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February 2, 2022

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Re: A Discussion Paper on Client Clearing: Access and Portability

Dear Sirs:

I submit this response to the above-captioned Discussion Paper in my individual capacity as a longtime observer and participant in the derivatives industry. In particular, prior to becoming a consultant to major financial firms that employ derivatives as a hedging device, I practiced law in the derivatives space for over 40 years (most recently at Prudential Financial), taught derivatives law and regulation for 12 years (Columbia Law School), published and edited the leading law journal devoted to derivatives regulation for 41 years (*Futures and Derivatives Law Report*), served on the Staff of the Presidential Task Force on Market Mechanisms ("Brady Commission") and was appointed to the CFTC's Market Risk Advisory Committee for two terms.

One of the key experiences of my career in derivatives was my participation in the Brady Commission's study and analysis of how the clearing houses functioned (or nearly did not function) during the 1987 market break. The central importance of clearing became, for me, a lodestar for any understanding of how futures and cleared derivatives markets should perform normally and in a crisis. The clearing infrastructure epitomized in the U.S. by the CME is systemically important and must be as "bullet proof" as possible against member defaults and even more critical, a failure of the clearing house itself.

As the Discussion Paper implicitly understands, in the United States the infrastructure supporting central clearing (CCPs) requires that customers be intermediated by Central Clearing Services Providers (CCSPs), which in the U.S. are Futures Commission Merchants (FCMs). Yet, the number of FCMs to choose among is very limited, especially for large institutional customers like the regulated funds, pension plans and insurance companies that the Discussion Paper specifically refers to. Further, this class of end-users are considered "financial entities" under U.S. law and therefore are required by law to clear most of their derivatives through the central clearing eco-system that under current practice requires the intermediation of an FCM.

Particularly in the case of pension plans and life insurers, their cleared derivatives in interest rate, equity and credit swaps are generally one directional which places a greater burden on the capital requirements of their intermediating FCMs – further limiting the number of FCMs that these end-users can choose among to only the largest and themselves, systemically important CCSPs.

As the Discussion Paper says, one way to ameliorate the risk of over concentration would be to disintermediate the CCSPs by allowing direct access to CCPs; i.e., for large end-users such as pension plans and insurers to self-clear. In the current U.S. clearing system this idea poses challenges, but it is not entirely infeasible.

First, pension plans and insurers might post original margin directly to CCPs in the form of the high-quality bonds (e.g., corporate and sovereign debt) that they customarily hold in their investment portfolios. Second, but more problematic, these end-users will have to have a means to meet a CCP's rapid intra- and end-of-day margin calls, including mark-to-market variation margin calls that require immediate cash flows. As a rule, pension plans and insurers do not maintain large cash reserves. Therefore, in order to accommodate such direct access customers, the CCP will have to provide a liquidity facility that allows the conversion of bonds to cash (e.g., a repo arrangement) whereby the end-user provides bonds and the CCP funds the margin call with cash. However, because variation margin flows are "final" and the direct access customers may not wish to sell their bonds, the direct access customer should have an option to provide cash in the ordinary course (perhaps on a 24-hour delay) to "redeem" their bonds back from the CCP.

Another potential challenge for insurers likely will be the need to obtain state-level approval of their direct access to CCPs from state insurance regulators. Again, this should not be an insurmountable problem because in most respects the direct access model is functionally the same as the intermediated one while it benefits from the removal of the credit risk presented by the FCM in the middle of the arrangement. Of course, this assumes as a fundamental principle that each direct access customer's account with the CCP is a separate and distinct "silo" and that there is no mutuality risk. In other words, a direct access customer will never be required to contribute to a CCP's default fund for any obligation that is not their own direct debt to the CCP.

Whether in the final analysis, the benefits conferred by the direct access model (i.e., principally the disintermediation of FCMs) out-weights its implicit complexity and cost is a matter for further consideration. In the meantime, however, the Discussion Paper's kernel of ideas is worthy of that further consideration and study.

Respectfully submitted,

Richard A. Miller