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AGENCY

US Securities and Exchange Commission (SEC)

Rule title
Clearing Agency Standards for Operation and Governance

RIN	3235-AL13
Publication Date	November 2, 2012
Stage	Final

RULE SUMMARY

The regulation establishes uniform standards and procedures governing security-based swap transactions and clearing agencies designated as "systemically important." It sets forth minimum standards for clearing agencies that act as central counterparties (and thus are exposed to risk of financial loss if participants default on their obligations) in a number of areas, including risk management, standards for membership, recordkeeping, and financial disclosure. The rule includes minimum standards for credit exposure monitoring, margin requirements, financial resources, margin model validation, membership standards, recordkeeping, and financial disclosures. The rule also requires registered clearing agencies to maintain written policies and procedures related to a number of other operational and risk management areas.

COMMENTARY

The SEC's analysis asserts that this rule will prevent future financial crises by preventing defaults that could trigger the collapse of an entire clearing agency and by improving transparency and encouraging more investors to enter the market because their assets are better protected. These benefits are simply asserted; the analysis makes no attempt to estimate their size and presents no evidence that the regulation will actually produce these results. The only costs that are quantified are the costs of paperwork, information collection, and monitoring. Few significant alternatives are considered, and they are not really analyzed, just dismissed in a few sentences. One bright spot is a discussion of how minimum capital requirements for exchange membership can hamper competition by creating a barrier to entry. When setting the minimum capital requirement, the commission apparently balanced concerns about market power against concerns about reducing risk, though it is not clear how this reasoning led to the specific figure chosen ($50 million).

This rule's economic analysis was scored by a team of economists as the basis for Jerry Ellig and Hester Peirce's study, "SEC Regulatory Analysis: 'A Long Way to Go and a Short Time to Get There.'"
For more information about Regulatory Report Cards issued by the Mercatus Center at George Mason University, see www.mercatus.org/reportcard.

OPENNESS	Score	Comments
1. How easily were the RIA, the proposed rule, and any supplementary materials found online?	5	1A
2. How verifiable are the data used in the analysis?	1	1B
3. How verifiable are the models and assumptions used in the analysis?	1	1C
4. Was the Regulatory Impact Analysis comprehensible to an informed layperson?	2	1D
Total Openness (Sum of 1–4)	9	

ANALYSIS	Score	Comments
5. How well does the analysis identify the desired outcomes and demonstrate that the regulation will achieve them?	1	2A
6. How well does the analysis identify and demonstrate the existence of a market failure or other systemic problem the regulation is supposed to solve?	1	2B
7. How well does the analysis assess the effectiveness of alternative approaches?	2	2C
8. How well does the analysis assess costs and benefits?	1	2D
Total Analysis (Sum of 5–8)	5	

USE	Score	Comments
9. Does the proposed rule or the RIA present evidence that the agency used the Regulatory Impact Analysis?	3	3A
10. Did the agency maximize net benefits or explain why it chose another alternative?	0	3B
11. Does the proposed rule establish measures and goals that can be used to track the regulation's results in the future?	0	3C
12. Did the agency indicate what data it will use to assess the regulation's performance in the future and establish provisions for doing so?	0	3D
Total Use (Sum of 9–12)	3	

Total Score	**17**	

This analysis was evaluated using the 2008–2012 scoring system, which evaluated regulatory analyses based on 12 criteria. This analysis was scored on a scale from zero to 60 points.

