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Via email

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**Re: CPMI-IOSCO Consultative paper, “Resilience and recovery of central counterparties (CCPs): Further guidance on the PFMI”**

Ladies and Gentlemen:

The Depository Trust & Clearing Corporation (“**DTCC**”) appreciates the work of the Committee on Payments and Market Infrastructures (“**CPMI**”) and the Board of the International Organization of Securities Commissions (“**IOSCO**”) (collectively, “**CPMI-IOSCO**”) to provide proposed additional guidance in the form of the recently published consultative report, entitled *Resilience and recovery of central counterparties (CCPs): Further guidance on the PFMI* (the “**Consultative Report**”), with the intent of furthering CCPs’ ongoing efforts to enhance their resiliency and ability to recover from extreme stress events. We also appreciate the opportunity to comment on the Consultative Report, and hope that our comments will be taken into consideration in finalizing the proposed guidance.

**I. Introduction**

It is important when evaluating the proposals and their potential impact to consider them in their full context. For this reason and by way of background, we provide the following details about DTCC—who we are, how we are organized, and who our stakeholders are.

DTCC is the operator of the U.S. cash market securities CCPs—National Securities Clearing Corporation (“**NSCC**”) and Fixed Income Clearing Corporation (“**FICC**”), both of which have been designated as systemically important financial market utilities (“**SIFMUs**”) under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“**Dodd-Frank**”). NSCC and FICC provide critical clearing and settlement services for multiple asset classes, including US

equities, corporate and municipal bonds, and government and mortgage-backed securities. DTCC is the parent company of NSCC and FICC.<sup>1</sup>

DTCC is owned and governed by the users of its SIFMU subsidiaries, all of whom commit capital as owners, pay fees for services and ultimately benefit from the safeguards, efficiencies and risk mitigation that DTCC provides. This ownership model effectively aligns interests among our users, our Board of Directors and management, while fostering capital efficiency and delivering cost-effective operating and processing solutions. DTCC's Board is currently comprised of 20 directors, a majority of which (12) are representatives of participants in the SIFMU subsidiaries, including international broker-dealers, custodian and clearing banks and investment institutions. Another 4 directors are individuals who are not affiliated with any participant, but who have backgrounds in financial services and provide independent perspective. Individuals are nominated for election as Directors based on their ability to represent DTCC's diverse client base, including direct and indirect users across the global financial services industry. Directors serve on a variety of Board committees with responsibility to oversee all aspects of DTCC and its SIFMU operations, including the management of risk.

Given that the proposed guidance is applicable to all CCPs, these two key differences—our cash markets services and our user-ownership and governance structure—need to be considered when analyzing the impact of the proposed guidance; particularly as the impetus behind the development of the guidance stems largely from the mandate for central derivatives clearing<sup>2</sup> and, as such, has focused on derivatives CCPs, which differ materially in their design, corporate ownership and governance structure.

## II. Executive Summary

DTCC recognizes the significant effort of CPMI-IOSCO in preparing the Consultative Report. It builds off the foundational work of the past several years, including CPMI-IOSCO's sponsorship and participation in numerous industry workshops and roundtables, and conducting industry stock-taking with CCP surveys to gauge stress-testing and margin practices, recovery tools and the status of recovery planning.<sup>3</sup> The members of CPMI-IOSCO have clearly made great strides to address concerns raised over the past few years regarding CCP resilience and risk practices by derivatives industry trade groups, CCPs, prudential and supervisory regulators, and others. We fully appreciate the enormity and complexity of this task, particularly in balancing the interests of all constituents.

One of the great strengths of the PFMI is its principles-based approach, which enables FMIs that differ in their design, organization and structure to take different approaches to achieve a common desired result.<sup>4</sup> This approach provides a CCP with the flexibility to achieve these

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<sup>1</sup> DTCC is also the parent of The Depository Trust Company, the U.S. central securities depository, an entity also designated as a SIFMU.

<sup>2</sup> See Communique of Pittsburgh G-20 summit, September 2009, which stated that “[a]ll standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.”

<sup>3</sup> Following the release of the CPMI-IOSCO Final Report, *Recovery of financial market infrastructures* (October 2014) (referred to as the “**Recovery Report**”), in 2015 CPMI-IOSCO conducted stock-taking surveys of CCP financial risk management practices relating to margin, recovery planning, prefunded loss absorption capacity, and CCP contribution to losses.

<sup>4</sup> See section 1.2 of the PFMI Report: “In general, these standards are expressed as broad principles in recognition of FMI's differing organizations, functions, and designs, and the different ways to achieve a particular result. In some

regulatory standards in a manner that is both consistent with its business model and that best effectuates the goals of the PFMI.

The current Consultative Report appears to follow the path taken in this year's cyber resilience guidance,<sup>5</sup> in layering significant granular detail on the expectations that international regulators have, in particular, with respect to CCP Boards of directors and their governance obligations (and by implication, on boards and governance of FMIs generally).<sup>6</sup> We agree in principle with the stated objectives of CPMI-IOSCO and we strongly support efforts to improve CCP resiliency reduce systemic risk in the financial markets. We have significant concerns, however, that much of the proposed guidance in the Consultative Report is too prescriptive or may be impractical, particularly relative to different markets and asset classes cleared by CCPs. These shortcomings risk overshadowing or contradicting the benefits of a principles-based approach.

