CME Group

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VIA ELECTRONIC MAIL

Secretariat
Committee on Payment and Settlement Systems
Bank for International Settlements
cpss@bis.org

Secretariat
Technical Committee
International Organization of Securities Commissions
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Re: Consultative Report: *Recovery and resolution of financial market infrastructures*

Ladies and Gentlemen:

Chicago Mercantile Exchange Inc. (CME) and CME Clearing Europe Ltd. (CMECE) would like to express appreciation to the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) for the opportunity to comment upon their consultative report: *Recovery and resolution of financial market infrastructures* (Consultative Report). CME's clearing house division (CME Clearing) offers central counterparty clearing services for exchange-traded futures and options contracts and for OTC derivatives. CME is registered with the U.S. Commodity Futures Trading Commission (CFTC) as a derivatives clearing organization (DCO) and as a designated contract market. CMECE is authorized by the U.K. Financial Services Authority (FSA) as a recognised clearing house. At present, CMECE acts as central counterparty for OTC commodity derivatives.

We previously commented on the March 2011 CPSS-IOSCO consultative report on *Principles for financial market infrastructures* (PFMIs), which preceded the final version of the PFMIs issued in April 2012. In that letter, we emphasized the importance of being mindful that standards for financial market infrastructures (FMIs) "are expressed as broad principles in recognition that FMIs can differ in organization, function, design, and that there are often different ways to achieve a particular result."[1] In submitting the present letter, we reiterate that call for flexibility by responding to the request for comments in the cover note to the Consultative Report (Cover Note) and requesting clarification on specific matters. We are supportive of CPSS-IOSCO's desire to develop standards that ensure the continued operation of FMIs' critical operations and services during periods of extreme distress, a goal to which we remain steadfastly committed. We agree that, as reforms are implemented in the financial services industry, it will be necessary to re-evaluate the most effective methods for recovery and resolution, especially with respect to FMIs, such as central counterparties (CCPs), that are exposed to credit risk.

I. Comments on CPSS-IOSCO questions

CME and CMECE share CPSS-IOSCO's view that robust arrangements for the recovery and, if necessary, the resolution of FMIs must exist to prevent systemic disruption to the global financial system. Without such arrangements, the interconnected nature of the largest financial institutions poses a threat

[1] Letter from CME Group Inc. to CPSS and IOSCO, (July 28, 2011), p. 1.

to the global economy should one or more of these institutions fail or show signs of failing. At the same time, we would like to reiterate the statements made in the Consultative Report that CCPs have rules and procedures to allocate uncovered losses.[2] These rules and procedures make it less likely that a CCP would need to be resolved by the relevant authorities. However, even though a resolution may be less likely, it cannot be ruled out that there could be a crisis that could threaten the ongoing viability of a CCP. The unique and unpredictable nature of such a crisis calls for flexibility in the resolution process. This, together with the loss allocation rules and well-developed default management capabilities of CCPs, also implies that resolution should not be implemented in a way that encourages supervisors to become overly interventionist and prescriptive in the recovery process.

This call for flexibility is echoed in the comment letter written by the Securities Industry and Financial Markets Association, The Clearing House, The Financial Services Roundtable, the American Bankers Association, the Association for Financial Markets in Europe, and the Institute of International Bankers responding to the Notice of Proposed Rulemaking Implementing Resolution Plan and Credit Exposure Report Requirements of Section 165(d) of the Dodd-Frank Act. In the letter, the trade associations propose that resolution plans be modified to provide additional flexibility for nonbank financial companies to consider their unique circumstances.[3] A second comment letter written by a group of banks responding to the same proposed rule asks regulators to allow resolution plans to have sufficient flexibility to reflect the diversity of covered companies.[4]

Moreover, it is important that recovery and resolution plans (RRPs) reflect differences among FMIs and the different ways FMIs can fail. The details of this diversity, and how this diversity should affect the recovery and resolution process, will be clearer after analytics have been conducted as part of the first round of RRP filings. This suggests that the details of any new resolution regime should not be finalized until after the first round of RRPs have been received and reviewed. We also agree with the comment in the Consultative Report that the primary responsibility for planning and implementing an FMI's recovery rests with the FMI itself,[5] and believe that such planning should be undertaken within the framework of a CCP's risk governance structures.[6]

Section four of the Cover Note, Requests for comments on the Consultative Report, includes 19 questions for which views are sought. This letter individually addresses those questions CME and CMECE find most relevant to our businesses at this time.

