



asset management group

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Committee on Payments and Market Infrastructures

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Board of International Organization of Securities Commissions

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Financial Stability Board

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Re: Response to (1) Consultative Report of the Committee on Payments and Market Infrastructures and Board of International Organization of Securities Commissions re: Resilience and recovery of central counterparties (CCPs): Further guidance on the PFMI dated August 2016 (“CPMI-IOSCO Consultative Report”); (2) Discussion Note of the Financial Stability Board re Essential Aspects of CCP Resolution Planning dated 16 August 2016 (“FSB Discussion Note”)¹

Dear Sirs and Madams:

The Securities Industry and Financial Markets Association’s Asset Management Group (“SIFMA AMG” or “AMG”)² appreciates the opportunity to respond to the CPMI-IOSCO Consultative Report and FSB Discussion Note, which, in combination, propose further guidance on the Principles of Financial Market Infrastructures for CCPs (the “PFMI”).³ AMG appreciates the efforts of the FSB, CPMI and IOSCO to facilitate CCP resilience, recovery and resolution, including providing this further proposed guidance, studying current practices of central counterparties (“CCPs”) through CPMI and IOSCO’s Report on the financial risk management and recovery

¹ CPMI-IOSCO Consultative Report, available at: <http://www.bis.org/cpmi/publ/d149.htm>; FSB Discussion Note, available at: <http://www.fsb.org/2016/08/essential-aspects-of-ccp-resolution-planning/>.

² SIFMA AMG’s members represent U.S. and multinational asset management firms whose combined global assets under management exceed \$34 trillion. The clients of AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

³ CPMI (formerly known as the Committee on Payment and Settlement Systems) and the Technical Committee of IOSCO, *Principles for Financial Market Infrastructures* (April 2012), available at: <http://www.bis.org/cpmi/publ/d101.htm>.

practices of 10 derivatives CCPs (“CPMI-IOSCO August 2016 Level 3 Report”) and planning future reviews.⁴

The success of the G20’s OTC derivatives market reforms hinges on whether CCPs can withstand the next crisis with a financial system that increasingly depends upon central clearing. The dramatic shift to clearing more swaps—both mandated and voluntary—amplifies the important role that CCPs play. Given this new challenge, the standards by which CCPs risk manage and plan for recovery and resolution scenarios are even more crucial.⁵

AMG urges the FSB, CPMI and IOSCO, in their review of CCP resilience, recovery and resolution standards, to consider the interests of clearing members’ customers, many of whom have increased their centrally cleared positions due to regulatory directives. AMG’s members are fiduciaries that manage investments for clearing member customers including pension funds, retail investor funds (*e.g.*, mutual funds and UCITS) and private funds, among others. AMG members, in managing their clients’ investments, generally clear positions that are capable of being cleared. This direction has been imposed both by direct regulation of OTC derivatives and indirect pressures that have increased the costs of uncleared transactions. The value of this shift to clearing will depend in large part on whether asset managers’ clients—ultimate stakeholders of cleared positions with no control of the CCP and no stake in the CCP’s profits—are protected by CCP resilience, recovery and resolution standards set at an international level through the CPMI, IOSCO and FSB and implemented via national regulation. Our comments below recommend stronger standards that would benefit all market participants, including customers, and further recommend safeguarding certain customer protections.

Regarding CCP resiliency, AMG believes that dynamic margin calculations, risk-based CCP skin-in-the-game, clearing member assessments and standby credit should comprise the available pre-resolution, dedicated resources to satisfy the credit and liquidity risks measured by stress tests. We believe that procyclicality concerns should be taken into account holistically across all types of financial resource categories. We further believe CCPs should be expressly excluded from risk managing on the basis of a presumption that the CCP will be able to use the margin of non-defaulting customers to cover credit or liquidity shortfalls. Customer collateral should never be used as a backstop in CCP risk management practices. While we understand and agree with the regulatory imperative of avoiding a future tax payer bailout of a CCP, we believe that the most appropriate way to do so is to incentivize CCPs, who generate revenue by clearing trades with margin and risk management requirements, to risk manage appropriately and put their own assets at stake rather than jeopardize the assets of pension funds, U.S. mutual funds, UCITS and other investors who have no control over how CCPs calculate margin and accept new products for

⁴ CPMI-IOSCO August 2016 Level 3 Report, *available at*: <http://www.bis.org/press/p160816.htm>.

⁵ We understand that CPMI, IOSCO and FSB have agreed to a CCP work plan such that CPMI and IOSCO will address resilience and recovery while FSB will address resolution. Due to the interrelated nature of these standards, we have provided one response so that the topics can be addressed in an integrated, comprehensive manner. We have provided specific recommendations with respect to each consultation, where relevant.

clearing. AMG further believes that public disclosures and CCP recovery tools should be improved, as detailed below.

