

of which is to alter, supplement, or require a derivatives clearing organization to adopt a specific rule or procedure, or to take or refrain from taking a specific action.

**§39.7 Fraud in connection with the clearing of transactions on a derivatives clearing organization.**

It shall be unlawful for any person, directly or indirectly, in or in connection with the clearing of transactions by a derivatives clearing organization:

- (a) To cheat or defraud or attempt to cheat or defraud any person;
- (b) Willfully to make or cause to be made to any person any false report or statement or cause to be entered for any person any false record; or
- (c) Willfully to deceive or attempt to deceive any person by any means whatsoever.

**APPENDIX A TO PART 39—APPLICATION GUIDANCE AND COMPLIANCE WITH CORE PRINCIPLES**

This appendix provides guidance concerning the core principles with which applicants must demonstrate the ability to comply and with which registered derivatives clearing organizations must continue to comply to be granted and to maintain registration as a derivatives clearing organization under section 5b of the Act and §39.3 and §39.5 of the Commission's regulations. The guidance follows each core principle and can be used to demonstrate core principle compliance under §39.3(a)(iv) and §39.5(d). The guidance for each core principle is illustrative only of the types of matters a clearing organization may address, as applicable, and is not intended to be a mandatory checklist. Addressing the criteria set forth in this appendix would help the Commission in its consideration of whether the clearing organization is in compliance with the core principles. To the extent that compliance with, or satisfaction of, a core principle is not self-explanatory from the face of a clearing organization's rules, an application pursuant to §39.3 or a submission pursuant to §39.5 should include an explanation or other form of documentation demonstrating that the clearing organization is able to or does comply with the core principles.

*Core Principle A: IN GENERAL—To be registered and to maintain registration as a derivatives clearing organization, an applicant shall demonstrate to the Commission that the applicant complies with the core principles specified in this paragraph. The applicant shall have reasonable discretion in establishing the manner in which it complies with the core principles.*

An entity preparing to submit to the Commission an application to operate as a derivatives clearing organization is encouraged to contact Commission staff for guidance and assistance in preparing its application. Applicants may submit a draft application for review prior to the submission of an actual application without triggering the application review procedures of §39.3 of the Commission's regulations. The Commission also may require a derivatives clearing organization to demonstrate to the Commission that it is operating in compliance with one or more core principles.

**Core Principle B: FINANCIAL RESOURCES**—The applicant shall demonstrate that the applicant has adequate financial, operational, and managerial resources to discharge the responsibilities of a derivatives clearing organization.

In addressing Core Principle B, applicants and registered derivatives clearing organizations may describe or otherwise document:

- 1. The resources dedicated to supporting the clearing function:
  - a. The level of resources available to the clearing organization and the sufficiency of those resources to assure that no material adverse break in clearing operations will occur in a variety of market conditions; and
  - b. The level of member/participant default such resources could support as demonstrated through use of hypothetical default scenarios that explain assumptions and variables factored into the illustrations.
- 2. The nature of resources dedicated to supporting the clearing function:
  - a. The type of the resources, including their liquidity, and how they could be accessed and applied by the clearing organization promptly;
  - b. How financial and other material information will be updated and reported to members, the public, if and when appropriate, and to the Commission on an ongoing basis; and
  - c. Any legal or operational impediments or conditions to access.

**Core Principle C: PARTICIPANT AND PRODUCT ELIGIBILITY**—The applicant shall establish (i) appropriate admission and continuing eligibility standards (including appropriate minimum financial requirements) for members of and participants in the organization; and (ii) appropriate standards for determining eligibility of agreements, contracts, or transactions submitted to the applicant.

In addressing Core Principle C, applicants and registered derivatives clearing organizations may describe or otherwise document:

- 1. Member/participant admission criteria:
  - a. How admission standards for its clearing members/participants would contribute to the soundness and integrity of operations; and
  - b. Matters such as whether these criteria would be in the form of organization rules

that apply to all clearing members/participants, whether different levels of membership/participation would relate to different levels of net worth, income, and credit-worthiness of members/participants, and whether margin levels, position limits and other controls would vary in accordance with these levels.

2. Member/participant continuing eligibility criteria:

a. A program for monitoring the financial status of its members/participants; and

b. Whether and how the clearing organization would be able to change continuing eligibility criteria in accordance with changes in a member's/participant's financial status.

3. Criteria for instruments acceptable for clearing:

a. The criteria, and the factors considered in establishing the criteria, for the types of agreements, contracts, or transactions it will clear; and

b. How those criteria take into account the different risks inherent in clearing different agreements, contracts, or transactions and how they affect maintenance of assets to support the guarantee function in varying risk environments.

