21. For which markets, asset or product classes and client types would client participation be most feasible and/or desirable? What would be the incentives for clients to participate in auctions? Does this differ for direct vs indirect client participation? Please elaborate in your response.

CCPs should always have the ability to (and seek to) include clients in default management auctions. Similar to clearing members, many types of clients have an economic motivation to bid on the positions in a defaulted portfolio, and their participation can only increase the likelihood of a successful auction.

Importantly, permitting client participation is consistent with the overarching objective of resolving a default at the lowest possible cost to the CCP and its participants. In particular:

- Including all available sources of private sector investment capital increases the likelihood of a successful auction with more competitive bidding and a fair and efficient final price.

- Increasing the diversity of auction participants reduces the likelihood that an otherwise homogenous universe of participants will be similarly constrained in their auction participation by adverse market events. This is preferable to limiting auction participation to a small group of bank clearing members with business models that are highly correlated to each other (not to mention to that of the defaulted clearing member).

- Certain clients are leading market makers in the futures and options markets, and increasingly in the cleared OTC derivatives markets as well. It is essential to include leading market makers in default management auctions, as they have unique capabilities and the capacity to price and absorb large risk transfers.

- Other client segments specialize in managing large directional portfolios, and may thus be better situated than clearing members to absorb a defaulted portfolio, which by definition, includes material directional risk.

Experience with past default management auctions has clearly demonstrated the value of client participation. For example, clients were instrumental in successfully resolving the Lehman default at CME, providing the highest bid in a majority of the auctions held (*see* Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner's Report Volume 5 (Mar. 11, 2010), available at https://web.stanford.edu/~jbulow/Lehmandocs/menu.html at pages 1851-55).

We note that the CFTC's Market Risk Advisory Committee highlighted the importance of permitting clients to participate in auctions as part of its recommendations regarding CCP default management (*see* https://www.cftc.gov/sites/default/files/idc/groups/public/@aboutcftc/documents/file/mrac111716_ccpdrecommendations.pdf at page 4).

22. The discussion paper describes some ways to address the risks borne by a clearing member arising from its clients bidding in an auction. Are there additional ways to address the risks? Are there incentives that a CCP could employ to encourage client participation in an auction (eg ways to encourage clearing members to facilitate their clients' participation)?

In order to participate in an auction, a client must have a clearing member that is prepared to clear the positions in the defaulted portfolio that the client is bidding on. Therefore, the client's participation in the auction will be consistent with, and governed by, the terms of the clearing arrangement bilaterally negotiated between the client and its clearing member. These bilaterally-negotiated terms provide the clearing member with the ability to manage any risks associated with the client's participation in the auction, such as by establishing notional-based or exposure-based risk limits for the client's clearing activities.

Given the ability of a clearing member to use the bilaterally-negotiated clearing arrangement to manage any risks associated with one of its clients participating in an auction, it should not be necessary for the client to submit auction bids indirectly through its clearing member – rather, clients should be able to bid directly in the auction. Requiring clients to indirectly submit bids through a clearing member could lead to potential conflicts of interest given that the clearing member will also likely be bidding in the auction on a principal basis.

In addition, we note that a client's participation in an auction should not create any new or unique risks for third-party clearing members compared to general client clearing activities. Therefore, approval from other clearing members, or the CCP's risk committee, should not be required in order for a client to participate in an auction. Such requirements could create the risk of anti-competitive behavior, as other clearing members may wish to limit the number of competing bidders.

Overall, client participation will be encouraged by CCPs adopting clear rules regarding eligibility and the overall bidding process.

a. **One option for addressing a disparity in incentives between clearing members and clients is to require clients to contribute an established amount to the default fund prior to participating in an auction. What are the implications of this requirement (such as regulatory, economic or contractual implications) and how can a CCP address these implications?**

We set out below why requiring clients to contribute to the default fund in order to participate in an auction is inconsistent with the overarching objective of establishing auction procedures that are designed to resolve a default at the lowest possible cost to the CCP and its participants.