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

- As currently drafted, it would appear that many of the duties expressly assigned to the Board encompass functions that are properly the purview of management, particularly in their collective detailed effect. Board accountability should not equate to involvement in management's proper function, since this risks reducing the effectiveness of the board's independence and oversight.
- With respect to CCP governance, and the specificity with which expectations on directors responsibilities are enumerated, we believe this approach could have a significant unintended impact on the ability of CCPs to attract and retain individuals with the requisite talent to serve as directors.
- The prescriptive nature of some of the guidance could limit necessary flexibility and discretion in times of stress, and leave the CCP and its board without the means to seek alternative approaches or tools, or the ability to apply appropriate judgment to mitigate model-driven effects.
- Overly prescriptive guidance designed to address concerns expressed by stakeholders whose focus is on derivatives markets and risk models, may not necessarily, or appropriately, translate to the cash markets in all cases. Some examples of this include issues and mechanisms to re-establish a matched book, stress testing for client collateral or client positions (in markets where separate client positions do not exist at the CCP level), and using unsynchronized stress scenarios and test results to size prefunded resources.
- The aggregate effect of the recommendations—including guidance to mitigate procyclicality and knock-on effects--could increase the costs of clearing significantly, without necessarily providing a concomitant risk mitigating benefit. We urge CPMI-IOSCO to seek a

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cases the principles also incorporate a specific minimum requirement. . . to ensure a common base level of risk management across FMIs and countries."

<sup>5</sup> See the CPMI-IOSCO Final Report, *Guidance on cyber resilience for financial market infrastructures* (June 2016).

<sup>6</sup> See section 1.2.1 of the *Consultative Report* (Purpose of the report): "The guidance in this report is not intended to create additional standards for CCPs beyond those set out in the PFMI, but rather to provide a more granular description of how the Committees expect the PFMI to be implemented by CCPs."

balance that does not result in further concentration of CCP membership (which itself creates additional risk).

- We also recognize there are areas of the Consultative Report where CPMI-IOSCO has adhered more to the principles-based approach and sought to balance stakeholder views with the appropriate concerns of CCPs. In particular we note, and support, the guidance that the CCP's board should assess and determine (i) the requisite level of financial and liquidity resources the CCP should maintain, and (ii) the amount and structure of the CCP's own contribution to its loss waterfall, taking into account the results of stakeholder engagement.
- Given how the guidance is drafted, it would seem that CPMI-IOSCO anticipates that some of the guidance will likely require regulatory implementation at the national level. Given the specificity of the guidance, technology enhancements may also be necessary in order for CCPs to achieve compliance. Accordingly, we believe that CCPs may need some time beyond year-end 2017 to fully implement all of the guidance, once it is finalized. We believe the most appropriate way to advance implementation would be to permit CCPs to prioritize those aspects of the guidance most material to their structure, design and markets, and agree on implementation timelines with their supervisory authorities in a manner that integrates the guidance with prevailing regulatory priorities.

### **III. Discussion of Specific Comments**

#### **1. Governance**

Chapter 2 of the Consultative Report is intended to build on Principle 2 (Governance) of the PFMI, which sets forth high-level governance requirements for FMIs, including CCPs. In particular, Principle 2 provides that an FMI must have documented governance arrangements that provide clear and direct lines of responsibility and accountability and clearly specified roles and responsibilities for the FMI's board of directors and for its management. Principle 2 also sets forth the explicit responsibility of an FMI's board of directors to establish a clear, documented, risk management framework that includes the FMI's risk tolerance policy, and to ensure that the FMI's design, rules, overall strategy and major decisions reflect appropriately the legitimate interests of its direct and indirect participants and other relevant stakeholders. These duties of the board to establish a risk management framework appropriately rest with the board, since it is the board of directors of the FMI that is tasked with the over-arching governance of the enterprise. How these requirements are specifically implemented may vary by organization, but the responsibility for ensuring that the implementation is effectively carried out rests with the board.

The Guidance contained in chapter 2 of the Consultative Report is intended to build on the governance requirements of Principle 2 by enumerating specific elements that the risk management framework of a CCP should contain. However, rather than directly specifying the elements of a risk management framework (which could properly follow from the requirements of Principle 3—Framework for the comprehensive management of risk, rather than Principle 2) and leaving it to the CCP's board, in the exercise of its fiduciary duty, to determine the appropriate manner of implementation, the Consultative Report calls for the board to be "explicitly responsible" for many elements that fall under the day-to-day risk management of the CCP, such as:

- Ensuring that the margin system and stress-testing framework are designed to set and maintain on an ongoing basis the CCP's required level of financial resources, which includes (i)

the required level of total prefunded financial resources to cover credit exposures and (ii) the required level of qualified liquid resources in each currency to cover liquidity exposures.