4. The clearing function for each instrument the organization undertakes to clear.

*Core Principle D: RISK MANAGEMENT—The applicant shall have the ability to manage the risks associated with discharging the responsibilities of a derivatives clearing organization through the use of appropriate tools and procedures.*

In addressing Core Principle D, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Use of risk analysis tools and procedures:

a. How the adequacy of the overall level of financial resources would be tested on an ongoing periodic basis in a variety of market conditions;

b. How the organization would use specific risk management tools such as stress testing and value at risk calculations; and

c. What contingency plans the applicant has for managing extreme market events.

2. Use of collateral:

a. What forms and levels of collateral would be established and collected;

b. How amounts would be adequate to secure prudentially obligations arising from clearing transactions and, where applicable, performing as a central counterparty;

c. The factors considered in determining appropriate margin levels for an instrument cleared and for clearing members/participants;

d. The appropriateness of required or allowed forms of margin given the liquidity and related requirements of the clearing organization;

e. How the clearing organization would value open positions and collateral assets; and

f. The proposed margin collection schedule and how it would relate to changes in the value of market positions and collateral values.

3. Use of credit limits:

If systems would be implemented that would prevent members/participants and other market participants from exceeding credit limits and how they would operate.

*Core Principle E: SETTLEMENT PROCEDURES—The applicant shall have the ability to (i) complete settlements on a timely basis under varying circumstances; (ii) maintain an adequate record of the flow of funds associated with each transaction that the applicant clears; and (iii) comply with the terms and conditions of any permitted netting or offset arrangements with other clearing organizations.*

In addressing Core Principle E, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Settlement timeframe:

a. Procedures for completing settlements on a timely basis during times of normal operating conditions; and

b. Procedures for completing settlements on a timely basis in varying market circumstances including during a period when one or more significant members/participants have defaulted.

2. Recordkeeping:

a. The nature and quality of the information collected concerning the flow of funds involved in clearing and settlement; and

b. How such information would be recorded, maintained and accessed.

3. Interfaces with other clearing organizations:

How compliance with the terms and conditions of netting or offset arrangements with other clearing organizations would be met, including, among others, common banking or common clearing programs.

*Core Principle F: TREATMENT OF FUNDS—The applicant shall have standards and procedures designed to protect and ensure the safety of member and participant funds.*

In addressing Core Principle F, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Safe custody:

a. The safekeeping of funds, whether in accounts, in depositories, or with custodians, and how it would meet industry standards of safety;

b. Any written terms regarding the legal status of the funds and the specific conditions or prerequisites for movement of the funds; and

c. The extent to which the deposit of funds in accounts in depositories or with custodians would limit concentration of risk.

2. Segregation between customer and proprietary funds:

Requirements or restrictions regarding commingling customer funds with proprietary funds, obligating customer funds for any purpose other than to purchase, clear, and settle the products the clearing organization is clearing, or procedures regarding customer funds which are subject to cross-margin or similar agreements, and any other aspects of customer fund segregation.

3. Investment standards:

a. How customer funds would be invested consistent with high standards of safety; and  
b. How the organization will gather and keep associated records and data regarding the details of such investments.

*Core Principle G: DEFAULT RULES AND PROCEDURES—The applicant shall have rules and procedures designed to allow for efficient, fair, and safe management of events when members or participants become insolvent or otherwise default on their obligations to the derivatives clearing organization.*

In addressing Core Principle G, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Definition of default:

a. The events that will constitute member or participant default;

b. What action the organization would take upon a default and how the organization would otherwise enforce the definition of default; and

c. How the organization would address situations related to but which may not constitute an event of default, such as failure to comply with certain rules, failure to maintain eligibility standards, actions taken by other regulatory bodies, or other events.

2. Remedial action:

The authority pursuant to which, and how, the clearing organization may take appropriate action in the event of the default of a member/participant which may include, among other things, closing out positions, replacing positions, set-off, and applying margin.

3. Process to address shortfalls:

Procedures for the prompt application of clearing organization and/or member/participant financial resources to address monetary shortfalls resulting from a default.

4. Use of cross-margin programs:

How cross-margining programs would provide for clear, fair, and efficient means of covering losses in the event of a program participant default.

5. Customer priority rule:

Rules and procedures regarding priority of customer accounts over proprietary accounts of defaulting members/participants and, where applicable, in the context of specialized margin reduction programs such as cross-margining or trading links with other exchanges.

