit exposure for each cleared swaps customer and affiliate (sometimes each a "counterparty") using a proprietary methodology that meets specified minimum quantitative and qualitative model standards ("internal risk model").[53] The quantitative standards would be that the internal risk model:

- Estimates a potential future exposure over a minimum 10-day horizon and 99% confidence level and captures all material risk factors, including but not limited to general

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51 *See generally* 17 CFR 240.15c3-1e(a)(1). A BD/FCM would only need to submit information to the extent it is relevant to the portfolio margining of cleared CDS. The BD/FCM may seek confidential treatment for information submitted as part of such application.

52 *See* Proposed Order, ¶ (c)(1)(ii)(D).

53 *See* Proposed Order, ¶ (c)(1).

movements in credit spread term structure, basis risk between index and single name positions, and interest rate risk;

- Includes a concentration/liquidity requirement; and

- Includes a jump-to-default requirement for the sale of CDS protection equal to the largest loss of a single name exposure assuming a conservative recovery rate that may not exceed 40%.

The qualitative standards would require that:

- The internal risk model must be adequately documented and the model documentation must provide a description of the model assumptions, data inputs, parameters, and methodologies employed to measure risk;

- The internal risk model must be subject to an annual model review by a model group that is independent of the business function;

- The internal risk model must be subject to at least quarterly backtesting by counterparty or account; and

- The BD/FCM must provide written notice to the Commission or Commission staff prior to implementing any material change to its internal risk model.

These quantitative and qualitative requirements generally are consistent with the quantitative and qualitative requirements for internal risk models under Appendix E to Rule 15c3-1 and under new Rule 18a-1. These rules permit certain broker-dealers and SBSDs, respectively, to compute capital charges using internal models.[54] For example, the standards in the proposed order generally would require that the model cover a 10-day horizon, 99% confidence level, and material risks, and that the BD/FCM backtest the model and subject it to review.[55]

The second standard for the internal risk management program is that it would need to have the following minimum risk management system standards:

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54 *See* 17 CFR 240.15c3-1e and 18a-1; and Capital, Margin, and Segregation Adopting Release.

55 *See* 17 CFR 15c3-1e(d).

- The BD/FCM would need standards to measure and manage risk exposure arising from counterparties' CDS portfolios that are independent of any central counterparty margin methodology;

- The BD/FCM would need to have an internal credit risk rating model that assesses the credit risk of each individual counterparty;

- The BD/FCM's monitoring of credit risk would need to include the prudent setting of an exposure limit for each individual counterparty, and the exposure limit would need to be reviewed if the counterparty's credit risk profile changes and at least quarterly;

- The BD/FCM would need to have the ability to limit or reduce the exposure to a counterparty through the collection of additional margin;

- The BD/FCM would need to have documented procedures to value positions conservatively in view of current market prices and the amount that might be realized upon liquidation; and

- The BD/FCM would need to have well-defined procedures and systems in place for the daily collection and payment of initial and variation margin.[56]

This proposed standards requirement is a condition in the BD/FCM staff letters. These proposed risk management standards are designed to require a BD/FCM to take prudent measures to protect the firm from losses that can result from failing to account for and control risk with respect to its CDS portfolio margin program. Requiring a BD/FCM to incorporate these proposed standards is designed to promote the establishment of effective internal risk management programs to address the risks of portfolio margining cleared CDS.

The third standard for the internal risk management program is that the BD/FCM would need to report to the Commission and FINRA staffs on a monthly basis within 5 business days after month end or as otherwise requested details of its top 25 counterparties' portfolios as measured by net credit exposure as well as the top 25 counterparties' portfolios as measured by

[56] *See* Proposed Order, ¶ (c)(2).

gross notional amount.[57] This proposed requirement is a condition in the BD/FCM staff letters. Based on Commission staff's experience with the BD/FCM staff letter requirements, the Commission preliminarily believes that it would be appropriate to require this monthly reporting as it will assist Commission staff in monitoring the risk to the BD/FCM arising from its portfolio margining of cleared CDS. Understanding the magnitude of this risk will assist the Commission staff in evaluating the appropriateness of a given firm's internal risk management program in terms of its procedures and controls to mitigate risk.

The proposed order would not include other conditions in the BD/FCM staff letters, including the capital concentration charge. Based on Commission staff experience monitoring the BD/FCMs participating in the CDS portfolio margin program, the Commission preliminarily believes that the capital concentration charge and other conditions in the BD/FCM staff letters may not be necessary in light of the requirement to have a reasonably designed internal risk management program. A reasonably designed internal risk management program will provide a BD/FCM the tools to better understand the risks that arise from its portfolio margining of cleared CDS and address them as the firm deems appropriate (*e.g.*, through risk limits, threshold triggers, house margin, heightened monitoring, or other controls). Therefore, the Commission is proposing not to incorporate these conditions into the proposed order.