OPENNESS			
Criterion	**Score**	Com. No.	Comment
1. How easily were the RIA, the proposed rule, and any supplementary materials found online?	5	1	The notice can be found at regulations.gov using a RIN or keyword search for "clearing agency standards." It can also be found in a list of final rules under the "Regulation" tab on the SEC web site. Economic analysis is a section of the notice.
2. How verifiable are the data used in the analysis?	1	2	Hardly any data was used to estimate the rule's overall benefits and costs. Cost data were difficult to verify because they were sourced to another regulatory proceeding and discussions with industry participants. Data used to calculate the paperwork burden were provided in footnotes but not sourced.
3. How verifiable are the models and assumptions used in the analysis?	1	3	In a few cases, a partial theory is elaborated but not sourced or supported with research. In many cases, the problem or benefits are merely asserted with little underlying theory. In the section of the notice discussing comments, two papers are cited in support of factual claims about the volume of credit default swaps.
4. Was the analysis comprehensible to an informed layperson?	2	4	The analysis catalogs claimed benefits and costs, but it is so scant that it's hard to understand how the analysis arrived at the conclusions. The section-by-section discussion gets a little repetitious, but it is worth having the breakdown of individual elements of the regulations. There are large amounts of acronyms and jargon. The structure of the analysis never allows the SEC to summarize overall benefits and costs.
ANALYSIS			
5. How well does the analysis identify the desired outcomes and demonstrate that the regulation will achieve them?	1		
Does the analysis clearly identify ultimate outcomes that affect citizens' quality of life?	3	5A	The rule is intended to promote capital formation by encouraging more investors to enter the market because their assets are better protected. The rule is supposed to prevent future financial crises by preventing defaults that could trigger the collapse of an entire clearing agency. It is also intended to promote efficiency by improving transparency, access to clearing agencies by new entrants, and efficient operation of clearing agencies. The analysis also mentions that the rules will reduce opportunities for regulatory arbitrage by making US regulations more consistent with international standards, and it will create legal certainty by codifying existing practices. Another claimed benefit is that they give the commission a benchmark to use in evaluating agenices' practices and proposed changes. Some of these claimed benefits are outcomes, but some of them, such as provision of a benchmark, are not.
Does the analysis identify how these outcomes are to be measured?	0	5B	The analysis admits that the size of the effect of these rules on future risks is unknown. The SEC says it knows of no data that would allow it to estimate the effect on new membership in clearing agencies. No attempt was made to estimate benefits or explain how they could be measured.

Does the analysis provide a coherent and testable theory showing how the regulation will produce the desired outcomes?	1	5C	The analysis provides mostly assertions that the regulation will reduce risk and improve stability for the clearing system without elaborating much of a theory. A couple paragraphs on capital requirements lay out a rudimentary theory of how reducing capital requirements for membership in agencies that clear security-related swaps could encourage more investors to become members. Adding to the confusion is the fact that many of the rules codify existing practices, which would imply that the benefits of these rules are zero, but the analysis does not acknowledge this.
Does the analysis present credible empirical support for the theory?	0	5D	No evidence is presented that demonstrates the regulation will have the intended results.
Does the analysis adequately assess uncertainty about the outcomes?	1	5E	Uncertainty is acknowledged only to the extent that the SEC says regulation will have to adapt to a changing market and it does not have data that would let it estimate the size of the benefits.
6. How well does the analysis identify and demonstrate the existence of a market failure or other systemic problem the regulation is supposed to solve?	1		
Does the analysis identify a market failure or other systemic problem?	3	6A	The analysis states that clearing agencies may have market power due to economies of scale, barriers to entry, and legal mandates. Market power could lead to lower levels of service, higher prices, or underinvestment in risk management systems. Another part of the analysis suggests that clearing agencies may use minimum portfolio size and other membership requirements to inhibit new entrants who want access to the clearing agency. It also asserts that clearing agencies and their users may generate negative externalities for other market participants if they do not adequately manage their risks. So the analysis names some potential market failures but does not really explain where most of them come from or how they create the claimed problems.
Does the analysis outline a coherent and testable theory that explains why the problem (associated with the outcome above) is systemic rather than anecdotal?	2	6B	The links between market power and service, prices, and risk management are simply asserted, not explained. The externality theory is not explained very carefully, so the causation mechanism is not clear. The discussion of membership requirements lays out a rudimentary theory of how they can be barriers to entry.
Does the analysis present credible empirical support for the theory?	0	6C	No empirical support is offered. The notice cites the FMI report as evidence, but this report cites neither theory nor evidence of market failure.
Does the analysis adequately assess uncertainty about the existence or size of the problem?	0	6D	There is no acknowledgement of uncertainty.
7. How well does the analysis assess the effectiveness of alternative approaches?	2		