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[2] Recovery and resolution of financial market infrastructures, CPSS-IOSCO (July 2012), p. 2.

[3] Letter from The Securities Industry and Financial Markets Association, The Clearing House Association L.L.C, the American Bankers Association, the Association for Financial Markets in Europe, The Financial Services Roundtable and the Institute of International Bankers to Federal Reserve and FDIC (June 10, 2011), pp. 1-2.

[4] Letter from The PNC Financial Services Group, Inc., Capital One Financial Corporation, SunTrust Banks Inc., BB&T Corporation, Regions Financial Corporation, Fifth Third Bank, KeyCorp, M&T Bank Corporation, Comerica Incorporated, Huntington Bank to Federal Reserve and FDIC (June 10, 2011), p. 2.

[5] Recovery and resolution of financial market infrastructures, CPSS-IOSCO (July 2012), p. 3.

[6] Pursuant to Subchapter IV of Chapter 7 of the U.S. Bankruptcy Code, because CME is a derivatives clearing organization (DCO) which is a form of "commodity broker", it would be limited to Chapter 7 bankruptcy proceedings. In addition the Part 190 Bankruptcy Rules of the Commodity Futures Trading Commission provide that "[c]ommodity contracts held by a clearing organization which is a debtor may not be transferred." 17 C.F.R. §190.06(f)(ii)(2).

A. *In what circumstances and for what types of FMI can a statutory management, administration or conservatorship offer an appropriate process within which to ensure a continuity of critical services?*

Standards should allow for statutory management, administration or conservatorship to offer processes for all designated FMIs in all circumstances so as to retain as much flexibility as possible. It is our belief that supervisors should retain the authority to determine which resolution regime to use at a point of intervention when an FMI is no longer viable in its current form. A regime designed especially for systemically important FMIs is important because typical insolvency laws do not have the objective of avoiding systemic disruption, and therefore are unlikely to minimize systemic disruption of the home and host country and global economies. Temporary stays on exercising termination rights, allowed under traditional insolvency procedures, could interfere with continuity of operations. In addition, insolvency laws generally prevent FMIs from imposing asymmetric haircuts or selective tear-ups and provide limited ability to protect new funding.

B. *What qualitative or quantitative indicators of non-viability should be used in determining the trigger for resolution for CCPs?*

While we recognize the importance of identifying the circumstances when resolution would be necessary, we believe it would be premature to decide upon specific indicators at this time. FMIs will be in a better position to identify indicators and to discuss those with their supervisors and the designated resolution authorities (who in some cases may be one and the same), after the first round of RRPs has been completed. It is also important to acknowledge that there is no appropriate resolution trigger common to all FMIs, especially considering the differences between credit-risk taking and non-credit-risk taking institutions. At the same time, capital and liquidity could be seen as general indicators of most FMIs' overall viability. Nevertheless, when indicators are formulated, they should address the unique nature of each FMI, and the trigger should be sufficiently flexible to reflect the unique nature of each crisis. In particular, triggers should not be so inflexible that they pre-empt successful recovery.

C. *What loss allocation methods must be available to a resolution authority, and for CCPs? Could or should these resolution powers include tear-up, cash calls or a mandatory replenishment of default fund contributions by an FMI's direct participants? Does it make a difference if the losses are from a defaulting member or are made up of other losses (e.g. losses in investments made by the FMI)? In what circumstances, and by what methods, should losses be passed on beyond the direct participants – e.g. to the clients or FMI shareholders – in resolution?*

Each resolution authority should have the flexibility to determine which loss allocation methods are most suitable to a particular FMI dependent on the characteristics of the particular crisis, and the precise methods actually used in each case would not be known until the time of the resolution since the circumstances of each resolution are unique. Our view is that prescriptive intervention by authorities before the point of resolution, and while an FMI is in recovery, would rarely if ever be helpful. As a general principle, credit losses in the clearing process stemming from member default should be considered the responsibility of the clearing members, who may then assign losses to clients if they so choose.

