CME's Financial and Regulatory Surveillance Department Issues Long-Awaited Guidance

October 23, 2024

FRS's Annual Examination of CME Clearing Members and CME Rule 930.K

The back-office operations, finance and compliance teams of the futures commission merchant (FCM) clearing members of the CME Clearing House mark their calendars by the annual examination season. Overseen by the CME's Financial and Regulatory Surveillance Department, the annual financial and operational risk-based exam typically focuses on the FCM's margin processes, the accuracy and integrity of its financial statements, and its controls around customer asset protection.

The annual FRS exam can also be a forum for surfacing and enforcing emergent disciplinary concerns of FRS and its proxy, the Joint Audit Committee. During the 2021-22 examination season, FRS began auditing FCM clearing agreements for contractual grace or cure periods, conditioning a customer's failure to satisfy a margin call (not qualified by reference to administrative or operational reasons for the failure), and deeming the inclusion of such grace/cure periods to be a violation of CME Rule 930.K.[1] Those examinations have resulted in four disciplinary actions this year (one based on a 2022 exam, the other three based on 2023 exams), settling alleged violations of CME Rule 930.K. Prior to the 2021-22 examination season, FRS examinations and CME disciplinary actions did not raise the issue highlighted in this year's 930.K Actions. Indeed, a search of CME disciplinary notices from 2000 to the present day for references to Rule 930.K yielded only four results – namely, the recent 930.K Actions.

For many years, CME clearing members or their affiliates have traded other asset classes under documentation that includes grace or cure periods in respect of failures to pay.[2] As a result, customers contracting for futures execution and clearing services with CME clearing members had developed a settled expectation that such grace or cure periods would be available under their futures documentation as well. But in communications during recent annual exams, FRS examiners have adopted the view that a CME clearing member may never, even in its reasonable risk management judgment, deem an account eligible for a contractual cure or grace period upon a margin payment fail (even notably, in cases where the clearing member has otherwise provided for limits and appropriate margin levels for the account, and regardless of the client's credit quality); any such view, FRS maintained, constitutes a violative relinquishment of the "full discretion" required to be maintained under CME Rule 930.K.

[1] CME Rule 930.K states, in relevant part: "If an account holder fails to comply with a performance bond call within a reasonable time (the clearing member may deem one hour to be a reasonable time), the clearing member may close out the account holder's trades or sufficient contracts thereof to restore the account holder's account to required performance bond status. Clearing members shall maintain full discretion to determine when and under what circumstances positions in any account shall be liquidated."

[2] *See*, e.g., 2002 ISDA Master Agreement at 5(a)(i) (providing that a failure to make a required payment does not constitute an event of default if remedied "on or before the first Local Business Day" following notice of such failure to the affected counterparty); SIFMA Master Securities Loan Agreement (MSLA) (2017 Version) at 12.4 and 12.8 (providing for unqualified one Business Day cure periods for specified failures to pay); SIFMA Master Securities Forward Transaction Agreement (MSFTA) (2012 Version) at 2(j) (permitting parties to define payment default events by reference to an unqualified cure period).

Informational Asymmetry

The awareness of the FRS examination initiative around Rule 930.K was not, however, broadly shared among the various buy-side constituencies. Buy-side money managers are bound by their fiduciary duty to the customers who own their trading accounts to negotiate the best available terms with their counterparties, broker-dealers, and FCMs. When confronted with the message from clearing members that "applicable law" prohibits an unconditional one-business day grace/cure period for margin payment fails, those managers naturally asked for evidence of that claim – as, indeed, they are bound to do under that fiduciary duty. The clearing members could point to the 930.K Actions or the text of Rule 930.K – but neither source clearly states that unconditional grace or cure periods are entirely prohibited. The two-fold result was predictable: negotiations over futures agreements stalled; and managers started routing business away from clearing members under an exam mandate to start enforcing FRS's view of 930.K. Where managers lacked legal certainty around the grace/cure period issue and had an alternative provider under documentation that includes an unconditional cure or grace period (because it was negotiated prior to the recent FRS focus on the issue), they naturally gravitated to the alternative provider under that legacy documentation (over the clearing member insisting that applicable law prohibits such unconditional grace/cure periods).

Because the FRS was enforcing its interpretation of Rule 930.K through ad hoc communications in examinations and through the four 930.K Actions, a coherent message about that interpretation had not landed with the buy-side. Some buy-side clients had heard nothing about it; their agreements (which may have included legacy provisions for an unconditional grace/cure period) had not been flagged in exams, so clearing members had no reason to contact them about the issue. Other clients were engaged by some of their clearing members on Rule 930.K – but inevitably, given the fragmented nature of the regulatory message, those clients had alternatives among their clearing providers where the issue remained dormant.

The resulting informational asymmetry moved many CME clearing members to petition FRS for written guidance clearly stating that the requirement under Rule 930.K that clearing members must "maintain full discretion to determine when and under what circumstances position in any account shall be liquidated" is inconsistent with any clearing member's agreeing to a cure or grace period in connection with any customer's failure to satisfy a clearing member's call for required performance bond (other than where such failure arises from administrative or operational issues).

FRB #24-2

The good news for clearing members is that the FRS finally issued that guidance last week. Financial and Regulatory Bulletin #24-02[3] is styled as a "reminder" of the "long-established rule" that clearing members:

> "must not enter into agreements where the contractual terms provide for a period of time during which the firm's full discretion to determine when and under what circumstances positions could be liquidated is restricted. Clearing members who suspect these non-compliant contractual terms might be in existing customer agreements should consider performing a review of their agreements. Any existing agreements discovered to be in violation of the rule should be remediated and brought into compliance."

Arguing over how "long-established" this interpretation really is – or, more substantively, over whether this is the right policy – may now give way, hopefully, to negotiations and customer engagement on a level playing field. Fiduciaries now have a clear indication that the "applicable law" governing their futures agreement includes a prohibition of unconditional grace/cure periods. And clearing members are now uniformly operating under the same standard.

FRS is to be commended for realizing (if somewhat belatedly) the limits of regulation by examination.

[3] FRB #24-02 is available here. A footnote provides that this prohibition does not extend to a carve-out for "reasonable, one-day administrative or operational exceptions."

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