- Ensuring that the stress-testing framework includes proper identification, scenario selection, risk measurement and appropriate analyses of stress-testing scenarios, models and underlying parameters and assumptions.
- Responsibility for identifying, clarifying and evaluating the choices and trade-offs present in the design of the overall risk management framework, including the target degree of credit and liquidity risk mutualization. Part of this process entails evaluation of various models and approaches and selection of those most appropriate for the product(s) cleared.
- Making pro-active decisions on resizing margin and default fund amounts to maintain required levels of financial resources, and ensuring that the CCP maintains the required levels of financial resources on an ongoing basis.
- Responsibility to assess and limit – to the extent practicable and prudent – destabilising, procyclical changes in the overall quantity of financial resources collected from direct participants, including initial margins, margin add-ons, default fund contributions and the impact of collateral haircuts. In this regard the board is directed to establish quantitative and qualitative criteria to assist in evaluating procyclical effects.
- Ensuring that the validation of the CCP's margin system and stress-testing framework for both credit and liquidity risks is conducted at least annually and in a manner that is independent of the development, implementation and operation of the models and their methodologies.
- Explicit responsibility for determining and exposing to certain losses an amount of the CCP's own financial resources that would enhance confidence in the CCP's risk management; particularly, the amount and characteristics (e.g. form, composition, segregation and seniority in a loss "waterfall") of a CCP's own contribution to absorb potential losses resulting from a participant default and the custody and investment of participant assets.
- Responsibility to establish a comprehensive disclosure and feedback mechanism for soliciting views from direct participants, indirect participants and other relevant stakeholders to inform the board's decision-making regarding the CCP's margin system, the stress-testing methodology and stress-testing results, and related disclosure of information to participants and any other relevant stakeholders to facilitate their review.
- Other examples include the requirement that the board be explicitly responsible for any material change to the margin system and stress-testing framework.

By using language such as "explicitly responsible", the Consultative Report suggests that the Board itself must perform these risk management tasks. To have this detailed level of risk management prescription as a board responsibility is highly unusual and is generally inconsistent with corporate governance best practices.<sup>7</sup> These highly specific and technical

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<sup>7</sup> See Committee of Sponsoring Organizations of the Treadway Commission ("COSO") report on *Effective Enterprise Risk Oversight — the Role of the Board of Directors* (2009) available at [www.coso.org](http://www.coso.org): "An entity's board of directors plays a critical role in overseeing an enterprise-wide approach to risk management." "Boards should inquire of management about existing risk management processes and challenge management to demonstrate the

requirements would more appropriately be a responsibility of the CCP, with the board of the CCP responsible, from a governance perspective, for overseeing the effective implementation of these and other regulatory requirements by CCP management.

This is particularly concerning because the more prescriptive the requirements imposed on the board, the more the line between board oversight and enterprise management is blurred, corroding the independence of the board necessary to achieve appropriate challenge and oversight. Rather what directors bring to their oversight role is their seasoned business judgment, honed from their own business experience (whether in the financial industry, the public sector or otherwise). The level of prescriptive detail of explicit board responsibilities appears to conflate board accountability with standards for risk management, the details of which are best left to management's expertise.

Although there is a general statement that the board may delegate certain responsibilities to management, provided that, when doing so, the board clearly defines such delegated roles and responsibilities,<sup>8</sup> *the clear implication is that the primary management and implementation of these elements rests with the board and that every exception must be documented.* We believe this turns proper board oversight of management on its head, contrary to accepted corporate governance norms. Rather, the assumption should be that management is primarily responsible for achieving the stated objectives, with proper oversight and accountability by the board.

If it is deemed appropriate by regulators to require the board of directors to specifically review and approve certain risk management policies and procedures, that can be specified in the guidance, provided that the list of such designated tasks does not, taken as a whole, effectively transfer proper management functions to the board. Indeed, this approach is adopted in certain subparts of Section 2.<sup>9</sup> Mandating board review and oversight of the CCP's risk management program and policies, including its overall risk management framework, is a more appropriate allocation of responsibility from a governance standpoint, as the board should not have primary responsibility for carrying out the risk management functions on a day-to-day basis. While the ultimate responsibility rests with the board of directors, management, as the subject matter experts, should be made directly responsible for effective implementation of the risk management framework and program.

What is not clear is whether, in this section, CPMI-IOSCO intends to deviate from accepted corporate governance norms and best practices, or whether the issue is one of clarity that can

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effectiveness of those processes in identifying, assessing, and managing the organization's most significant enterprise-wide risk exposures." "Because management is accountable to the board of directors, the board's focus on effective risk oversight is central to setting the tone and culture towards effective risk management through strategy setting, formulating high level objectives and approving broad-based allocations." See also Eric J. Pan, *The Duty to Monitor under Delaware Law from Caremark to Citigroup* (the Conference Board No. DN-004 February 2010), "Pre-Caremark case law (*In re Caremark International Inc. Derivative Litigation*, 698 A. 2d 959 (Del Ct. 1996)) perpetuated a CEO-centric model of corporate governance with little obligation on boards to supervise officers and employees. *Caremark* gave more substance to the duty to monitor. Taken to its logical extension, *Caremark* shifted the burden onto boards to put into place and evaluate the adequacy of its internal control and information reporting systems and to take into consideration the legal and economic environment of the corporation."