*Core Principle H: RULE ENFORCEMENT—The applicant shall (i) maintain adequate arrangements and resources for the effective monitoring and enforcement of compliance with rules of the applicant and for resolution of disputes; and (ii) have the authority and ability to discipline, limit, suspend, or terminate a member's or participant's activities for violations of rules of the applicant.*

In addressing Core Principle H, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Surveillance:

Arrangements and resources for the effective monitoring of compliance with rules relating to clearing practices and financial surveillance.

2. Enforcement:

Arrangements and resources for the effective enforcement of rules and authority and ability to discipline and limit or suspend a member's/participant's activities pursuant to clear and fair standards.

3. Dispute resolution:

Where applicable, arrangements and resources for resolution of disputes between customers and members/participants, and between members/participants.

*Core Principle I: SYSTEM SAFEGUARDS—The applicant shall demonstrate that the applicant (i) has established and will maintain a program of oversight and risk analysis to ensure that the automated systems of the applicant function properly and have adequate capacity and security; and (ii) has established and will maintain emergency procedures and a plan for disaster recovery, and will periodically test backup facilities sufficient to ensure daily processing, clearing, and settlement of transactions.*

In addressing Core Principle I, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Oversight/risk analysis program:

a. Whether a program addresses appropriate principles and procedures for the oversight of automated systems to ensure that its clearing systems function properly and have adequate capacity and security. The Commission believes that the guidelines issued by the International Organization of Securities Commissions (IOSCO) in 1990 and adopted by the Commission on November 21, 1990 (55 FR 48670), as supplemented in October 2000, are appropriate guidelines for an automated clearing system to apply.

b. Emergency procedures and a plan for disaster recovery; and

c. Periodic testing of back-up facilities and ability to provide timely processing, clearing, and settlement of transactions.

2. Appropriate periodic objective system reviews/testing:

a. Any program for the periodic objective testing and review of the system, including tests conducted and results; and

b. Confirmation that such testing and review would be performed or assessed by a qualified independent professional.

*Core Principle J: REPORTING—The applicant shall provide to the Commission all information necessary for the Commission to conduct the oversight function of the applicant with respect to the activities of the derivatives clearing organization.*

In addressing Core Principle J, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Information available to or generated by the clearing organization that will be made routinely available to the Commission, upon request and/or as appropriate, to enable the Commission to perform properly its oversight function, including information regarding counterparties and their positions, stress test results, internal governance, legal proceedings, and other clearing activities;

2. Information the clearing organization will make available to the Commission on a non-routine basis and the circumstances which would trigger such action;

3. The information the organization intends to make routinely available to members/participants and/or the general public; and

4. Provision of information:

a. The manner in which all relevant routine or non-routine information will be provided to the Commission, whether by electronic or other means; and

b. The manner in which any information will be made available to members/participants and/or the general public.

*Core Principle K: RECORDKEEPING—The applicant shall maintain records of all activities related to the business of the applicant as a derivatives clearing organization in a form and manner acceptable to the Commission for a period of 5 years.*

In addressing Core Principle K, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. The different activities related to the entity as a clearing organization for which it must maintain records; and

2. How the entity would satisfy the performance standards of Commission regulation 1.31 (17 CFR 1.31), reserved in this part 39 and applicable to derivatives clearing organizations, including:

a. What “full” or “complete” would encompass with respect to each type of book or record that would be maintained;

b. The form and manner in which books or records would be compiled and maintained with respect to each type of activity for which such books or records would be kept;

c. Confirmation that books and records would be open to inspection by any representative of the Commission or of the U.S. Department of Justice;

d. How long books and records would be readily available and how they would be

made readily available during the first two years; and

e. How long books and records would be maintained (and confirmation that, in any event, they would be maintained for at least five years).

*Core Principle L: PUBLIC INFORMATION—The applicant shall make information concerning the rules and operating procedures governing the clearing and settlement systems (including default procedures) available to market participants.*

In addressing Core Principle L, applicants and registered derivatives clearing organizations may describe or otherwise document:

Disclosure of information regarding rules and operating procedures governing clearing and settlement systems:

a. Which rules and operating procedures governing clearing and settlement systems should be disclosed to the public, to whom they would be disclosed, and how they would be disclosed;

b. What other information would be available regarding the operation, purpose and effect of the clearing organization’s rules;

c. How members/participants may become familiar with such procedures before participating in operations; and

d. How members/participants will be informed of their specific rights and obligations preceding a default and upon a default, and of the specific rights, options and obligations of the clearing organization preceding and upon the member’s/participant’s default.