The fourth BD/FCM condition in the proposed order would require that the BD/FCM be in compliance with applicable laws and regulations relating to risk management, capital, and liquidity, and be in compliance with applicable clearing agency/DCO rules and CFTC requirements (including margin, segregation, and related books and records provisions) with respect to CFTC cleared swaps customer accounts and cleared swaps proprietary accounts

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57 *See* Proposed Order, ¶ (c)(3).

subject to the CDS portfolio margin program.[58] The purpose of this condition is to help ensure that the exemption is available only when the BD/FCM is in compliance with applicable regulatory requirements.

The fifth BD/FCM condition in the proposed order would require that each cleared swaps customer and affiliate of the BD/FCM participating in the CDS portfolio margin program be an "eligible contract participant."[59] As with the third condition in the proposed order for clearing agency/DCOs, the Commission preliminarily believes it would be appropriate to limit the availability of this exemption to eligible contract participants. Eligible contract participants should have the expertise or resources to effectively determine the risks associated with engaging in these types of transactions.

The sixth BD/FCM condition in the proposed order would require that, before receiving any money, securities, or property of a cleared swaps customer or affiliate to margin, guarantee, or secure positions consisting of cleared CDS, the BD/FCM would need to furnish to the cleared swaps customer or affiliate a disclosure document containing: (1) a statement indicating that the cleared swaps customer's or affiliate's money, securities, and property will be held in a CFTC cleared swaps account, and that the cleared swaps customer or affiliate has elected to seek protections under the commodity broker liquidation provisions with respect to such money, securities, and property; and (2) a statement that the broker-dealer segregation requirements of Sections 15(c)(3) and 3E of the Exchange Act and the rules thereunder, and any customer protections under SIPA and the stockbroker liquidation provisions, will not apply to such cleared

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58 *See* Proposed Order, ¶ (b)(4). *See also* supra note 22.

59 *See* Proposed Order, ¶ (b)(5). The 2012 Order requires that each customer of the BD/FCM participating in a program to commingle and portfolio margin CDS be an "eligible contract participant" as defined in Section 1a(18) of the CEA. 77 FR at 75220. *See also supra* note 22.

swaps customer or affiliate money, securities, and property.[60] The disclosure document would need to be provided to the cleared swaps customer or affiliate at or prior to the time that the cleared swaps customer or affiliate opens the CFTC cleared swaps account and, in all cases, prior to the BD/FCM receiving any money, securities or property into the CFTC cleared swaps account of the cleared swaps customer or affiliate. This condition is designed to provide market participants that elect to participate in the CDS portfolio margin program with important disclosures regarding the legal framework that will govern their transactions.

Accordingly, pursuant to its authority under Sections 3E(c)(2)[61] and 36[62] of the Exchange Act, the Commission preliminarily believes that the proposed order, under the terms and conditions described above, would be necessary or appropriate in the public interest and consistent with the protection of investors.

IV. Request for Comments

The Commission is seeking comment on all aspects of the proposed exemption. In particular, the Commission requests comment on the following questions. When responding to the request for comment, please explain your reasoning.

1. Should any of the proposed exemptions or conditions be eliminated or modified?

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60 *See* Proposed Order, ¶ (b)(6). *See also* supra note 22.

61 15 U.S.C. 78c-5(c)(2). Section 3E(c)(2) of the Exchange Act provides that the Commission may, notwithstanding Section 3E(b) of the Exchange Act, by rule, regulation, or order prescribe terms and conditions under which any money, securities, or property of a customer with respect to cleared security-based swaps may be commingled and deposited with any other money, securities, or property received by the broker-dealer or SBSD and required by the Commission to be separately accounted for and treated and dealt with as belonging to the security-based swap customer of the broker-dealer or SBSD.