<sup>8</sup> See Section 2.1.1 of the Consultative Report, which provides that, "[i]n order for the board to ensure timely and appropriate action regarding the CCP's margin system and stress-testing framework, the board may delegate certain responsibilities to management. When doing so, the board should clearly define any delegated roles and responsibilities."

<sup>9</sup> For example, in section 2.2.8 the board is tasked with reviewing the CCPs policies and procedures at least annually to ensure they are effective. In section 2.2.13 the board is tasked with ensuring that the CCP conducts regular and rigorous due diligence of its participants' understanding of, and their ability to predict and manage, potential changes in margin, default fund and collateral haircuts in times of market stress.

be remedied through drafting changes. The Guidance on governance standards –and stakeholder input--needs to be properly calibrated with corporate law and board fiduciary duty standards, together with an understanding of its potential impact on the willingness of qualified individuals to serve in boardroom roles. Further, CPMI-IOSCO needs to be cognizant of the implications this guidance has on governance of FMIs more generally—particularly if the guidance is viewed as merely an implicit extension of Principle 2, which applies to all FMIs. Where the guidance veers from the principles covered in the PFMI by virtue of granular requirements, we believe the specific guidance may require implementation via regulation adopted at the national level, with appropriate notice and an opportunity for comment.

Accordingly, we believe the Consultative Report should be revised to directly require a CCP adopt a risk management framework that contains the enumerated elements (which could properly follow from the requirements of PFMI Principle 3 – Framework for the comprehensive management of risk, rather than Principle 2) and to explicitly require the CCP’s board, in the exercise of its fiduciary duty, to take ownership of the risk management framework and oversee that these elements are fully implemented and that the tasks are being performed properly.<sup>10</sup>

## **2. Disclosure and feedback mechanism**

The Consultative Report assigns explicit responsibility to the board for the establishment of a “comprehensive disclosure and feedback mechanism for soliciting views from direct participants, indirect participants and other relevant stakeholders to inform the board’s decision-making regarding the CCP’s margin system, the stress-testing methodology and stress-testing results.” (2.2.15) (Other relevant stakeholders may include other (presumably linked) CCPs, SSS and CSDs.) The guidance recognizes that effective feedback will necessarily entail relevant disclosure, but then describes, in significant detail, the elements and types of information that CPMI-IOSCO view are required for an effective disclosure and feedback mechanism (2.2.17).

This approach may stem from the desire of participants to have meaningful participation in CCP governance,<sup>11</sup> a view with which DTCC concurs. However we believe that achievement of that goal should not be confused with nor require prescriptive measures on how a CCP’s board performs its fiduciary duties.

### ***CCP Boards should have flexibility to determine the appropriate avenue for outreach.***

Given the differences in CCP ownership, design and regulatory structures, it is DTCC’s expectation that there can be *multiple* avenues and approaches through which effective outreach can be achieved, and that the approach a CCP selects is most appropriately assessed by its board, taking into account these factors.

Where a CCP is user-owned and governed, or otherwise has adopted a governance process that provides for user representation, participant input becomes imbedded in the governance process. In many cases a CCP will have, as noted above, a separate Risk Committee comprised of participant representatives who are not board members, but provide industry

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<sup>10</sup> Specifically, Section 2.1.1 should be revised to make clear that, while the CCP’s management is responsible for the implementation of the CCP’s overall risk management, including the CCP’s margin system and stress-testing framework, through the development of risk management processes, the board is responsible for carefully overseeing that implementation, communicating with the CCP’s management about the risk management processes and appropriately challenging management to demonstrate the effectiveness of those processes when assessing the CCP’s risk management framework.

<sup>11</sup> See, e.g. September 18, 2015 letter from The Clearing House to CPMI-IOSCO regarding *Recommendations on Current CCP Risk Governance & Member Consultation Processes*, available at [www.theclearinghouse.org](http://www.theclearinghouse.org).

perspectives from their employer-organizations which will reflect their commercial interests. Other viable approaches for obtaining both direct and indirect participant feedback include CCP's participating in industry groups or organizing bespoke advisory councils. Many CCPs use a combination of one or more of these approaches to obtain stakeholder feedback.<sup>12</sup>

The implicit assumption in this discussion is that the CCP has responsibility for outreach to both direct and indirect participants. But DTCC believes the guidance needs to be cognizant of the differences in CCP design and regulatory structure —especially the difference in whether indirect participants are known to the CCP. For example, given the US cash markets structure where the customer protection regime applies at the broker-dealer level and in-flight transactions do not belong to the customer (who is thus generally unknown to the CCP), we believe a CCP should be able to satisfy the requirement of indirect participant outreach by requiring that direct participants be responsible to reach out to their customers, and provide relevant feedback to the CCP.

