

SEC SIMPLIFIES RULES FOR “COVERED CLEARING AGENCIES”

On April 9, 2020, the Securities and Exchange Commission (“SEC”) acted on its proposal published in 2016 and adopted rules that are designed to simplify the scope of “covered clearing agency” in Rule 17Ad-22(a)(5) under the Securities Exchange Act of 1934 (“Exchange Act”). The amendments provide greater clarity as to which clearing agencies are subject to the more rigorous standards in Exchange Act Rule 17Ad-22(e).¹ As adopted, the requirements of Rule 17Ad-22(e) are limited to clearing agencies registered with the SEC that provide central counterparty or central securities depository services. Clearing agencies that are not covered clearing agencies continue to be subject to the requirements of Rule 17Ad-22(d).

As noted by the SEC, prior to the amendments, the definition of “covered clearing agency” required a subjective analysis of multiple concepts and factors.² The SEC was concerned that such analyses could result in conflicting outcomes, competitive asymmetries between registered clearing agencies that otherwise provide similar clearing agency services, and impair public trust stemming from different regulatory behaviors and outcomes across clearing agencies that provide the same clearing agency services and present similar risks to the U.S. securities markets.

The adopted definition states that a “covered clearing agency” is a registered clearing agency that provides services as a central counterparty (“CCP”) or a central securities depository (“CSD”). The definition of CCP is unchanged in Rule 17Ad-22(a)(2) as “a clearing agency that interposes itself between the counterparties to securities transactions, acting functionally as the buyer to every seller and the seller to every buyer.” Although CCPs encompass a wide variety of services, the SEC noted that “the essence of a CCP is its role in managing and mitigating credit exposures and liquidity risk.”³

The definition of CSD in Rule 17Ad-22(a)(3) has been clarified so that its coverage is the same as the statutory scope in Section 3(a)(23)(A) of the Exchange Act.⁴

The SEC had proposed to include a clearing agency that was a “securities settlement system” in the definition of covered clearing agency. That term would have applied to a clearing agency that “enables securities to be transferred and settled by book entry according to a set of predetermined multilateral rules.” The proposal received adverse commentary as being unclear, ambiguous, and superfluous. The SEC essentially agreed with the

**MURPHY &
McGONIGLE**
A Professional Corporation

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For more information:

LARRY BERGMANN

Murphy & McGonigle

202-661-7032

lbergmann@mmlawus.com

JACK DROGIN

Murphy & McGonigle

202-220-1936

jdrogin@mmlawus.com

¹ Exchange Act Release No. 88616 (April 9, 2020) (“Adopting Release”), <https://www.sec.gov/rules/final/2020/34-88616.pdf>.

² Adopting Release at 6-7. The factors included “whether the registered clearing agency is involved in activities with a more complex risk profile.”

³ Id. at 11.

⁴ The SEC believes that the concepts of CCP and CSD “have become widespread and well-known among market participants, and therefore the Commission believes that using terminology consistent with industry practice in the definition of ‘covered clearing agency’ should help enhance the public’s understanding of the relevant clearing agency services that meet the definition.” Adopting Release at 8-9.

commenters and decided not to include this part of the proposal, because the services of a securities settlement system have not been, and are not currently, offered as standalone services by any clearing agency.⁵

Finally, the amendments addressed the definition of the “sensitivity analysis” in Rule 17Ad-22(a)(16). As explained by the SEC, “a covered clearing agency that provides CCP services must establish, implement, maintain and enforce written policies and procedures reasonably designed to regularly review, test, and verify its risk-based margin system by conducting a sensitivity analysis of its margin model, among other things.”⁶ The adopted amendments did not substantively change the requirements. The provision now requires a CCP to conduct an analysis that involves “analyzing the sensitivity of a model to its assumptions, parameters, and inputs that (i) considers the impact on the model of both moderate and extreme changes in a wide range of inputs, parameters, and assumptions, including correlations of price movements or returns if relevant, which reflect a variety of historical and hypothetical market conditions; (ii) uses actual portfolios and, where applicable, hypothetical portfolios that reflect the characteristics of proprietary positions and customer positions; (iii) considers the most volatile relevant periods, where practical, that have been experienced by the markets served by the clearing agency; and (iv) tests the sensitivity of the model to stressed market conditions, including the market conditions that may ensue after the default of a member and other extreme but plausible conditions as defined in a covered clearing agency’s risk policies.”⁷

While the amendments provide some clarity to the definition “covered clearing agency,” interpretive questions remain in the definition of “clearing agency” itself, including the scope of covered securities depository activities.⁸ Moreover, the scope of “covered clearing agency” is potentially narrower and broader than the previous definition. It is narrower in the sense that only those entities acting as a CCP or a CSD are covered. It is broader on the sense that the term is no longer limited to clearing agencies that have been designated as systemically important by the Financial Stability Oversight Council or that are involved in activities with a complex risk profile as in the superseded definition.⁹ Two additional considerations should be mentioned: (1) the term is limited to *registered* clearing agencies, i.e., entities registered with the SEC pursuant to Section 17A(b) of the Exchange Act;¹⁰ and (2) various entities that may provide CCP or CSD functions are excluded from the definition of “clearing agency” by virtue of Section 3(a)(23)(B) of the Exchange Act.

⁵ Adopting Release at 16-17.

⁶ *Id.* at 14.

⁷ *Id.* at 14-15. Although a commenter recommended that the SEC refer specifically to reverse stress testing in the amendments to the rule, the SEC declined to do so because it is a distinct concept from sensitivity analysis, and noted that a clearing agency retained flexibility to incorporate reverse stress testing in its stress testing framework. *Id.* at 15.

⁸ Exchange Act 3(a)(23)(A).

⁹ One additional registered clearing agency now meets the definition of a “covered clearing agency” and is subject to the requirements of Rule 17Ad-22(e). Adopting Release at 9 n.21.

¹⁰ The superseded definition was not limited to “registered” clearing agencies. Some entities perform clearing agency functions but have been granted exemptions by the SEC from registration as clearing agencies. See, e.g., Exchange Act Release No. 76514 (November 24, 2015) (exemptions for Bloomberg STP, LLC, and SS&C Technologies, Inc.).