Regarding CCP recovery, AMG believes that a CCP's return to a matched book would be aided by an open auction and mechanisms to continue the payment of variation margin to and from the customers of a defunct clearing member. AMG does not believe that extraordinary measures, including mutualisation of losses to non-defaulting customers, tear-up of contracts and forced allocations, should be available for the CCP's use in recovery. Rather, these extraordinary measures should be expressly prohibited until resolution. Only after full write-down of equity positions, which may incentivize equity holders or other parties to recapitalize, and after change of control to the resolution authority should such measures be deployed and, even then, they should be used only if no better means are available to return to a matched book or to wind up the CCP.

Regarding CCP resolution, a pre-designated regulatory authority should have constrained flexibility to initiate resolution. In considering whether to move to resolution, the designated authority should include in its consideration whether extraordinary measures, including loss mutualisation and tear up, are required to return the CCP to a matched book or to wind up the CCP's business. AMG agrees that CCP resolution strategies should have the objectives of financial stability and continuity of critical functions without exposing taxpayers to risk of loss, and that resolution aims should still include returning the CCP to a matched book.⁶ AMG believes, however, that these objectives can be achieved while providing greater protections for customers, including achieving fairness in any mutualisation of loss with non-defaulting customer assets and certainty in priority of payments during a wind-up.

AMG discusses each of these topics below and makes specific recommendations on changes to the CPMI-IOSCO Consultative Report and FSB Discussion Note at the end of each section.

1. CCP RESILIENCE

1.1. Financial Resources to Cover Credit and Liquidity Risks Should be Robust and Exclude Diversion of Non-Defaulting Customer Assets

AMG supports the CPMI-IOSCO Consultative Report's guidance relating to the measurement and monitoring of risks through stress testing. We agree with CPMI and IOSCO's recommendations that a CCP should use both historical and forward-looking data to "conduct distinct but consistent stress tests for credit risk and liquidity risk," including stress tests that capture credit and liquidity risks to which the CCP could be exposed in extreme but plausible market conditions, and that the results of these tests should be used to size its respective credit and liquidity exposures.⁷ We agree that the stress tests should include bespoke scenarios specific to the CCP.⁸

⁶ FSB 1.1 and 1.2.

⁷ CPMI-IOSCO Consultative Report at Section 3.

⁸ CPMI-IOSCO August 2016 Consultative Report at 3.2.2.

In taking into account client exposures, we agree that “a CCP should make the conservative assumption that no payments will be made on behalf of a defaulting participant’s clients unless there are arrangements for direct payments from such clients to the CCP” and that “a CCP should assume that it will be unable to port client positions.”⁹ While we believe that the viability of porting should be strengthened and provide recommendations in section 1.3 below to support this result, porting is unfortunately not a certainty during times of market stress. As AMG members have experienced during prior clearing member insolvencies, porting was difficult to achieve. Porting will be even more challenging in the future due to the reduced number of clearing members in the market, the elevated role of clearing and increases to clearing member capital requirements.

AMG believes that further guidance is required on the management of credit and liquidity risks through available financial resources. Specifically:

Appropriately-Sized Margin, Including Adjustments for Risk in the System

CPMI and IOSCO should require CCPs to increase initial margin requirements to cover emerging risks in the system, including the default of a clearing member(s). This adjustment would be in addition to potential future exposure and volatility adjustments that also would result in increases. These additional margin payments should have the same protections as any initial margin paid by counterparties in the ordinary course. While some may argue that such margin adjustments could negatively impact market liquidity, the answer to the problems of market liquidity cannot be reliance upon non-defaulting customer assets, as discussed further below.

“Cover 2” as Baseline Measure for Additional Financial Resources

CPMI and IOSCO should mandate that all CCPs (1) must have prefunded and committed resources to cover the possibility that its largest two clearing members will fail and (2) either demonstrate that Cover 2 is sufficient or provide additional cover deemed sufficient beyond this level. The maintenance of financial resources below Cover 2 is insufficient to protect clearing members’ customers from a CCP failure and, under certain circumstances, even Cover 2 is insufficient. For example, a CCP that has numerous small clearing members will have more broadly distributed risks for which its two largest clearing members’ exposure would be disproportionate in light of the total exposure. Each CCP has its own risk profile that will need to be qualitatively reviewed; however, AMG believes that setting this baseline and having CCPs demonstrate sufficiency will best protect the financial system and customers.

Risk-Based Formula for Prefunded CCP Skin-in-the-Game

CPMI and IOSCO should mandate a specific formula for CCP skin-in-the-game and the formula should be tied to the risk that the CCP is being paid to manage. We believe that regulators experienced with setting bank capital requirements are well-equipped to set CCP

⁹ CPMI-IOSCO August 2016 Consultative Report at 3.2.50 and 3.2.51. With respect to porting, see Section 1.3 *infra*.

skin-in-the-game and do not understand why no such minimum is recommended in the CPMI-IOSCO Consultative Report.¹⁰ In addition to providing financial resource during market distress, CCP skin-in-the-game also puts pressure on CCPs to appropriately size margin notwithstanding the potential impact on clearing revenues that the CCP generates. CCPs are in the business of charging derivatives counterparties to centrally clear risk that would otherwise need to be held bilaterally. Regardless of the CCP's business model, for-profit or not-for-profit, CCPs generate revenue by accepting and managing this risk.