After having obtained feedback, CCP boards need to be able to evaluate advisory committee, industry trade group, and other feedback (including any other advice from outside experts) within the context it is given—whether risk-based or commercial--and account for potential conflicts of interest and varied impacts on and among participants. This is particularly important because, at the end of the day, they are the body responsible for determining that the CCP has a comprehensive and effective risk management framework. In making such evaluations, and to encourage fulsome discussion and open exchange of views in the board room, we do not believe it appropriate or necessary to mandate granular documentation requirements, as disclosure and transparency will be addressed by corporate governance best practices and effective oversight of the outreach process and procedures approved by the board. Generally, CCP boards should articulate the reasons behind the major risk management decisions they make, but intrusive direction into the boardroom process by which those decisions are made and documented is neither beneficial nor appropriate.<sup>13</sup>

DTCC believes the intent of section 2.2.18 of the Consultative Report is to encompass such varied approaches to outreach and permit the needed flexibility as described above, but we suggest that the final guidance be clarified to avoid any ambiguity.

**Disclosure.** As regards disclosure of information, the Cover Note to the Resilience Report asks whether the current level of public disclosure by CCPs is appropriate, and includes a rather detailed list of items suggested for disclosure by an industry trade group. We do not believe it is appropriate at this time to specify such a detailed list. CCPs currently make a significant amount of information available to the public and their membership. In addition to public rulebooks, this includes detailed disclosures pursuant to the PFMI Disclosure Framework, as well as significant quantitative disclosures pursuant to CPMI-IOSCO's Quantitative Disclosures for CCPs. We believe that both regulators and industry groups should take some time to evaluate the breadth of information currently available, including information provided to participants under confidential arrangements, and see how comprehensive it is before seeking additional sensitive information. The recently implemented quantitative disclosure framework took a balanced approach between disclosure of relevant information on the one hand, and the proper concerns of confidentiality/costs and burdens of additional disclosure, on the other.

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<sup>12</sup> The Consultative Report also notes that another accepted channel for feedback is the public comment periods for proposed changes to CCP rules, procedures and operations. (Section 2.2.18).

<sup>13</sup> As for the statement (also in 2.2.18) that "records should be kept when participants or other relevant stakeholders are consulted, no matter what the forum," we do not believe it is practical or necessary to document every contact or conversation.

Thus we believe there should be a high bar in determining that additional information is needed or useful before imposing additional burdensome requirements on CCP management. Rather we believe that it should be left to management and the board, in fashioning an effective disclosure and feedback program, to determine what additional information should reasonably be provided to participants and others to effectuate the program's objectives.

### **3. Stress testing**

The Consultative Report properly notes in section 3.1.4 that the “challenges of stress testing are identifying the credit and liquidity risks to which a CCP could be exposed, constructing a range of stress scenarios that adequately capture potential future extreme but plausible market conditions, and using these scenarios to derive suitable measures of the CCP's aggregate credit and liquidity exposures and resources available to absorb these exposures, and evaluating the adequacy of its financial and liquid resources.” This chapter sets out the expectations for the rigor with which these tests are constructed and conducted.

While we concur with the objectives of the stress testing guidance, we note the following:

In developing appropriate stress testing frameworks (as well as margin models, and other areas within CCPs' risk management frameworks), we appreciate that some market participants are looking to CPMI-IOSCO to provide explicit granular requirements on assumptions, scenarios, parameters, and other aspects that would apply across all CCPs and be fully transparent. We believe such an approach is too restrictive, does not appropriately take account of differences in markets, asset classes and CCP design, and would not allow CCPs the needed flexibility to address changes to account for innovation, market developments or other idiosyncratic events. Moreover, such granular prescriptions would effectively undermine the principles-based nature of the PFMI, and could raise questions concerning regulatory standardization or mandates as to other aspects of CCP risk management.

We believe that market participants' interests in this regard are best served by CCPs engaging fully with their regulators and relevant stakeholders through appropriate outreach efforts (such as member-based risk committees or other CCP-designated stakeholder feedback mechanisms discussed above) in developing their stress testing programs, and that appropriate detail<sup>14</sup> concerning test results should be available to clearing members.

With respect to the development and selection of stress scenarios, we observe that:

- Knock-on effects and second order impacts of stress scenarios (whether singly or in combination) are difficult for a CCP to quantify, and are certainly not practical or feasible without input from CCP members and other CCPs.
- CCPs should be encouraged to review scenarios for informational purposes (that is, extreme scenarios that may not be—or are not currently—viewed as plausible) to assess the impact such events would have on their financial resources to determine if there are margin weaknesses or model issues that could develop in unexpected situations. These scenarios are not intended to form the basis on which CCP resources are sized, but they aid CCP management in the ongoing evaluation of their models under extreme market events. We believe it important that there be a clear distinction between scenarios used for such purposes, and those scenarios included in the stress tests used to determine the sizing of the requisite

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<sup>14</sup> Taking into account relevant concerns about confidentiality and sensitive market data.

financial resources. Absent such clarity in the final guidance, we are concerned that CCPs could be disincentivized from evaluating scenarios for informational purposes.