Losses owing to FMI operational failure or investment losses, on the other hand, should be borne by the capital reserve of the FMI. If these losses are greater than the capital reserve, other loss recovery mechanisms, including the possibility of additional shareholder contributions and the bail-in resolution discussed in the Consultative Report, may be considered. However, as a general principle, the resources to recover from such losses should come from the FMI's equity and debt structure, not from its clearing fund or other default resources. Before going into the details of such arrangements, the FMI's specific governance and ownership structure will have to be assessed. Alternatively, a CCP's clearing members,

who have an interest in the survival of the CCP, could put up capital in exchange for ownership of the CCP when it exits resolution. If clearing members do not want to support the CCP, or are restricted by regulators from owning the CCP[7], an unrelated third party buyer could be found to put up capital.

D. What, if any, special considerations or methods should be applied when allocating losses whose maximum value cannot be capped (e.g. when allocating potential losses that might arise from open and uncapped positions at a CCP)?

Given the unique circumstances of each FMI and each crisis, special considerations will necessarily be FMI specific. In general, however loss allocation approaches that do not require the FMI to provide a precise valuation will be easier to implement. For example, an FMI in resolution should have the right to return surplus funds to members if haircuts prove to have been too large. Moreover, CCPs that stipulate their loss allocation plans in their rule books (which are part of the contract between a CCP and its clearing members) should not have these rules overridden by regulatory intervention during the recovery. As a general principle, uncapped losses in resolution, when the limits of assessment powers have been reached, should remain the responsibility of the defaulting clearing member, who may decide to impose losses on all clients in order to remain solvent.

E. Are there circumstances in which loss allocation in resolution should result in a different distribution of losses to losses borne in insolvency? Does it make a difference if the losses stem from a defaulting member or are made up of other losses (e.g. losses in investments made by the FMI or resulting from operational risks)?

We believe FMIs and resolution authorities will not know whether there are circumstances in which the financial system will be better protected if losses in resolution were to be distributed differently than losses in insolvency until the first round of RRPs is completed. In order to maintain as much flexibility as possible, FMIs should wait to comment on loss allocation and resolution options until after the first round of FMIs has completed RRPs.

F. Are there any circumstances in which the ability to exercise termination rights as a result of the use of resolution powers should outweigh the objective of ensuring continuity?

Maintaining the continuity of systemically important operations is more important that the ability to exercise termination rights provided that the broader public benefit realized is greater than the private costs incurred. That said, no resolution plan should necessarily set as its goal the continuity of all services run by an FMI unless all services are systemically important. When considering services provided by an FMI that are not systemically important but nevertheless provide public benefit, authorities should take an approach that balances competing objectives while maintaining the goal of preserving the stability of the financial system.

G. Are there any circumstances in which a temporary stay on exercising termination rights should apply for any event of default and not just where triggered by the resolution measures?

We believe there are very few instances in which a stay on exercising termination rights would be an effective recovery option for a CCP. In fact, a temporary stay imposed upon a clearing member default would most likely impair our ability to handle the default effectively and leave the CCP exposed to accumulating losses. Given the importance of considering as many clearing member default recovery

[7] The CFTC, for example, has proposed regulations that, if adopted, would limit (by specified percentages) members' ownership of voting equity or the exercise of voting power in DCOs. *See generally* 75 Fed. Reg. 63732 (Oct. 18, 2010).

options as possible, CME and CMECE request further clarification on this question to better understand the possible circumstances in which it is contemplated that a stay could be helpful for a CCP. We specifically ask if "any event of default" refers to the default of an FMI or, in the case of a CCP, the default of a clearing member.

H. *Are there any circumstances in which a moratorium with a suspension of payments to unsecured creditors may be appropriate when resolving an FMI? Should this be limited to certain types of FMI and/or certain types of payment?*

The power to suspend payments to unsecured creditors of an FMI in resolution could be useful to the extent it increases flexibility. The power should be used sparingly, however, since it could reduce the predictability of contract execution. CCPs especially would find a moratorium a less useful resolution tool as the flow of funds in and out of a CCP is essential to the continuity of its critical services. Members would likely hesitate to clear with a CCP in recovery if such a moratorium allowed for the arbitrary suspension of payments in resolution, given that members are forward looking.