AMG believes that regulators should develop a formula to set CCP skin-in-the-game and require CCPs to commit that skin-in-the-game to pay uncovered losses due to a clearing member default. Instead of leaving the decision to the discretion of the CCP's board, regulators should establish a minimum standard. In the absence of a formulation proposed by regulators, AMG proposes sizing CCP prefunded skin-in-the-game contributions to the highest of: US\$20 million; cover for the third largest clearing member; 12% of the guarantee fund, depending upon risks specific to the individual CCP; or a test specific to the risk profile of the CCP where the other categories do not sufficiently cover the risk. This type of risk-based approach has been recommended for a number of years by both clearing members and asset managers.¹¹

AMG believes that CCP skin-in-the-game should not count towards the Cover 2 standard, which should be satisfied by other prefunded, liquid financial resources, but rather be an additional prefunded resource available for use during times of market stress. Further, we believe that CPMI and IOSCO should make clear that skin-in-the-game and other capital requirements must be satisfied both during normal market conditions and stressed conditions given the critical function that CCP skin-in-the-game and capital serves.

Ex Ante Certainty of Clearing Member Contributions

Clearing member contributions should have *ex ante* certainty in order to encourage the inclusion of more clearing members in CCPs and, relatedly, to rationalize clearing member capital requirements by accounting for the risk mitigation provided by margin. The increasing concentration of clearing member business, particularly for swaps, poses systemic risks and increases the challenges of asset managers handling client transactions. Further, excessive capital requirements, which do not acknowledge the exposure-reducing effects of margin posted to clearinghouses, exacerbates this problem. We believe that, by providing

¹⁰ CPMI-IOSCO August 2016 Consultative Report at Section 6.

¹¹ See, e.g., JPMorgan Chase & Co. Perspectives: What is the Resolution Plans for CCPs? (Sept. 2014), *available at*: <https://www.jpmorganchase.com/corporate/About-JPMC/document/resolution-plan-ccps.pdf>; PIMCO Viewpoint: Setting Global Standards for Central Clearinghouses (October 2014), *available at*: <https://www.pimco.com/insights/viewpoints/viewpoints/setting-global-standards-for-central-clearinghouses>; Risk.net, "CCPs need thicker skins - Citi analysis," (Aug. 3, 2015); BlackRock, Letter to Robert Wasserman regarding Roundtable on Recovery of Derivatives Clearing Organizations (Apr. 27, 2015), *available at*: <http://www.blackrock.com/corporate/en-fr/literature/publication/cftc-recovery-of-derivatives-clearing-organizations-042715.pdf>.

advanced certainty of clearing member contributions, both clearing members and prudential regulators will be able to calculate the potential exposure, which hopefully will reverse this trend of consolidation.¹²

Exclusion of Non-Defaulting Customer Assets

CPMI and IOSCO should expressly state that both initial margin and variation margin of non-defaulting customers are excluded as financial resources for anything other than the customer's positions. The CPMI-IOSCO August 2016 Level 3 Report reflects the current practice of CCPs to not include non-defaulting customer assets in their calculations, stating that, "when testing for the adequacy of total financial resources, no CCP assumes hypothetical customer gains could be netted with house losses. CCPs' stress-test assumptions regarding customer accounts generally reflect existing customer segregation models and netting arrangements."¹³ Likewise, the CPMI-IOSCO August 2016 Consultative Report notes that "legal frameworks will generally prohibit the use of collateral or gains with respect to client accounts to be used to offset losses in proprietary accounts" and that "the permissible application of collateral and, separately, gains, between client accounts often varies based on the legal framework or the CCP's account structure."¹⁴ However, the Consultative Report does not then state that such application of non-defaulting customer assets to cover funds owed to customers due to clearing member defaults should be excluded from calculations of financial resources. AMG believes that customer collateral should never be viewed as a backstop for CCPs to risk manage clearing member defaults and urges CPMI and IOSCO to provide guidance to this effect.

Holistic Procyclicality Assessments

We believe that procyclicality concerns relating to one financial resource category should be considered across the broader context of all financial resources as well as the impact of financial resources and extraordinary tools upon investor behavior.¹⁵ CCPs will, at times,

¹² SIFMA AMG makes this recommendation in combination with its other financial resource recommendations and not a recommendation AMG would advance in isolation. The need to have *ex ante* certainty is something that AMG recommends as beneficial throughout the financial resources categories, including exclusion of non-defaulting customer assets as a financial resource. Further, providing *ex ante* certainty should not come at the cost of having sufficient financial resource coverage in other categories or by jeopardizing non-defaulting customer assets.

¹³ CPMI-IOSCO August 2016 Level 3 Report at p 46. The Report does not explicitly address whether CCPs include non-defaulting customer assets as cover for other customer positions upon a potential clearing member defaults.