- With respect to the use of peak intraday and intra-period price move scenarios, as well as to account for intra-period position changes, we believe that the determination for the need to include such scenarios, and the specific approach to their selection, should also be left to the judgment of each CCP, rather than explicitly mandated.

Given the specificity of the discussion of scenario selection and testing requirements, we note that not all scenario types or issues are relevant to all markets. Examples, in addition to those discussed above, include stress testing for client collateral or client positions. In some jurisdictions in the cash markets, separate client positions, and thus client margin, do not exist at the CCP level.<sup>15</sup> Similarly, unsynchronized stress scenarios are not generally reflective of how cash markets work in volatile situations. Thus for purposes of clarity, we recommend that the final guidance make clear that not all scenarios are applicable to all CCPs; rather it is up to each individual CCP to select the range of appropriate stress scenarios, the selection of which will depend on the products it clears, the regulatory structure for that market, and the structure and design of the CCP itself.

#### 4. Coverage

The Consultative Report reiterates that the Cover 1 or Cover 2 requirement (if applicable) is a minimum standard, and states that the CCP's board is responsible for setting the required level of financial and liquidity resources "commensurate with its risk tolerance," and for maintaining that amount on an ongoing basis.

DTCC supports the notion that it is up to the CCP and its board to determine, based upon its risk tolerance (and in consultation with its national supervisors), whether the regulatory minimum or some other amount is the appropriate level to address credit risk and liquidity risk. Given that the proposed guidance is designed to address both credit and liquidity risk for CCPs in all markets, asset classes and jurisdictions, this approach—with the requisite minimum—reflects, we believe, the appropriate balance and approach.<sup>16</sup>

#### 5. Margin

***Procyclicality.*** A significant amount of the guidance is devoted to the importance of limiting procyclicality. The discussion is highly detailed and prescriptive, and somewhat disproportionate given the other aspects of the overall guidance. While some of the ideas discussed (such as margin floors) make intuitive sense and may have merit, we do not believe that all of the ideas have been practically vetted and are workable.

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<sup>15</sup> See PFMI Principle 14, explanatory notes 3.14.5, 3.14.6 and footnote 122. In the case of NSCC and FICC, the applicable customer protection regime (under the Securities Exchange Act of 1934, as amended) provides for customer segregation requirements with respect to transactions processed through these CCPs to be accounted for on the books and records of the broker-dealer participant, and not at the CCP level. Under this regime, customer ownership generally occurs upon or after settlement, and "in flight" transactions and margin deposited by participants do not belong to the customer. As such, there is no customer trade or position entered into the CCP, and the CCP does not maintain separate house and client accounts.

<sup>16</sup> Here we note that liquidity is an example of where the cash and derivative markets have differing needs: In the cash markets, liquidity needs are driven by the need to settle the full notional/principal amount of the securities transactions, over the relevant settlement cycle. In derivatives transactions the liquidity needs are driven by the settlement of variation margin gains until the CCP re-establishes a matched book. Such differences, we believe, support the approach set out in this chapter of the Consultative Report.

We understand the desire of CPMI-IOSCO to limit the impacts of potentially destabilizing margin approaches. However, the choice of margin frameworks must strike the delicate balance between stability of the model outputs, and appropriate responsiveness to changing market conditions so as to ensure CCP resilience. Moreover, we believe that it is appropriate for a CCP's margin methodology to adjust to extreme events not anticipated in its risk framework, and this will lead to some degree of procyclicality; no model can protect against all potential market moves. We believe such balancing requires the application of experienced risk management judgment, and that CCPs need the appropriate authority to have sufficiently flexible margin practices given unexpected market dynamics, so as to be able to react promptly and effectively.

Rather than prescribing granular requirements across all markets and CCPs, we suggest that CCPs and their supervisors look to establish principles-based guidance that supports through-the-cycle margins and haircuts in lieu of costly buffers or other mandates. CCPs should also be encouraged to look at other tools to address procyclicality risk. This includes, for example, the move to shorten settlement cycles in the cash markets.<sup>17</sup> In the U.S., the members of the Association of Systemically Important Clearinghouses<sup>18</sup> have worked extensively with their participants to provide margin transparency—particularly under stressed market conditions—to enable them to understand and anticipate changes to margin requirements due to future market moves.

**Margin system components.** We believe that the Consultative Report generally provides the appropriate balance of (i) recognizing the reasons why CCPs may reasonably include add-on component charges in their margin formulas to address particular or idiosyncratic exposures, and (ii) limiting undue reliance on such charges in the margin regime where the particular risk may be otherwise addressed. We believe, however, that CCPs, when evaluating system-generated add-on components, should be able to take into account the level of materiality of the component to the overall margin formula, and apply an appropriate level of rigor commensurate with its relative impact.

Under any circumstance, CCPs need to retain a measure of discretion to be able to deal with individual member issues that may arise, or other idiosyncratic market or participant-based events. The application of judgment from experienced risk management enables CCPs to handle such events and limit their systemic impact.