62 15 U.S.C. 78mm. Section 36 of the Exchange Act authorizes the Commission to conditionally or unconditionally exempt, by rule, regulation, or order any person, security, or transaction (or any class or classes of persons, securities, or transactions) from any provision of the Exchange Act or any rule or regulation thereunder, to the extent such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

2. Are there other or different conditions that should apply to the proposed exemption?
3. Are there any specific written disclosures to cleared swaps customers or affiliates that a BD/FCM should be required to provide in addition to those that are a condition to the proposed exemption?
4. At what stage during the account opening process does the cleared swaps customer or affiliate enter into a non-conforming subordination agreement as required by the 2012 Order? Is it before, at the same time, or after the cleared swaps customer or affiliate receives the required written disclosures from the BD/FCM? Should the proposed condition related to the written disclosure document be modified to require that the BD/FCM furnish it to the cleared swaps customer or affiliate before the customer enters into the non-conforming subordination agreement with the BD/FCM (and before the BD/FCM receives any money, securities, or property to margin the CDS positions)?
5. Does the proposed modified text required in the non-conforming subordination agreements achieve the objectives of: (1) removing portfolio margin cleared swaps customers and affiliates from the definitions of "customer" under Rule 15c3-3, SIPA, and the stockbroker liquidation provisions with respect to securities or cash held in CFTC cleared swaps accounts; (2) not undermining the protections afforded to the portfolio margin cleared swaps customers and affiliates under the rules of the CFTC, the CEA, and commodity broker liquidation provisions; and (3) not requiring portfolio margin cleared swaps customers or affiliates to subordinate their claims, in the event that their cleared swaps customer or affiliate claims are not fully satisfied by the distribution of assets held in their CFTC cleared swaps accounts, to assets that

may be included in the debtor's general estate? Is there alternative language that would better achieve these objectives? Does the text in the 2012 Order achieve these objectives? If this modification or some other modification were made to the order, would it require BD/FCMs to amend all their existing agreements with cleared swaps customers and affiliates participating in the portfolio margin program? If so, would this be a significant burden?

6. Should clearing agencies/DCOs be required to provide market participants with the ability to select an SEC SBS account as an alternative to a CFTC cleared swaps account?
7. Have market participants expressed an interest in portfolio margining cleared CDS in an SEC SBS account? If so, how has this interest changed since 2012?
8. Would there be interest by BD/FCMs in offering market participants the option to portfolio margin cleared CDS in an SEC SBS account after the October 6, 2021 compliance date for the SEC's final capital, margin, and segregation rules for security-based swaps, when the customer protection framework for security-based swaps is in place?
9. If there was no regulatory requirement to provide market participants with the ability to select an SEC SBS account as an alternative to a CFTC cleared swaps account, would clearing agencies/DCOs be incentivized to offer such an alternative in the future, if market conditions changed and demand rose for an SEC SBS account alternative?
10. Are the proposed standards for the BD/FCM's internal risk management program appropriate?

11. Is it appropriate for the proposed order to deem a BD/FCM to have an internal risk management program that has been approved by the Commission or the Commission staff as required by paragraph (b)(3) of the proposed order if it has received prior approval of its margin methodology?

12. Would the proposed exemption have a competitive impact – either positive or negative – on market participants in the context of CDS clearing? What would be the potential benefits and costs of the proposed exemption? Would the proposed modifications to the 2012 Order impact investor protection? If so, what would those impacts be?

By the Commission.

J. Matthew DeLesDernier
Assistant Secretary

APPENDIX

Text of Proposed Order

It is hereby ordered that any broker-dealer also registered as a futures commission merchant that has received approval of its margin methodology by the Commission or Commission staff prior to the date of this order is deemed to have an internal risk management program that has been approved by the Commission or the Commission staff as required by paragraph (b)(3) of this order.

It is hereby further ordered, pursuant to Section 3E(c)(2) and Section 36 of the Securities Exchange Act of 1934 ("Exchange Act"), that the following exemptions from Exchange Act requirements will apply:

(a) *Exemption for dually-registered clearing agencies/derivatives clearing organizations*. A clearing agency registered pursuant to Section 17A of the Exchange Act and registered as a derivatives clearing organization pursuant to Section 5b of the CEA (a "clearing agency/DCO") will be exempt from Sections 3E(b), (d), and (e) of the Exchange Act and any rules thereunder, solely to perform the functions of a clearing agency for credit default swaps ("CDS") under a program to commingle and portfolio margin cleared CDS for cleared swaps customer and affiliate positions, subject to the following conditions:

(1) The clearing agency/DCO has obtained any other relief needed to permit its clearing members that are registered under Section 15(b) of the Exchange Act (other than paragraph (11) thereof) and also registered as a futures commission merchant pursuant to Section 4f(a)(1) of the CEA (a "BD/FCM") (at the BD/FCM's election), to maintain cleared swaps customer or affiliate money, securities, and property received by the BD/FCM to margin, guarantee, or secure cleared swaps customer or affiliate positions in cleared CDS, which include both swaps and security-

based swaps, in a segregated account established and maintained in accordance with Section 4d(f) of the CEA and rules thereunder (in the case of a cleared swaps customer) or a cleared swaps proprietary account (in the case of an affiliate) for the purpose of clearing (as a clearing member of the clearing agency/DCO) such cleared swaps customer or affiliate positions under a program to commingle and portfolio margin CDS.