We recognize one potential issue surrounding the formulation of resolution powers in relation to CCPs is the concern that by working to ensure the continuity of a CCP's critical services, resolution authorities may create a moral hazard. There could be a concern that clearing members and participants will expose themselves to unwarranted levels of risk that arise uniquely in a crisis, and therefore not be immediately visible to a CCP even though its monitoring is fully effective otherwise, believing a CCP would spread losses to unsecured creditors. At the same time, however, a CCP has an incentive to build methodologies that can monitor such risks for the soundness of its own books and the maintenance of its reputation.

I. *If so, should resolution authorities retain the discretion to apply a moratorium and, if so, what restrictions (if any) on its use would be appropriate (e.g. scope, duration or purpose)?*

FMIs will be better able to address this question after the first round of RRPs is complete. Analysis done at that time will show what restrictions on flexibility are appropriate for certain kinds of FMIs.

J. *Should the bail-in tool be available to collateral, margin (including initial margin) and other sources of funds if they would bear losses in insolvency?*

We believe that a CCP can construct a loss allocation waterfall such that a bail-in would not be needed as a resolution tool. Furthermore, some FMIs may not issue debt directly, but instead obtain funds from a holding company or affiliate that is not facing resolution, which makes debt-to-equity conversion problematic. In the case of CME and CMECE, our parent holding company (CME Group Inc.) – issues debt (not CME or CMECE), making it difficult for either clearing entity to convert or write down unsecured debt as a resolution tool. In order to fully understand the implications of their particular arrangements, FMIs should reconsider this question after the first round of RRPs has been written.

K. *In what circumstances and for what types of FMI should wider loss recovery arrangements exist beyond the FMI's own rules and the resolution powers of the resolution authority?*

Only an extreme event with unforeseen circumstances would require wider loss recovery arrangements beyond the scope of the FMI or the resolution authority itself. Given the rarity of such events, it would be difficult to create rules that would be effective in such circumstances. Instead, resolution authorities should have a number of loss allocation schemes available to them for use in resolution, enabling them to use the one best suited to the specific circumstances of a failure. As a general principle, FMIs should have loss allocation rules for use in recovery that cover all foreseeable and describable events. Firm-specific vulnerabilities will emerge through the development of RRPs, enabling resolution authorities to tailor any wider loss recovery arrangements to the extent that they may be required.

In order to provide resolution authorities with useful comments as they establish loss allocation methods, we request clarification of the term "wider loss recovery arrangements." Would "wider loss recovery arrangements" include an FMI allocation of losses to institutions that are not creditors under such arrangements?

It is important to note that when a clearing member is systemically important and where taking on significant additional losses in a crisis would threaten its viability and therefore could threaten financial system stability, the resolution authority may want to consider wider loss allocation arrangements in order to protect those members who are systemically critical from unmanageable loss. As a general principle, the resolution authority could consider implementing wider loss recovery arrangements in extreme circumstances when such arrangements significantly reduce systemic risk.

L. In conducting a resolvability assessment of an FMI, what factors should authorities pay particular attention to?

Given the diverse range of roles FMIs play in the global financial system, factors of particular importance will depend on the kind of FMI being considered. FMIs that take on credit risk, for example, could be evaluated on the internal recovery tools in place in the event of the default of an entity or entities to which the FMI has credit exposure. We think it is reasonable that interdependencies between CCPs be assessed and evaluated, but we caution against paying too much attention to inter-operability and cross-margining due to the limited nature of these arrangements. A greater concern that should receive special attention is the ubiquitous interdependencies between FMIs and institutions with which the FMI must interact on an ongoing basis, such as a custodian bank/depository or a settlement bank. FMIs will be more capable of providing useful comments on resolvability assessments after the first round of RRPs is complete.

M. Is tear-up an appropriate loss allocation arrangement prior to resolution of a CCP? If so, in what circumstances?

We support tear-up as a loss allocation arrangement to the extent tear-up maintains flexibility for institutions in resolution. While it is too soon to know how tear-ups might best be used, there is a risk customers may avoid FMIs with the ability to selectively terminate unmatched contracts.