¹⁴ CPMI-IOSCO August 2016 Consultative Report at 3.2.49.

¹⁵ The holistic nature of standards applicable to CCP resilience, recovery and resolution is noted in the CPMI-IOSCO Consultative Report. See CPMI-IOSCO Consultative Report at page 1 ("The guidance topics in this report are interrelated. The guidance in this report is intended to be applied holistically along with the requirements set out in the PFMI.") and at paragraph 1.1.3 (stating that the PFMI principals "are designed to

focus on the procyclical effects of increasing margin while not considering the procyclical impact of variation margin gains haircutting. While we understand the procyclicality concerns of margin increases during times of stress, we believe that the knowledge that additional assets are supporting open positions should improve confidence in the CCP and carry lower procyclicality concerns than the prospect of variation margin gains haircutting, which will force directional market participants to close-out at the earliest signs of CCP distress. We further believe that margin increases, as described above, will alleviate pressure on clearing members whose viability will be essential to the continuing operation of a CCP facing distress.

For these reasons, AMG responds and recommends as follows:

- 1.1.1. Paragraph 2.2.4 of the CPMI-IOSCO Consultative Report, which states that, “[f]or the purposes of the design of the margin system, the board should have explicit 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 mutualisation,” should be amended to exclude credit and liquidity risk mutualisation to non-defaulting customers. The margin system should be designed with the working assumption that non-defaulting customers will not bear mutualisation of credit or liquidity shortfalls.
- 1.1.2. Paragraph 2.2.9 of the CPMI-IOSCO Consultative Report should be revised to include a requirement that the CCP’s board review a risk-based formula for the CCP’s own loss-absorbing capabilities in accordance with express standards established by CPMI and IOSCO. Further, Section 6.2 should provide for a risk-based formula for CCP skin-in-the-game established by regulators. CCP skin-in-the-game should be in addition to the Cover 2 required from other resources and should be required to be exhausted with CCP equity written down prior to the mutualisation of any losses to non-defaulting customers during resolution proceedings.
- 1.1.3. Paragraphs 2.2.11 through 2.2.13 and subsequent paragraphs 5.2.33 through 5.2.44 of the CPMI-IOSCO Consultative Report, which requires the board to assess and limit destabilizing, procyclical changes in financial resources collected, including initial margins, margin add-ons, default fund contributions and the impact of collateral haircuts should be revised to require consideration of procyclical impact of potential mutualisation of losses to non-defaulting customers in a resolution. Also, these paragraphs should expressly exclude from the board’s assessment of financial cover any loss mutualisation with non-defaulting customers. AMG further recommends that CCP skin-in-the-game contributions should be included as a counter-factor for procyclicality consideration in paragraph 2.2.11, as the board should assess whether increasing CCP skin-in-the-game may counterbalance procyclical impacts of increasing margin.

be applied holistically because of the significant interaction between principles; it is expected that the principles would be applied as a set and not on a standalone basis.”).

- 1.1.4. Paragraphs 2.2.6 through 2.2.8 of the CPMI-IOSCO Consultative Report, which concern ongoing maintenance of financial resources, should state that the board should exclude non-defaulting customer assets from available financial resources to cover credit and liquidity risks.
- 1.1.5. Paragraphs 3.2.48 through 3.2.51 of the CPMI-IOSCO Consultative Report, which concerns treatment of client exposures, should be amended to exclude the use of non-defaulting customer collateral to cover default losses.
- 1.1.6. Section 4.2 of the CPMI-IOSCO Consultative Report should be revised to make Cover 2 a minimum that either must be exceeded or justified per the analysis provided above. Further, section 4.2 should expressly exclude non-defaulting customer assets as cover. Finally, section 4.2 should expressly provide ex ante certainty of clearing member contributions.
- 1.1.7. Paragraphs 5.2.12 through 5.2.16 of the CPMI-IOSCO Consultative Report should be revised to include a requirement to increase initial margin to cover emerging risks in the system, including the default of a clearing member(s).
- 1.1.8. In response to FSB Discussion Note Question 4 (“Should CCPs be required to hold any additional pre-funded resources for resolution, or otherwise adopt measures to ensure that there are sufficient resources committed or reserved for resolution? If yes, what form should they take and how should they be funded?”) and Question 5 (“How should the appropriate quantum of any additional CCP resources be determined? In sizing the appropriate quantum, what factors and considerations should be taken into account? Do your answers vary for default and non-default losses?”), AMG believes that correctly sizing cover with margin, clearing member contributions, CCP skin-in-the-game, additional CCP capital to fund critical functions and standby credit should provide the necessary financial coverage for default losses during recovery and resolution. AMG provides its response relating to non-default losses in section 3.4 below.