*Core Principle M: INFORMATION SHARING—The applicant shall (i) enter into and abide by the terms of all appropriate and applicable domestic and international information-sharing agreements; and (ii) use relevant information obtained from the agreements in carrying out the clearing organization’s risk management program.*

In addressing Core Principle M, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Applicable appropriate domestic and international information-sharing agreements and arrangements including the different types of domestic and international information-sharing arrangements, both formal and informal, which the clearing organization views as appropriate and applicable to its operations.

2. How information obtained from information-sharing arrangements would be used to carry out risk management and surveillance programs:

a. How information obtained from any information-sharing arrangements would be used to further the objectives of the clearing organization’s risk management program and any of its surveillance programs including financial surveillance and continuing eligibility of its members/participants;

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b. How accurate information is expected to be obtained and the mechanisms or procedures which would make timely use and application of all information; and

c. The types of information expected to be shared and how that information would be shared.

*Core Principle N: ANTITRUST CONSIDERATIONS—Unless appropriate to achieve the purposes of this Act, the derivatives clearing organization shall avoid (i) adopting any rule or taking any action that results in any unreasonable restraint of trade; or (ii) imposing any material anticompetitive burden on trading on the contract market.*

Pursuant to section 5b(c)(3) of the Act, a registered derivatives clearing organization or an entity seeking registration as a derivatives clearing organization may request that the Commission issue an order concerning whether a rule or practice of the organization is the least anticompetitive means of achieving the objectives, purposes, and policies of the Act. The Commission intends to apply section 15(b) of the Act to its consideration of issues under this core principle in a manner consistent with that previously applied to contract markets.

### **PART 40—PROVISIONS COMMON TO CONTRACT MARKETS, DERIVATIVES TRANSACTION EXECUTION FACILITIES AND DERIVATIVES CLEARING ORGANIZATIONS**

Sec.

40.1 Definitions.

40.2 Listing products for trading by certification.

40.3 Voluntary submission of new products for Commission review and approval.

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40.5 Voluntary submission of rules for Commission review and approval.

40.6 Self-certification of rules by designated contract markets and registered derivatives clearing organizations.

40.7 Delegations.

40.8 Availability of public information.

APPENDIX A TO PART 40—GUIDELINE NO. 1

APPENDIX B TO PART 40—SCHEDULE OF FEES

APPENDIX C TO PART 40—INFORMATION THAT A FOREIGN BOARD OF TRADE SHOULD SUBMIT WHEN SEEKING NO-ACTION RELIEF TO OFFER AND SELL, TO PERSONS LOCATED IN THE UNITED STATES, A FUTURES CONTRACT ON A FOREIGN SECURITIES INDEX TRADED ON THAT FOREIGN BOARD OF TRADE

AUTHORITY: 7 U.S.C. 1a, 2, 5, 6, 6c, 7, 7a, 8 and 12a, as amended by appendix E of Pub. L. 106-554, 114 Stat. 2763A-365.

SOURCE: 66 FR 42283, Aug. 10, 2001, unless otherwise noted.

### **§ 40.1 Definitions.**

As used in this part:

*Business hours* means the hours between 8:15 a.m. and 4:45 p.m., eastern standard time or eastern daylight savings time, whichever is currently in effect in Washington, DC all days except Saturdays, Sundays and legal public holidays.

*Dormant contract* or *dormant product* means any commodity futures or option contract or other agreement, contract, transaction or instrument in which no trading has occurred in any future or option expiration for a period of six complete calendar months; *provided, however*, no contract or instrument shall be considered to be dormant until the end of thirty-six complete calendar months following initial exchange certification or Commission approval.

*Dormant contract market* means any designated contract market on which no trading has occurred for a period of six complete calendar months; *provided, however*, no contract market shall be considered to be dormant until the end of 36 complete calendar months following the day that the order of designation was issued or that the contract market was deemed to be designated.

*Dormant derivatives clearing organization* means any derivatives clearing organization that has not accepted for clearing any agreement, contract or transaction that is required or permitted to be cleared by a derivatives clearing organization under sections 5b(a) and 5b(b) of the Act, respectively, for a period of six complete calendar months; *provided, however*, no derivatives clearing organization shall be considered to be dormant until the end of 36 complete calendar months following the day that the order of registration was issued or that the derivatives clearing organization was deemed to be registered.

*Dormant derivatives transaction execution facility* means any derivatives transaction execution facility on which no trading has occurred for a period of