N. To what extent should the possibility of a tear-up in recovery be articulated in ex ante rules?

We believe that rules governing tear-up in recovery are useful and agree they should be expressed. CME has such rules in place.

O. Should there be a limit to the number of contracts that are eligible for tear-up?

To the extent not addressed in ex ante rules of the CCP, any limit on the number of contracts eligible for tear-up should be determined on a case-by-case basis in resolution. In general, however, we anticipate that a firm limit would be overly prescriptive. When formulating rules regarding tear-up powers, it is important to avoid overly prescriptive regulatory actions in recovery.

P. How should the appropriate haircuts be determined?

We believe haircuts in recovery are helpful and should be precise. As such, CME has haircut procedures in place. In resolution, however, the resolution authority should have additional options beyond the haircut methodologies available in recovery. Because it is extremely difficult to calculate default distributions in an uncertain environment, we propose loss allocation approaches that do not require precise valuations. While some estimate of losses would need to be generated for loss allocation, the amount need not be

precise if excess money collected to cover losses can be returned once the value of losses is known. This arrangement would require that any over-contribution to the loss fund be protected from other creditors in resolution and be returned to the contributors.

> Q. *How should equity in FMIs be treated in resolution scenarios: should it be written down in all circumstances?*

Some of the equity in a CCP is notionally assigned to protecting the CCP against loss from its operational risk and investment risk and therefore should not be written down against losses arising from member default or from losses in affiliate businesses. The equity is best used in recovery from an operational loss or investment loss, and, if insufficient to cover the loss, capital should be replenished in resolution by the new owners of the FMI. The mechanisms for recapitalization are best determined as part of the resolution plan.

II. Range of recovery options

The Consultative Report notes that an FMI that takes on credit risk has a waterfall that determines the order in which different financial safeguards are drawn from to absorb losses. CME, for example, has three independent guaranty funds and financial safeguards waterfalls: one for IRS, one for CDS, and one for futures and cleared OTC products other than IRS or CDS (the Base Guaranty Fund). [8] Funding from these waterfalls is CME Clearing's first response in the event of clearing member default.

In the event of a clearing member default, CME Clearing may act immediately to:

- Transfer customer positions and collateral to other clearing members;
- Take control of, or liquidate, positions in the clearing member's house account;
- Apply the clearing member's guaranty fund and house performance bond deposits to satisfy the clearing member's obligations to CME Clearing;
- Utilize all other assets of the clearing member that are available to CME Clearing (e.g., exchange memberships); and/or;
- Invoke any applicable parent guarantee.

If unsatisfied obligations remain after these procedures, CME Clearing would:

- Apply CME-designated funds. CME-designated contributed capital for the financial safeguards package that includes the Base Guaranty Fund is $100 million. CME-designated contributed capital for the IRS and CDS financial safeguard packages is also $100 million each;
- Apply the remaining contribution of non-defaulting clearing members to the respective guaranty fund;
- Invoke its right to assess non-defaulting clearing members to the extent permitted by the CME Clearing rules associated with the default.

If unsatisfied obligations still exist, the terms of CME Rule 818 (Close-Out Netting) would apply. Rule 818, which stipulates the terms for CME's bankruptcy, requires that all open positions at CME Clearing be closed promptly.

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[8] CMECE has a separate financial safeguards package (and will soon introduce a second for IRS), and separate contractual powers in its rulebook, which are similar to the arrangements of CME.

If a marketplace (e.g., IRS, CDS, exchange-traded contracts) is systemically critical, regulatory intervention to maintain the continuity of operations would likely take place only after all assessments on non-defaulting clearing members had taken place. If the failing marketplace was not systemically critical, it could be shut down via the application of Rule 818 without CME Inc being put into resolution. If all three marketplaces were non viable, or clearing members lost confidence in the ability of CME Clearing to continue, it would be appropriate to begin resolution procedures for CME Inc. The regulatory authority should preserve flexibility to decide when to initiate resolution proceedings in accordance with the unique circumstances of each crisis and as part of the FMI's RRP.