1.2. Public Disclosure Should be Reliable, Readily Available and Uniform

AMG believes that, pursuant to PFMI Principle 5, CPMI and IOSCO should further strengthen the Public Quantitative Disclosure Standards so that customers can effectively risk assess a CCP’s resiliency prior to the consequences of unknown, poor risk management coming to light during a financial crisis.¹⁶ In so doing, regulators harness the analytical abilities of the market place

¹⁶ See e.g., Key Consideration 5, Principle 4 (Credit Risk), PFMI at 37 (stating that “[a] CCP should determine the amount and regularly test the sufficiency of its total financial resources available in the event of a default or multiple defaults in extreme but plausible market conditions through rigorous stress testing.”) and Principle 7 (Liquidity Risk), PFMI at 57 (stating that “[a]n FMI should maintain sufficient liquid resources . . . with a high degree of confidence under a wide range of potential stress scenarios that . . . would generate the largest aggregate liquidity obligation for the FMI in extreme but plausible market conditions.”); Principle 13

to scrutinize CCP risk controls and incentivize CCPs to pass the public test in addition to the various non-public evaluations undertaken by the CCP and regulators. Specifically:

Public Quantitative Disclosures Should be Accurate, with Preventative Controls and Penalties for Material Misstatements

AMG members that have reviewed the Public Quantitative Disclosures have found inaccuracies, including contradictions between fields that demonstrate a lack of care in publishing this information by some CCPs. Given the important function that Public Quantitative Disclosures serve, accuracy is essential since market participants rely on the information. We recommend that CPMI and IOSCO make clear that Public Quantitative Disclosures constitute reports filed with regulators and that the reports must be audited prior to publication. In so doing, reliability should increase and both the CCP and auditor will be held accountable for material inaccuracies.

Public Quantitative Disclosures Should be Available on Central Website

Much like the financial statements of publicly traded companies, Public Quantitative Disclosures should be publicly filed in a central location. Currently, Public Quantitative Disclosures are difficult to find for many CCPs, undermining the regulatory purpose of requiring the disclosures. AMG recommends the submission of Public Quantitative Disclosures to a regulator in the CCP's home jurisdiction and that regulators maintain a website of the Disclosures.

Public Quantitative Disclosures Should be Expanded to Require the Running and Full Disclosure of New "Benchmarking" Stress Tests

While AMG understands the concerns expressed by some CCPs regarding the full disclosure of all stress testing scenarios, we believe that CPMI and IOSCO should mandate the running and full disclosure of certain standardized stress tests to be completed by every CCP solely for the purpose of public disclosure. CPMI-IOSCO's Public Quantitative Disclosure Standards and current CCP practices provide the outputs resulting from certain stress tests without disclosure of the scenarios or specific stress test parameters.¹⁷ While the output of the stress tests does have some value, AMG members cannot make informed comparisons between the CCPs based on the output alone.

(Participant-Default Rules and Procedures), PFMI at 78; and Principle 23 (Disclosure of Rules, Key Procedures, and Market Data), PFMI at 121.

¹⁷ Public Quantitative Disclosure Standards for Central Counterparties (Feb. 2015), available at: <http://www.bis.org/cpmi/publ/d125.htm>. We note that the CPMI-IOSCO August 2016 Consultative Report states that a CCP should disclose information "at a level of detail sufficient to enable stakeholders to understand and effectively provide feedback concerning the rigour of the CCP's approach, methodologies, parameters, assumptions and scenarios" (Report at 2.2.16); however, we do not believe that these general statements are intended to require CCPs to disclose the specific information sought.

Disclosure of uniform stress tests results for each CCP would aid AMG members in making informed decisions about which CCP will be in the best interest of their clients. Asset managers as fiduciaries need to decide whether higher margin costs of a CCP are in the best interest of their clients; such disclosure will help in this assessment. Further, while each CCP has its own unique risk profile, market disruption is not bespoke but rather affects all market participants. Investors and their fiduciaries need to know how different CCPs are expected to perform when such events occur.

AMG recommends that regulators review and refresh the construction of these publicly-disclosed, uniform stress tests with input from the CCPs. We further recommend that these stress tests assess the diversity of the CCP's clearing members and, in turn, the diversity of clearing members' customers (*e.g.*, whether certain stressors result in outsized intraday margin calls). While these benchmarking stress tests would not be used to directly inform the CCP's risk management, a CCP should use this additional analysis to judge whether it would be prudent to make any adjustments.

For these reasons, AMG responds and recommends as follows:

- 1.2.1. Paragraphs 2.2.15 through 2.2.20 of the CPMI-IOSCO Consultative Report relating to disclosure and feedback mechanism for reviewing the margin system and stress-testing framework should include oversight of the Public Quantitative Disclosures.
- 1.2.2. An additional section should be added to the CPMI-IOSCO Consultative Report to require the filing of Public Quantitative Disclosures with a designated regulator in each jurisdiction, the posting of Public Quantitative Disclosure filings by the designated regulator on a central website, clarity that Public Quantitative Disclosures constitute reports filed with regulators, auditing of the reports by the CCP prior to submission.
- 1.2.3. An additional section should be added to the CPMI-IOSCO Consultative Report to require the running and full disclosure of uniform stress tests that market participants can use to compare and contrast each CCP's resiliency. While this stress test would not be used for risk management decisions, its results could inform the CCP's risk management decisions.