(2) The clearing agency/DCO has appropriate rules and operational practices to permit a BD/FCM that is a clearing member (at the BD/FCM's election) to maintain cleared swaps customer or affiliate money, securities, and property received by the BD/FCM to margin, guarantee, or secure cleared swaps customer or affiliate positions in cleared CDS, which include both swaps and security-based swaps, in a segregated account established and maintained in accordance with Section 4d(f) of the CEA and rules thereunder (in the case of a cleared swaps customer) or a cleared swaps proprietary account (in the case of an affiliate) for the purpose of clearing (as a clearing member of the clearing agency/DCO) such cleared swaps customer or affiliate positions under a program to commingle and portfolio margin CDS.

(3) The rules of the clearing agency/DCO require that each cleared swaps customer and affiliate of the BD/FCM participating in a program to commingle and portfolio margin CDS must be an "eligible contract participant" as defined in Section 1a(18) of the CEA.

(b) *Exemption for certain BD/FCMs that elect to offer a program to commingle and portfolio margin cleared swaps customer and affiliate positions in cleared CDS.* Solely to perform the functions of a BD/FCM for cleared CDS, with respect to any cleared swaps customer or affiliate money, securities, and property received by the BD/FCM to margin, guarantee, or secure cleared swaps customer or affiliate positions in security-based swaps included in a segregated account established and maintained in accordance with Section 4d(f) of

the CEA and rules thereunder (in the case of a cleared swaps customer) or a cleared swaps proprietary account (in the case of an affiliate) under a program to commingle and portfolio margin cleared swaps customer or affiliate positions in CDS, a BD/FCM will be exempt from Exchange Act Sections 3E(b), (d), and (e), and Section 15(c)(3) and Rule 15c3-3 thereunder and any requirement to treat an affiliate (as defined in association with the definition of "cleared **s**waps proprietary account" pursuant to CFTC Rule 22.1) as a customer for purposes of Section 8 of the Exchange Act and Exchange Act Rules 8c-1 and 15c2-1 thereunder, subject to the following conditions:

(1) With respect to cleared swaps customers that are not affiliates of the BD/FCM,

(i) The BD/FCM must maintain cleared swaps customer money, securities, and property received to margin, guarantee or secure cleared swaps customer positions consisting of cleared CDS, which include both swaps and security-based swaps, in a segregated account established and maintained in accordance with Section 4d(f) of the CEA and rules thereunder for the purpose of clearing (as a clearing member or through a clearing member of a clearing agency/DCO operating pursuant to the exemption in paragraph (a) above) such cleared swaps customer positions under a program to commingle and portfolio margin CDS; and

(ii) The BD/FCM must enter into a non-conforming subordination agreement with each cleared swaps customer. The agreement must contain a specific acknowledgment by the cleared swaps customer that such money, securities or property will not receive customer treatment under the Exchange Act or SIPA or be treated as "customer property" as defined in 11 U.S.C. 741 in a liquidation of the BD/FCM and that such money, securities or property will be subject to any applicable protections under Subchapter IV of Chapter 7 of Title 11 of the United States Code and rules and regulations thereunder; as well as an affirmation by the cleared swaps

customer that claims to "customer property" as defined in SIPA or 11 U.S.C. 741 against the BD/FCM will be subordinated to the claims of securities customers and security-based swap customers.

(2) With respect to affiliates of the BD/FCM,

(i) The BD/FCM maintains money, securities, and property of affiliates received to margin, guarantee, or secure positions consisting of cleared CDS, which include both swaps and security-based swaps, in a cleared swaps proprietary account for the purpose of clearing (as a clearing member of a clearing agency/DCO operating pursuant to the exemption in paragraph (a) above) such positions under a program to commingle and portfolio margin CDS;

(ii) The BD/FCM enters into a non-conforming subordination agreement with each affiliate. The agreement must contain a specific acknowledgment by the affiliate that such money, securities or property will not receive customer treatment under the Exchange Act or SIPA or be treated as "customer property" as defined in 11 U.S.C. 741 in a liquidation of the BD/FCM, and that such money, securities or property will be held in a proprietary account in accordance with the CFTC requirements and will be subject to any applicable protections under Subchapter IV of Chapter 7 of Title 11 of the United States Code and rules and regulations thereunder; as well as an affirmation by the affiliate that claims to "customer property" as defined in SIPA or 11 U.S.C. 741 against the BD/FCM will be subordinated to the claims of securities customers and security-based swap customers; and

(iii) The BD/FCM obtains from the affiliate an opinion of counsel that the affiliate is legally authorized to subordinate all of its claims against the BD/FCM to those of securities customers and security-based swap customers.