## **6. CCP contributions to losses**

In this chapter of the Consultative Report, CPMI-IOSCO notes that a CCP's contribution of its own resources to losses resulting from a participant's default or from the custody and investment of participant assets can improve confidence “that the legitimate interests of participants and other relevant stakeholders are reflected in the CCP's risk management. . .”, as expected.<sup>19</sup>

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<sup>17</sup> In this regard we support the recent rule proposal of the U.S. Securities and Exchange Commission to shorten the standard securities settlement cycle for most broker-dealer transactions from three days to two days. See Exchange Act Release No. 78962 (September 28, 2016), 81 FR 69240 (October 5, 2016).

<sup>18</sup> The Association of Systemically Important Clearinghouses is an association whose membership includes DTCC, CME Group, The Options Clearing Corporation, and ICE Clear Credit.

<sup>19</sup> Section 6.1.1, citing Key Consideration 7 of the Governance Principle (PFMI 2), which provides that the FMI's board should ensure the FMI's design, rules, overall strategy and major decisions reflect appropriately the legitimate interests of its direct and indirect participants and other relevant stakeholders.

There has been much public debate on this topic, and we recognize the efforts of CPMI-IOSCO to find a sensible and practical approach to address the concerns raised by direct and indirect participants, and by the CCPs themselves. The proposed guidance, we believe correctly, avoids prescribing a set approach or amount of so-called “skin-in-the-game” that should be contributed by a CCP to address default and non-default losses, but does suggest that CCPs should have some exposure to these types of losses, at least a portion of which should be provided senior/prior to participants’ funds being accessed. The proposed guidance, however, leaves the amount and structure of such contributions to a CCP’s waterfall to the determination of the CCP’s board, which is directed to consider the results of engagement with its stakeholders.

As we have indicated elsewhere, in determining the approach and amounts a CCP will contribute to cover losses, it is proper and appropriate for the board to consider the CCP’s ownership and governance structure, and the alignment of incentives with its market participants whose activity generates the risk to which the CCP is exposed.<sup>20</sup> This is in addition to any other factors the board deems relevant and appropriate in the exercise of directors’ fiduciary duty. Thus while we believe that CPMI-IOSCO has generally struck the correct balance in its guidance here, we believe they should make clear that a CCP’s board is *not* constrained in what it can or should consider in reaching a determination as to how, and how much, it would contribute to cover such losses.

Further, in considering what amount of CCP resources should be allocated to cover potential custody and investment losses, we believe it is appropriate for the board to consider applicable risk mitigants such as conservative investment policies, as well as standard market conventions for assigning risk of loss in custodial relationships.<sup>21</sup> Thus DTCC believes it appropriate for a board to consider such risk-based factors, as well as the CCP’s ownership model, in determining what CCP contribution amounts are appropriate in these circumstances.

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<sup>20</sup> See the DTCC White Paper, *CCP Resiliency and Resources* (the “DTCC White Paper”), available at [www.dtcc.com](http://www.dtcc.com). There we note (at p. 5) that:

By virtue of the company’s user-owned and governed utility model, the interests of DTCC and its CCPs’ members are already well aligned. DTCC nonetheless believes that its corporate contributions to NSCC’s and FICC’s default loss waterfalls signal confidence in our risk management framework. Such first-loss layers may also minimize systemic disruption and pro-cyclical impacts, provided they are sized to a level that would not materially weaken the CCP in a severe crisis. In order to provide certainty and an objectively-established contribution, DTCC would link NSCC’s and FICC’s CCP contributions to their regulatory capital requirements, which are generally based on the operating costs of each CCP. These first-loss layers—with discretion being left to DTCC’s Board of Directors to contribute more—would simplify default management in many scenarios and reduce the likelihood of NSCC or FICC having to allocate losses among non-defaulting members in a default situation.

DTCC would not link NSCC’s and FICC’s CCP contributions to the size of their guaranty funds, which are linked to members’ aggregate clearing activity and could fluctuate substantially in dynamic market conditions. It would be impractical (if not impossible) for NSCC or FICC to refuse to accept increased risk exposures created by its members’ aggregate trading activity, which occurs across multiple exchanges and trading venues. As an industry-owned utility, changes in our capital requirements would be met by our clearing members. For that reason, the additional collateral needed to protect either NSCC or FICC from increases in transaction volume is best raised through margin requirements imposed on those clearing members whose activity generated the increased risk.

<sup>21</sup> For example, it is common for custodians to disclaim liability for actions of their sub-custodians, as long as the custodian has been selected with reasonable care. We do not believe that a CCP should be held to a standard higher than common market convention.