1.3. CCP Rulebooks Should be Used to Strengthen Readiness for Recovery and Should Fully Disclose Recovery and Resolution Tools

AMG believes that CPMI and IOSCO should establish principles to use CCP rulebooks as a tool to support the resiliency of CCPs and their clearing members, and clearly disclose the impact of recovery and resolution tools on clearing members' customers. Specifically:

Mandatory Process to Facilitate Porting

Before market stress occurs, CCP rulebooks should require their clearing members to have a protocol to address porting of positions in the event that the clearing member becomes insolvent. For example, the protocol could require the clearing member to identify specific

individuals who will be expected to remain through resolution as post-insolvency points of contact that will be obligated to address requests to port positions within a set amount of time.¹⁸

Clear Disclosure of Recovery and Resolution Consequences Upon Customer Protections

Currently, CCP Rulebooks do not disclose the impact of recovery and resolution tools upon the customers of clearing members, which, in some cases, are not fully known. Further, while we do not believe that emergency powers should be used in recovery or resolution to negate protections in the CCP Rulebook, if such powers are authorized, the Rulebook should disclose such powers so that customers can include it in risk assessments.

For these reasons, AMG responds and recommends as follows:

- 1.3.1. Additional sections should be added to the to the CPMI-IOSCO Consultative Report to mandate the establishment of a porting protocol for each CCP's clearing members and to clearly disclose in CCP rulebooks the impacts of recovery and resolution tools upon the customers of clearing members.

2. CCP RECOVERY

2.1. An Auction Conducted During a CCP's Recovery Should be Strengthened by Inclusion of a Broad Range of Market Participants Without Artificial Barriers

AMG believes that open auctions during recovery are the best process to return to a matched book.¹⁹ While clearing members' participation or lack of participation impacts the clearing members' loss allocation, no such construct is needed to bring non-clearing members into the process. Asset managers are already incentivized to participate and can only improve the auction's outcome.

Proposals for asset managers or their clients to contribute capital as a cost for a seat at the auction fails to recognize the practical challenges of such a requirement without any corresponding benefit to the auction. Given that asset managers act on behalf of and for the benefit of their clients, the asset managers' own funds cannot be put at risk and practical challenges would arise by having clients put up their funds individually. For example, would each client send in individual wire transfers? On what basis would the funds not be returned and why would such non-return be

¹⁸ SIFMA AMG further believes that changes to bank capital requirements could improve the likelihood of porting during future market distress. Leverage ratios should recognize the exposure-reducing effect of margin posted for cleared customer positions. *See, e.g.,* SIFMA AMG Submits Comments to the Basel Committee on Banking Supervision on Revisions to the Basel III Leverage Ratio Framework (June 30, 2016), available at: <http://www.sifma.org/issues/item.aspx?id=8589961201>.

¹⁹ See CPMI-IOSCO August 2016 Consultative Report at 7.2.7 (p50) "Re-establishing a matched book"; FSB August 2016 CCP Planning Report Qs 7-8.

justified? Asset managers should be encouraged to participate in auctions on behalf of their clients and adding artificial barriers only hurts the process. Expanding the auction to a broader range of market participants increases liquidity and increases the likelihood that the CCP will return to a matched book quickly.

For these reasons, AMG responds and recommends as follows:

- 2.1.1. Section 7 of the CPMI-IOSCO Consultative Report should be amended to provide specific standards for auctions run during recovery, including that the auctions should be open to a broad range of participants, including non-clearing members, and should not be impeded by artificial barriers.

2.2. Variation Margin Payments Should Continue During a Clearing Member Failure While Extraordinary Tools that Mutualize Losses to Non-Defaulting Customers Should be Expressly Prohibited

In order to increase the likelihood that a CCP will recover after clearing member defaults, mechanisms should be put in place to ensure that customers of a defunct clearing member(s) can continue to make and receive payments on their open contracts, either by porting of the positions or having some procedure to allow customers to bypass the clearing member and settle directly with the CCP.

At the same time, CPMI, IOSCO and the FSB should prohibit the use of “Variation Margin Gains Haircutting” or “VMGH” at any point prior to resolution. The mutualisation of loss through taking non-defaulting customer property is an extraordinary measure that should only be deployed in resolution as a tool of last resort after equity holders have been incentivized to recapitalize and the resolution authority has taken over control from the failing CCP’s management.²⁰ To do otherwise would undermine the dynamics that have effectively incentivized corporate workouts for decades and treat clearing members’ customers worse than equity holders who, unlike customers, benefited or stood to benefit from the profitable performance of the CCP.