(3) The BD/FCM has adopted an internal risk management program that is reasonably designed to identify, measure, and manage the risks arising from its program to allow cleared swaps customers and affiliates to commingle and portfolio margin CDS that has been approved in advance by the Commission or the Commission staff and meets the standards in section (c) below.

(4) The BD/FCM must be in compliance with applicable laws and regulations relating to risk management, capital, and liquidity, and must be in compliance with applicable clearing agency/DCO rules and CFTC requirements (including segregation and related books and records provisions) for accounts established and maintained in accordance with Section 4d(f) of the CEA and rules thereunder (in the case of cleared swaps customers) and for cleared swaps proprietary accounts (in the case of affiliates), and subject to a program to commingle and portfolio margin CDS.

(5) Each cleared swaps customer and affiliate of the BD/FCM participating in a program to commingle and portfolio margin CDS is an "eligible contract participant" as defined in Section 1a(18) of the CEA.

(6) Before receiving any money, securities, or property of a cleared swaps customer or affiliate to margin, guarantee, or secure positions consisting of cleared CDS, which include both swaps and security-based swaps, under a program to commingle and portfolio margin CDS, the BD/FCM must furnish to the cleared swaps customer or affiliate a disclosure document containing the following information:

(i) A statement indicating that the cleared swaps customer's or affiliate's money, securities, and property will be held in an account maintained in accordance with the segregation requirements of Section 4d(f) of the CEA (in the case of a cleared swaps customer) or a cleared

swaps proprietary account (in the case of an affiliate), and that the cleared swaps customer or affiliate has elected to seek protections under Subchapter IV of Chapter 7 of Title 11 of the United States Code and the rules and regulations thereunder with respect to such money, securities, and property; and

(ii) A statement that the broker-dealer segregation requirements of Section 15(c)(3) and Section 3E of the Exchange Act and the rules thereunder, and any customer protections under SIPA and the stockbroker liquidation provisions, will not apply to such cleared swaps customer or affiliate money, securities, and property.

(c) *Standards for internal risk management program*. The internal risk management program required pursuant to condition (b)(3) of this order must have the following standards in place:

(1) *Internal Risk Model.* The BD/FCM must calculate a future credit exposure for each cleared swaps customer and affiliate (each a "counterparty") using its own proprietary methodology ("internal risk model") subject to the following minimum quantitative and qualitative model standards:

(i) *Quantitative Requirements*. (A) The internal risk model must estimate a potential future exposure over a minimum 10-day horizon and 99% confidence level and capture all material risk factors, including but not limited to general movements in credit spread term structure, basis risk between index and single name positions, and interest rate risk;

(B) The internal risk model must include a concentration/liquidity requirement; and

(C) The internal risk model must include a jump-to-default requirement for the sale of CDS protection equal to the largest loss of a single name exposure assuming a conservative recovery rate that may not exceed 40%.

(ii) *Qualitative Requirements*. (A) The internal risk model must be adequately documented and the documentation must provide a description of the model assumptions, data inputs, parameters, and methodologies employed to measure risk;

(B) The internal risk model must be subject to an annual model review by a model group that is independent of the business function;

(C) The internal risk model must be subject to at least quarterly backtesting by counterparty or account; and

(D) The BD/FCM must provide written notice to the Commission or Commission staff prior to implementing any material change to its internal risk model.

(2) *Minimum Risk Management System Standards*. (A) The BD/FCM must maintain risk management system standards to measure and manage risk exposure arising from counterparties' CDS portfolios that are independent of any central counterparty margin methodology;

(B) The BD/FCM must have an internal credit risk rating model that assesses the credit risk of each individual counterparty;

(C) The BD/FCM's monitoring of credit risk must include the prudent setting of an exposure limit for each individual counterparty and the exposure limit must be reviewed if the counterparty's credit risk profile changes and at least quarterly;

(D) The BD/FCM must have the ability to limit or reduce the exposure to a counterparty through the collection of additional margin;

(E) The BD/FCM must have documented procedures to value positions conservatively in view of current market prices and the amount that might be realized upon liquidation; and

(F) The BD/FCM must have well-defined procedures and systems in place for the daily collection and payment of initial and variation margin.

(3) *Monthly Reporting*. The BD/FCM must report to the Commission and FINRA staffs on a monthly basis within 5 business days after month end or as otherwise requested details of its top 25 counterparties' portfolios as measured by net credit exposure as well as the top 25 counterparties' portfolios as measured by gross notional amount.