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Committee on Payment and Settlement Systems
Bank for International Settlements
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Board of the International Organization of Securities Commissions
C Oquendo 12
28006 Madrid
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Re: Comment on CPSS-IOSCO Consultative Report on Recovery of Financial Market Infrastructures

Ladies and Gentlemen:

The Depository Trust and Clearing Corporation ("DTCC") supports the continued efforts of the Committee on Payment and Settlement Systems ("CPSS") and Board of the International Organization of Securities Commissions ("IOSCO") to develop recovery and resolution guidance for Financial Market Infrastructures ("FMIs") and appreciates the opportunity to comment on the CPSS-IOSCO consultative report on "Recovery of financial market infrastructures" (the "Consultative Report"). In addition, DTCC is pleased to address some of the topics highlighted by CPSS and IOSCO in the Cover Note to their Consultative Report and recognizes the significant efforts of CPSS and IOSCO in framing the issues with respect to effective recovery of FMIs.

DTCC strongly supports the stated purpose of the Consultative Report "to provide guidance to [FMIs] on the development of recovery plans" and appreciates that the Consultative Report "is not intended to create additional standards for FMIs . . . beyond those set out in the CPSS-IOSCO *Principles for financial market infrastructures* (PFMI) but, rather, to provide supplemental guidance on, and a menu of tools for, observance of the PFMI." As acknowledged by CPSS and IOSCO in the Consultative Report,

not every recovery tool identified would be appropriate for every FMI operating in every type of market, but rather, "[t]the appropriateness of recovery tools will vary based on the particular circumstances and on the type of FMI." DTCC recommends that any final document based on the Consultative Report be similarly construed as guidance and that FMIs retain the flexibility to develop and implement recovery tools that are appropriate for each FMI's unique risks and circumstances.

More specifically, and as discussed in more detail below, DTCC wishes to make the following points.

- DTCC believes that CPSS and IOSCO should avoid implicitly or explicitly endorsing any one loss allocation rule or adopting a one-size-fits-all approach to loss allocation rules.

- The treatment of indirect participants must take into account the FMI's rules, governance, market structure and regulatory environment.

- While working in close coordination with their primary supervisors, and with the active engagement of their boards of directors, FMIs need to have sufficient discretion to act in the best interests of their participants or members in uncertain market conditions.

- The recovery and resolution strategies developed by or with respect to the participants of FMIs should be consistent with the recovery strategies developed by FMIs.

- Further consideration is needed as to how an FMI may most efficiently replenish its financial resources after covering losses caused by a participant's default.

- Given the general ability of FMIs to adopt legally binding rules to allocate losses arising from a participant's default on an *ex ante* basis, DTCC believes that *recovery* tools may be as effective, if not more so, as *resolution* tools for allocating losses and thus supports the focus of CPSS and IOSCO on *recovery* vis-à-vis *resolution*.

Loss Allocation Tools in Situations of a Participant Default

DTCC agrees with CPSS and IOSCO that FMIs should aim to have in place legally binding rules that are capable of comprehensively allocating losses resulting from a participant's default. DTCC further agrees that the desire of market participants for predictability with respect to the application of loss allocation rules must be balanced against the needs of each FMI to have

the appropriate degree of flexibility to respond to the unique risks and circumstances that it faces. Towards that end, DTCC believes that:

- (i) CPSS and IOSCO should not limit the menu of loss allocation tools available to an FMI to those identified in the Consultative Report; (ii) any list of loss allocation tools in any forthcoming final guidance should be illustrative and not exhaustive; and (iii) CPSS and IOSCO should make explicit in any final guidance that there is no presumption in favor of any particular loss allocation tool;

- any guidance regarding the treatment of an FMI's indirect participants must allow for variations in regulatory and market structure; and

- FMIs must retain a suitable amount of discretion to act in a way that best serves the interests of their participants in market circumstances that cannot be perfectly predicted in advance, including having the ability to select loss allocation tools that are most appropriate for the circumstances at hand.

Potential Recovery Tools Should Not be Limited to Those Identified in the Consultative Report[1]

Consistent with the Consultative Report's description of a range of potential loss allocation tools, DTCC believes that it is appropriate for an FMI's comprehensive loss allocation tools to be comprised of a collection of various types of tools. Each of the specific tools described by CPSS and IOSCO in the Consultative Report—including prefunded resources, *ex post* assessments, position-based allocation tools, variation margin haircutting, initial margin haircutting and certain forms of tear ups—could be useful loss allocation tools for many FMIs operating in many different markets.