VMGH essentially amounts to the taking of a portion of a non-defaulting customers’ margin. We understand the proposed VMGH mechanics to be as follows: after triggering of VMGH, the CCP would continue to fully collect variation margin owed for net negative positions; however, instead of paying out the full net gains from the losses paid in, the CCP would discount net variation margin payments, redirecting those funds to pay down the uncovered debit. The customer who was not paid in full would not have funds returned and would either receive nothing in return for the funds taken for use by the CCP or would receive a debt claim. If the customer’s positions have a negative mark-to-market the next day, the customer would have to pay the full loss due, which again would not be paid out in full to the counterparty who had a net profitable position that day. Given this description, we believe that the term “haircut,” often used to refer to a

²⁰ Even in resolution, the process for loss mutualisation should be considered more fully in order to ensure fair allocation, which we discuss further in Section 3 below.

conservative valuation, is a misnomer. Rather, it should be referred to for what it is: the taking of non-defaulting customer property without regard to customer protections.

In addition to the fundamental problem of taking customer property for use by a failing CCP, VMGH is an arbitrary measure that results in *ex ante* unquantifiable exposure for customers. VMGH arbitrarily takes from market participants with net positive cleared positions. As such, “gains haircutting” disproportionately hurts directional market participants who happen to have net positive cleared positions even though directional participants bring no greater risk than participants who may have a net neutral position. Market participants like mutual funds, hedge funds and pension funds typically are taking a market view or hedging risk not held at the clearinghouse and, as a result, would be forced to pay proportionally more than other market participants with open positions. In addition, to the extent the cleared position is being used to hedge an uncleared position, customers would suddenly become exposed to market movements at a difficult time to make adjustments to positions.

Given the unprecedented nature of VMGH and the inability to calculate its impact *ex ante*, VMGH would create untenable challenges for asset managers handling their clients’ investments as a fiduciary responsible for acting in their best interests. Should an asset manager, as a fiduciary, continue paying variation margin that is owed if it knows that repayment will not be in full? How can asset managers manage the client’s broader investment without knowing whether margin, which would be applied to support other investments, will not be fully returned? How should daily net asset value (“NAV”) be calculated when some of the investors’ margin has been taken and more may be taken in future days?

Due to the impact VMGH has on investor behavior, it will have procyclical consequences that will undermine the market stability sought. Gains haircutting will likely lead to earlier close outs in anticipation of this consequence, potentially resulting in a run on the CCP at the first signs of clearing members’ instability, which would accelerate the CCP’s failure and undermine other recovery tools. Gains haircutting undermines investor confidence in centrally cleared markets even during times of non-stressed market conditions; if the regulators do not prioritize customer protection, transactions may be driven where possible to the uncleared space where, ironically, investors could achieve greater protections against loss mutualisation through third party custody arrangements. Clearly, this result was not the intention of G20 Leaders in making the commitment to clear standardized OTC derivatives contracts through CCPs.

Further, delaying resolution by resorting to VMGH reduces the incentives of equity holders to voluntarily inject capital to avoid the write down of their equity position. Its use also delays the ability of new equity rights to be granted to entities willing to recapitalize the CCP, which also could result in the CCP’s debit being covered by resources other than non-defaulting customer assets. These processes have been used to revive distressed companies and could serve as a route to restoring the CCP. As explained in the FSB Discussion Note, “imposing losses on existing owners would help create appropriate incentives to avoid resolution, including for existing owners to ensure that the CCP has robust risk-management arrangements in place and to encourage owners to

contribute funds beyond skin-in-the-game when a CCP's prefunded resources are insufficient to cover losses.”²¹

Finally, other extraordinary tools, including partial-tear up, use of customer margin to cover liquidity shortfalls and forced allocations should only be used in resolution.

For these reasons, AMG recommends and responds as follows:

- 2.2.1. Paragraph 7.2.3 of the CPMI-IOSCO Consultative Report should be revised such that, rather than endorsing the Recovery Report's mutualisation of credit or liquidity shortfalls with non-defaulting indirect participants (*i.e.*, clearing members' customers), the mutualisation of loss to non-defaulting participants is expressly excluded in recovery.
- 2.2.2. Paragraph 7.2.4 of the CPMI-IOSCO Consultative Report should be revised to include an express prohibition on the use of customer margin as a backstop to address liquidity shortfalls. AMG agrees that the tools outlined in paragraph 7.2.4 should be put in place but further clarity is required that customer assets will not be used, even temporarily.
- 2.2.3. Paragraph 7.2.7 of the CPMI-IOSCO Consultative Report regarding reestablishing a matched book should be revised to exclude the use of tools including VMGH, forced allocation and tear-up of contracts during recovery. These tools are extraordinary and implicate important rights of market participants, including non-defaulting customers. As such, they should be reserved for resolution.
- 2.2.4. Section 7.2 should include the requirement that CCPs establish a mechanism to enable customers of a defunct clearing member to continue to make and receive margin payments on their open contracts, either by porting of the positions or by some procedure to allow the customers to bypass the clearing member.
- 2.2.5. In response to FSB Discussion Note Question 2 (“What is the impact on incentives of the different aspects of resolution outlined in this note for CCP stakeholders to support recovery and resolution processes and participate in central clearing in general? Are there other potential effects that have not been considered?”), Question 18 (“Should CCP owners' equity be written down fully beyond the committed layer of capital irrespective of whether caused by default or non-default events?”) and Question 19 (“Should new equity or other instruments of ownership be awarded to those clearing participants and other creditors who absorb losses in resolution?”), AMG strongly agrees with Section 9 of the FSB Discussion Note's statements that holders of equity should bear first losses in resolution and that the loss of equity will help to create appropriate incentives to avoid resolution, including both risk management and voluntary recapitalization. Likewise, AMG agrees that new equity or senior debt claims should be awarded to those absorbing losses or to persons that