The Recovery section of the Consultative Report recommends that FMIs that take on credit risk allow for the termination of any unmatched contracts that could not be sold in auction, with cash settlement based on a valuation of the gains/losses to allow for the CCP to remain solvent. CME Clearing has already instituted this practice in its rules for IRS and CDS, tearing up contracts at a price determined by the settlement cycle, and CMECE has does likewise in its new IRS rules. Unmatched contracts are those to which the defaulter or defaulters were counterparty.

CME Clearing and CMECE believe CCPs should regularly and critically examine the adequacy of existing arrangements for their recovery, including loss allocation, as part of the RRP process. While the Consultative Report addresses credit risk as a threat to the viability of CCPs, liquidity risk, including the failure of a custodian or depository and the freezing of assets, may pose a greater danger.

III. Comments on the Consultative Report

In addition to the questions to which CPSS-IOSCO specifically requests comment, we offer the following comments about certain stipulations the Consultative Report makes in Section 2, Relationship and continuity between the *Key Attributes* and the *Principles*.

> 2.5, 2.6: activation and enforcement of recovery plans: *"… an FMI's execution of relevant recovery measures may be suboptimal in terms of timeliness, judgment or discretion. … In such cases, the relevant authorities should have the necessary powers to require implementation of recovery measures and drive optimal execution."*

While we recognize the need for timely and effective recovery measures, we believe assigning the power to require and enforce implementation measures to authorities invites the possibility of unnecessary or unhelpful intervention that could make recovery more difficult. A more effective approach is to ensure that the operators of the FMI have all the necessary incentives to implement a complete range of recovery actions.

It is premature to identify precise indicators for recovery at this time, but when reliable indicators are identified they should be used by FMI management to trigger recovery measures, not by the regulatory authorities to request subjective analysis from FMI management aimed at determining when the authorities should intervene with prescriptions for recovery measures.

> 2.9: resolution planning disclosure: *"Authorities should review the plans with the FMI to the extent necessary, but they may decide not to disclose them, or parts of them, to the FMI."*

We find it concerning that an FMI could be unaware of authorities' plans for its resolution. It is reasonable to expect authorities to engage FMIs in confidential discussions of resolution planning, in part to determine whether the plan is practical. The ability to withhold all or part of a resolution plan from the FMI to which it applies seems unnecessarily secretive and prone to unanticipated consequences.

IV. Proposed distinctions among FMIs

As we mentioned in the introduction, it is important to differentiate among different kinds of FMIs when formulating recovery and resolution procedures. The Consultative Report distinguishes between FMIs that do and do not take on credit risk. We believe this is a useful method of distinction and propose that (B) in the list below is the most practical method for identifying whether a given FMI is a credit-risk taking FMI:

A. If an FMI has a banking license, then it is credit-risk taking.
B. If an FMI takes settlement credit risk or novation credit risk, then it is credit-risk taking.
C. If an FMI takes any amount of credit risk, then it is credit-risk taking.

The distinction between credit-risk taking and non-credit-risk taking could be just one of several ways to distinguish among different kinds of FMIs. For example, another distinction could differentiate between FMIs that calculate and facilitate payments and settlements but do not take credit risk and those that are repositories or disseminators of trade information.

V. Regulatory jurisdictions

Finally, in order to facilitate rapid resolution, we request that fewer regulatory jurisdictions be involved in oversight, recovery, and resolution processes. Regulators from many jurisdictions may want to be involved, especially if an FMI deals in multiple jurisdictions and currencies, but such onerous intervention would hinder resolution. One possible solution is to implement a trusted regulatory regime where the oversight of the designated lead regulator is assigned to another trusted regulator that commits to following an agreed set of oversight standards and keeping all interested regulators informed of developments.

Again, we appreciate this opportunity to provide the Committee members with our comments. If you have any comments or questions about our submission, please feel free to contact Tim Doar by telephone at (312) 930-3162 or by e-mail at Tim.Doar@cmegroup.com; or Andrew Lamb by telephone at (44) 203-379-3130 or by e-mail at Andrew.Lamb@cmegroup.com.

Sincerely,

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