Does the analysis enumerate other alternatives to address the problem?	3	7A	The commission considered requiring agencies to perform assessments against CPSS-IOSCO recommendations rather than commission rules. The SEC also considered setting risk monitoring standards at the highest level of current practice. Other alternatives required each clearing agency to maintain sufficient financial resources to withstand default by the largest one or two participant families, instead of having the higher standard only for agencies that clear security-based swaps. Some other small variations on other individual rules were also considered.
Is the range of alternatives considered narrow (e.g., some exemptions to a regulation) or broad (e.g., performance-based regulation vs. command and control, market mechanisms, nonbinding guidance, information disclosure, addressing any government failures that caused the original problem)?	1	7B	Most of the alternatives were all small tweaks to the set of rules the SEC decided to adopt rather than fundamentally different approaches. The alternative of using international standards is also similar, given that the SEC rules are largely consistent with international standards.
Does the analysis evaluate how alternative approaches would affect the amount of the outcome achieved?	0	7C	There is no formal analysis of alternatives. Alternatives are usually dismissed with a rationale explained in a few sentences. There is no comprehensive prediction of benefits of alternatives. Pros and cons of higher or lower capital requirements for membership in a clearing agency are discussed in a couple paragraphs.
Does the analysis adequately address the baseline? That is, what the state of the world is likely to be in the absence of federal intervention not just now but in the future?	2	7D	The economic analysis provides an extensive narration of clearing agents' current risk management practices, which it contends are consistent with the RCCP and RSSS recommendations on which the regulation is based. Rules regarding model validation and membership practices are new. No explanation of how industry practices could be expected to evolve in the absence of new rules.
8. How well does the analysis assess costs and benefits?	1		
Does the analysis identify and quantify incremental costs of all alternatives considered?	1	8A	The analysis discusses the benefits and costs of each individual section of the rule, but the discussion is largely discursive and presents little evidence. Tighter requirements for securities-based swaps are discussed separately. Alternatives are usually dismissed with a few sentences, which sometimes imply that costs would be excessively high but provide no estimates.
Does the analysis identify all expenditures likely to arise as a result of the regulation?	3	8B	Costs of paperwork/information collection/monitoring are quantified. One-time cost of altering systems to permit model validation is quantified. Some other expenditures, such as employee training, are mentioned. There is no calculation of the SEC's costs.
Does the analysis identify how the regulation would likely affect the prices of goods and services?	1	8C	A few statements suggest that centralized clearing, greater transparency, etc. will lead to reduced costs, but no evidence is given and no estimate is provided.

Does the analysis examine costs that stem from changes in human behavior as consumers and producers respond to the regulation?	2	8D	A few statements indicate that the commission tried to avoid setting excessively high standards that would discourage entry by new clearing agencies. It did not appear to consider whether codifying existing practices and implementing international standards is tantamount to a government-enforced cartel. Discussion of the reduced capital requirement for membership in agencies clearing security-based swaps ($50 million) acknowledges that this might increase the risk fo default by an individual member.
If costs are uncertain, does the analysis present a range of estimates and/or perform a sensitivity analysis?	0	8E	No ranges of estimates are provided. Uncertainty is asknowledged only to the extent that the analysis does not quantify some of the costs that are mentioned.
Does the analysis identify the alternative that maximizes net benefits?	0	8F	Net benefits of the regulation and its alternatives are not calculated.
Does the analysis identify the cost-effectiveness of each alternative considered?	0	8G	Since benefits of the regulation are not estimated, no comparison of cost-effectiveness is possible.
Does the analysis identify all parties who would bear costs and assess the incidence of costs?	1	8H	There is not much discussion, but the parties bearing costs are assumed to be the clearing agencies and, in some cases, their members. There is some discussion of increased risk exposure because smaller entities will gain access to clearing agencies.
Does the analysis identify all parties who would receive benefits and assess the incidence of benefits?	2	8I	The analysis implies that preventing a financial crisis benefits society and that some aspects of the regulation benefit investors. But benefits are not estimated, and the effects on various parties are just mentioned in passing. The analysis does note that smaller firms will benefit by gaining access to clearing agencies.
USE			
9. Does the proposed rule or the RIA present evidence that the agency used the analysis?	3	9	Pros and cons of higher or lower capital requirements for membership in a clearing agency are discussed in a few paragraphs. The commission is trying to balance market power concerns against risk management, though it is not clear how any economic calculation led to the specific figure chosen ($50 million). This is about the only instance in which economic analysis appears to be used to make decisions.
10. Did the agency maximize net benefits or explain why it chose another alternative?	0	10	Neither benefits nor net benefits were calculated for the regulation or its alternatives. Therefore, there is little evidence that the SEC was cognizant of net benefits when it made its decisions.
11. Does the proposed rule establish measures and goals that can be used to track the regulation's results in the future?	0	11	There is no relevant content.
12. Did the agency indicate what data it will use to assess the regulation's performance in the future and establish provisions for doing so?	0	12	There is no relevant content.