1. **Requiring a client contribution to the default fund should not be expected to improve the functioning of the auction**

One argument advanced in support of requiring a client contribution to the default fund is that client and clearing member incentives are otherwise misaligned to an extent that can negatively impact the auction. This is not the case, as there is in fact a strong alignment of incentives that supports competitive bidding in the auction. In particular:

- From an economic perspective, both clients and clearing members will be approaching the auction bidding process in a similar manner – with an interest in accurately assessing the current fair market value of the defaulted portfolio and evaluating the potential upside associated with acquiring the defaulted portfolio.

- The CCP's default management waterfall also creates strong incentives for both clients and clearing members to see a successful auction at the lowest possible cost to the CCP. While clients do not have a default fund contribution that is part of the waterfall, they have a strong interest in avoiding the use of other default management tools that may be available to the CCP in the event the auction is unsuccessful, such as variation margin gains haircutting or partial tear-ups. In addition, both clients and clearing members have a strong interest in ensuring that the CCP remains solvent.

Experience with default management auctions clearly demonstrates this alignment of incentives, as clients have proven to be responsible and good faith bidders that are capable of winning auctions and assisting CCPs in successfully resolving clearing member defaults. There is no evidence of any fundamental design flaw resulting from client participation that impairs the efficient functioning of the auction.

We note that, to the extent any auction participant provided an off-market bid in bad faith, the bid would not leave the CCP any worse-off compared to if the firm had not participated at all, and that firm would at a minimum suffer material reputational consequences including, but not limited to, not being invited to participate in future auctions.

2. Requiring a client contribution to the default fund is not necessary to address information leakage concerns

Another argument is that, absent a default fund contribution, a client may be more likely to disclose confidential information regarding the defaulted portfolio or use the confidential information to trade against the defaulted portfolio. However, this argument ignores the non-disclosure agreement that is entered into between the CCP and each auction participant. A client would suffer serious legal, regulatory, and reputational consequences for breaching this non-disclosure agreement and would be no more likely to do so than a clearing member. As a result, there is no unique information leakage risk associated with client participation that needs to be addressed by requiring clients to contribute to the default fund.

3. Requiring a client contribution to the default fund would significantly impede client participation in auctions

Requiring clients to contribute to the default fund as a prerequisite to participating in an auction would constitute a significant barrier to client participation in auctions (not to mention the fact that certain client segments are legally prohibited from making default fund contributions at all). Impeding client participation in default management auctions is inconsistent with the overarching objective of establishing auction procedures that are designed to resolve a default at the lowest possible cost to the CCP and its participants. As discussed above and supported by actual market experience with default management auctions, there is no flaw associated with client auction participation that warrants requiring client default fund contributions as a remedy.

While clearing members may allege that it is unfair to allow clients to participate in auctions without having a default fund contribution at risk in the default management waterfall, it is important to note that being a direct clearing member entails not only material obligations but also material benefits. While clearing members are required to make a default fund contribution, they also have access to unique benefits, such as (a) extensive involvement in CCP governance and product strategy, (b) revenue share programs, (c) compression services, (d) lower clearing costs and/or margin levels, and (e) the ability to operate and earn revenue from a client clearing offering. It appears unfair to impose a significant cost of direct clearing membership on clients – just in order to participate in an auction – without providing access to the related benefits described above.

We encourage regulators to support client participation in auctions and note that CCPs have largely refrained from requiring default fund contributions from clients. In fact, we are only aware of one exception in a single asset class (and note that even in this one instance, the requirement is abandoned should the initial auction fail and a secondary auction is necessary – a clear admission that such a requirement is likely to impair both participation in and the likelihood of success of the initial auction). As such, requiring default fund contributions from clients as a prerequisite to auction participation would represent a significant change to current market practice and would have a serious impact on CCP default management frameworks.

26. Are there any additional points of consideration that would contribute to a successful auction that are not mentioned in this discussion paper? If so, what are they?

In our view, further investment is required from CCPs and clearing members to develop more robust and automated porting processes. Improving the ability of clients to efficiently port positions between clearing members can help to mitigate the impact of a clearing member default on non-defaulting clients and the broader market. We encourage regulators to monitor and assess the procedural steps and time required to port positions during normal market conditions, with a view to improving these statistics over time.