The guidance further provides (in section 6.2.5) that “a CCP should *ensure* [emphasis supplied] that any financial resources it contributes to its “waterfall” are only available for this purpose and cannot be applied to any other type of loss.”<sup>22</sup> While we understand that for purposes of sizing the amount of requisite resources that the CCP maintains in liquid net asset form, it should not “double count” amounts intended to cover default or investment losses with amounts intended to cover other losses or risks, the language in the proposed guidance appears to go well beyond what we understand is the import of PFMI Explanatory Note 3.4.24. We do not believe that a CCP is, or should be, required to hold its capital and liquid net assets in a bankruptcy remote manner (which could also have balance sheet implications), so long as they are in sufficiently liquid form to be accessed as needed. Thus we believe the guidance should be revised to clarify that the intent of the discussion relates to how the requisite capital amounts are calculated and determined, rather than how they are required to be held.<sup>23</sup>

## **7. Recovery planning and tools**

DTCC fully supports recovery planning and appreciates that the guidance in this chapter of the Consultative Report does not mandate, or prohibit, the use any particular recovery tool, but rather largely follows the reasoned guidance of the 2014 CPMI-IOSCO Recovery Report. As we have noted elsewhere, not all tools work for all CCPs;<sup>24</sup> accordingly, we believe the most effective approach for a CCP to fashion a realistic, and reasonable, recovery plan will be to select those tools, in consultation with its national supervisors and following outreach to its stakeholders, that are most appropriate to its asset class, system design and ownership model, and reflect an alignment of incentives that accounts for those participants whose activities present risk to the CCP. We believe that both mandatory and voluntary cash assessments can be appropriate tools, and in fact are reasonable for DTCC’s cash market and user-owned CCPs as an effective means to replenish financial resources.

DTCC recognizes that market participants require a certain degree of predictability regarding what types of recovery actions they can expect a CCP to take in a period of financial distress, and that providing this predictability may require that there be some bounds on a CCP’s discretion in such periods. Nevertheless, DTCC also cautions CPMI-IOSCO against explicitly or implicitly characterizing the ability of a CCP 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 its participants. In fact, where CCP’s 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 a

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<sup>22</sup> See the PFMI Report, Explanatory Note 3.4.24, which provides that “[f]or the purposes of this principle [Credit Risk], an FMI should not include as “available” to cover credit losses from participant defaults those resources that are needed to cover current operating expenses, potential general business losses, or other losses from other activities in which the FMI is engaged. . . .”

<sup>23</sup> This can be further illustrated in context of the requirement to establish and maintain a viable plan to replenish capital resources. Consider a case of participant default where the CCP’s board may decide to apply more of its own financial resources to cover a loss than may otherwise be required by agreement, rule or regulation. The CCP would not be in a position to apply additional financial resources if they are ring-fenced (i.e., untouchable) for other, pre-determined purposes, despite the CCP’s ability to implement its viable plan to replenish financial resources, if necessary. We therefore support the idea of CCPs maintaining unrestricted access to a single pool of financial resources, appropriately sized to cover various risks, including general business risk, participant default risk and custody and investment risk.

<sup>24</sup> See the DTCC Whitepaper, and DTCC’s letter to CPMI-IOSCO responding to the 2013 Consultative Report on *Recovery of financial market infrastructures* (October 2013), available at [www.bis.org](http://www.bis.org).

CCP, they must retain some discretion with respect to the application of loss allocation tools so as to implement these tools in a manner consistent with maintaining financial stability.

## **8. Implementation**

The Consultative Report states, in the section on implementation (1.5), that the proposed guidance “does not impose additional standards on CCPs or authorities beyond those in the PFMI...” In the same section, however, CPMI-IOSCO recognize that relevant authorities may need to make changes to their regulatory framework, and CCPs may need to make changes to their rules, procedures and governance arrangements to ensure practices are consistent with this guidance. (1.5.3). the stated expectation is that all of this will be fully accomplished by year-end 2017.

Given the amount of public debate over the topics covered in the Consultative Report and the Report’s level of granularity, we believe that the guidance provided goes beyond (and in some cases, well beyond) mere clarification of what is reasonably and fairly implied by the principles-based PFMI. For that reason we believe some of the guidance needs to be adopted through formal regulatory processes at the national level, with appropriate public notice and opportunity for comment. That process may affect the timing and the final outcome of the guidance at the national level. Further, CCPs may need some time—and additional technology resources-- to address gaps in their risk frameworks to be fully compliant with all of the issues discussed in the Consultative Report. CPMI-IOSCO also should recognize that not all of the issues or proposed actions outlined in the Report may be of equal relevance or materiality to a particular CCP; CCPs should thus be able to prioritize their work streams according to their risk tolerance and the relative material benefit of the proposed remedial action. The implementation timeline needs to take these factors into account. For example, we believe that assessments and recommendations for intraday stress testing and procyclicality can be done over the short to medium term, but the actual implementation may take longer due to technology needs and regulatory filing and approval requirements. The guidance around knock-on effects is already recognized by CPMI-IOSCO as complex. Accordingly, we suggest that CCPs establish appropriate work plans and agree on implementation timelines with their supervisory authorities in a manner that integrates the final guidance with prevailing regulatory priorities.

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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. If you have any questions or need further information, please contact me at [ltompson@dtcc.com](mailto:ltompson@dtcc.com).

Sincerely,



Larry E. Thompson