Each FMI, however, is exposed to different risks, has its own organizational structure, and operates in a specific market and regulatory environment. As a result, loss allocation tools that are appropriate for one FMI may not be practical or viable for another FMI. For example, DTCC recognizes that the variation margin haircutting loss allocation tool described by CPSS and IOSCO in the Consultative Report may be an effective and efficient loss allocation tool for central counterparties ("CCPs") in certain markets. However, variation margin haircutting may not be an effective loss allocation tool for those cash market CCPs that do not pass variation margin through to their members, or, as the Consultative Report acknowledges, for those CCPs that are not closed systems and where a "participant might have an equal (or larger) opposite position

[1] This section responds to items 2 – 3 and 5 – 7 of the Cover Note.

outside the CCP that it is hedging," such that "variation margin haircutting does not necessarily allocate losses to those who are best able to cope with them."

DTCC urges CPSS and IOSCO to recognize that the most appropriate loss allocation tool for one FMI will often not be the most appropriate tool for another FMI. In this regard, DTCC believes it is important for CPSS and IOSCO to avoid implicitly or explicitly endorsing any one loss allocation rule as the "gold standard" or adopting a *de facto* one-size-fits-all approach to loss allocation rules. Similarly, any determination as to whether one or more loss allocation tools is inappropriate for an FMI should be made by individual FMIs, in consultation with national supervisors and participants, and take into account the unique market and regulatory environment in which an FMI operates.

The Treatment of Indirect Participants Must Take Into Account the Market and Regulatory Environment[2]

DTCC recognizes the importance of considering the effect of loss allocation rules on *indirect* participants that access an FMI's services through a *direct* participant. Whatever guidelines, if any, that are developed to specifically address the treatment of indirect participants under an FMI's loss allocation rules, however, must consider variations in the market and regulatory environments in which different FMIs operate. Some FMIs operate in markets where market practice and regulatory requirements dictate that a direct participant's account at an FMI be segregated between the assets the direct participant holds for its own account and the assets its holds on behalf of its client—*i.e.*, an FMI's indirect participants. Other FMIs, however, operating in different market and regulatory environments, do not categorize the assets of their participants in this manner.

Where market and regulatory conditions are such that an FMI segregates the assets of the clients of its direct participants, it may be appropriate for the treatment of indirect participants under an FMI's loss allocation rules to be specifically addressed in those rules. In contrast, in markets where an FMI does not know which, if any, of a direct participant's assets are held on behalf of indirect participants, it will likely be more efficient to address the treatment of indirect participants at the level of the relationship between an FMI's direct participant and its clients—for example, by specifying in the contracts or regulations that govern the relationship between a direct participant and its clients how losses would flow through to a direct participant's clients—rather than at the level of the relationship between an FMI and its direct participants.

[2] This section responds to item 4 of the Cover Note.

FMIs Need Sufficient Discretion to Act in the Best Interests of Their Participants or Members[3]

DTCC recognizes that market participants require a certain degree of predictability regarding what types of recovery actions they can expect an FMI to take in a period of financial distress. DTCC further recognizes that providing this predictability may require that there be some bounds on an FMI's discretion in such periods. Nevertheless, DTCC cautions CPSS and IOSCO against explicitly or implicitly characterizing the ability of an FMI to have discretion in selecting the manner by which it responds to financial distress as being, in and of itself, contrary to the interests of an FMI's participants. In fact, where FMIs have discretion, they are generally obligated to exercise that discretion in a way that best serves the interests of their participants and can be expected to act in close coordination with their primary supervisors and with the active engagement of their boards of directors. Moreover, because it is impossible to predict with certainty what market conditions would exist at the time that a participant's default causes financial distress at an FMI, FMIs must retain discretion with respect to the application of loss allocation tools so as to implement these tools in a manner consistent with maintaining financial stability.

Ensuring that FMI Recovery Planning is Consistent with the Recovery and Resolution Plans of FMI Participants[4]

DTCC agrees with CPSS and IOSCO that FMIs should be prepared to address the risk of losses caused by a participant's default. DTCC also recognizes, however, that many of the most significant financial institutions that are participants of FMIs are subject to recovery or resolution planning requirements, pursuant to which these financial institutions must develop strategies to continue to meet their settlement obligations to FMIs in financial distress and resolution. The strategies of FMIs to address losses caused by a participant's default, on the one hand, and the strategies of the participants of FMIs to continue to satisfy settlement obligations in financial distress in resolution, on the other hand, will necessarily be related. There is a risk, however, that frictions may exist between these separately developed strategies. DTCC therefore urges FMIs, FMI participants and regulators to be cognizant of the risk of potential inconsistencies in these separately developed strategies and of conflicts that may arise in the execution of these strategies and recommends that CPSS and IOSCO consider ways to minimize those risks.

[3] This section responds to items 2 – 3 of the Cover Note.

[4] This section responds to item 1 of the Cover Note.

Replenishing Financial Resources After a Participant's Default[5]

DTCC agrees with CPSS and IOSCO that, after a participant has defaulted, in order to be able to continue providing critical services, an FMI would need to replenish any financial resources that could have been depleted as a result of covering the losses caused by the participant's default. DTCC also recognizes that it would be inappropriate to rely on public funds to replenish an FMI's financial resources. In contrast, DTCC believes that using assessments on an FMI's participants to replenish financial resources after allocating losses caused by a participant default would result in those parties that will benefit from the FMI's continued provision of critical services bearing the costs of replenishing its financial resources. This is particularly true where an FMI's participants are also its owners. DTCC therefore further agrees with CPSS and IOSCO that assessments on participants could be an appropriate and effective means of replenishing an FMI's loss absorbing financial resources after allocating losses caused by a participant's default. Even so, DTCC believes that FMIs, market participants, and regulators must give further consideration as to how an FMI may most efficiently replenish its financial resources after covering losses caused by a participant's default.

Incentives in Recovery and Resolution[6]

Finally, DTCC supports the focus of CPSS and IOSCO on *recovery* vis-à-vis *resolution*.

As noted by CPSS and IOSCO in the Consultative Report, when considering the recovery and resolution of FMIs, it is important to remember that, with the approval of their supervisors, FMIs generally have the capacity to adopt legally binding rules that would establish on an *ex ante* basis how losses would be allocated among an FMI, its owners and its participants. Furthermore, as suggested by CPSS and IOSCO, it may be possible for an FMI to have a suite of legally binding loss allocation tools that could be used in certain circumstances to comprehensively allocate virtually any shortfall or loss that may be incurred as a result of a participant default in a manner that avoids the insolvency of the FMI and allows it to continue to operate.

DTCC agrees with CPSS and IOSCO that, "losses that are not allocated by one method will necessarily be allocated by another method." Accordingly, losses that are not allocated using an FMI's recovery tools will be allocated under the rules of the applicable bankruptcy, insolvency or

[5] This section responds to items 2 – 3 and 5 – 7 of the Cover Note.

[6] This section responds to item 1 of the Cover Note.

other resolution regime. DTCC believes recovery tools will generally be the preferable mechanism to allocate losses. Recovery tools can be tailored to the unique risks and circumstances of each FMI and, where they are part of an FMI's binding rules or other contractual arrangements, would be adopted through established processes that take into account the interests of participants and other relevant stakeholders. In contrast, resolution tools, by their nature, must be broadly applicable to many different institutions.[7] Recovery tools are therefore more likely than resolution tools to result in greater market certainty regarding how losses would be allocated among stakeholders, provide appropriate incentives for FMIs and their participants and minimize moral hazard.

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We appreciate this opportunity to comment on the Consultative Report and your consideration of the views expressed in this letter. Many of these matters are complex, and we would welcome the opportunity to discuss the Consultative Report and our comments in this letter. If you have any questions or need further information, please contact me at lthompson@dtcc.com.

Sincerely,

Larry E. Thompson

Larry E. Thompson

[7] Nevertheless, DTCC also agrees with CPSS and IOSCO that, in the unlikely event that an FMI incurs losses that cannot be fully allocated by means of its *ex ante*, legally binding loss allocation rules, regulators need to have resolution powers with respect to FMIs that allow for the continuity of critical FMI functions. DTCC notes the work of the Financial Stability Board in this regard, and, in particular, its consultative document on the "Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions," but believes further thought must be given to tailoring resolution tools and concepts to FMIs and their rules.