²¹ FSB Discussion Note Section 9.2.

recapitalize the CCP, concepts reflected in FSB Discussion Note 9.4. AMG believes that these incentives and tools are undermined by the use of extraordinary measures in recovery, including partial tear up and loss mutualisation to non-defaulting customers.

- 2.2.6. In response to FSB Discussion Note Question 10 (“Which, if any, loss allocation tools should be reserved for use by the resolution authority (rather than for application by a CCP in recovery)?”), AMG believes that partial or full tear-up of contracts, forced allocation and loss mutualisation involving non-defaulting customers (VMGH or otherwise) should be reserved for resolution.

3. CCP RESOLUTION

3.1. A Pre-Designated Regulatory Authority Should Have Constrained Flexibility to Initiate CCP Resolution

A pre-designated regulatory authority should have constrained flexibility to put the CCP into resolution when it determines, in its judgment, that: (1) the CCP’s return to a matched book require extraordinary tools, like loss mutualisation of non-defaulting customer assets or partial tear up (“Reorganization”); or (2) the CCP has reached the “Point of Non-Viability” because the use of additional efforts and resources will not return the CCP to a matched book (“Wind Up”). As such, AMG believes that the decision to resolve a CCP should not be triggered by a preset test (*e.g.*, failure of an auction or exhaustion of a specified level of the waterfall). Importantly, the regulatory authority with this discretion should be clearly identified for each CCP so that clear decision-making authority is established well in advance of any market stress.

For these reasons, AMG responds and recommends as follows:

- 3.1.1. In response to FSB Question 3 (“What are the appropriate factors for determining timing of entry into resolution? How might a presumptive timing of entry (or range of timing), if any, be defined in light of the criteria set out in the FMI Annex to the *Key Attributes*? If defined, should the presumptive timing of entry be communicated to the CCP and its participants?”), AMG agrees that constrained flexibility is the preferred approach. AMG recommends that Section 6 of the FSB Discussion Note be revised to include a requirement that a specific resolution authority be designated in advance as the ultimate decision maker on whether the CCP should be put into resolution. AMG further recommends that Section 6 include the guidance that the need to use extraordinary tools, including partial tear-up and mutualisation of losses

to non-defaulting customers, be considered as indicators that a CCP should be put into resolution.

3.2. Resolution Tools to Return to a Matched Book Should Include Auction, Partial Tear-Up, Forced Allocation and, after Further Study, Loss Mutualisation Measures Exercised by the Resolution Authority

AMG's recommendations relating to auctions during recovery apply equally during resolution.²² An open auction with both clearing members and non-clearing members participating and without any artificial barriers for non-clearing members is the best tool available for the CCP to return to a matched book.

AMG believes that partial and full tear-ups and forced allocations, while not desirable tools to return a CCP to health or to wind up its business, should be available under the control of the resolution authority in resolution after CCP equity has been written down and no new equity contributions have occurred.

AMG further believes that loss mutualisation that includes non-defaulting customer assets—again, an undesirable outcome—should occur only in resolution after CCP equity has been written down and no new equity contributions have occurred. However, further consultation and comment is required to assess how loss mutualisation can be achieved fairly such that all open contracts bear a proportionate share of losses. As discussed above, VMGH has been put forward as a tool to be used on a net (a/k/a portfolio level) basis. However, to apply VMGH on a net basis and not on a gross basis or upon the full net equity position means that the loss allocation will arbitrarily impact positions that happen to be positive on the days applied and will not impact participants with a flat position at the clearinghouse. Problems of fairness also arise from the use of VMGH on a gross (a/k/a position level) basis. For example, a curve trade whereby a market participant is exposed to the difference between two or more maturity dates for the same instrument (*e.g.*, a calendar spread between the front month and next month of a futures contract), would become decoupled if VMGH applied on a gross basis. Rather than paying or receiving the variation margin reflecting the relationship between these related positions, the market participant would have to pay the full amount due on the out-of-the-money position and receive a discounted payment of the in-the-money amount due. In addition, any form of margin haircutting on cleared positions turn perfect or near-perfect hedges of positions held away from the clearinghouse into speculative ones. For example, a bond hedged by a credit default swap will become partially unhedged if margin payments are cut such that the investor, once agnostic to whether the bond or the credit default swap rose in value, is suddenly taking a market view.²³

²² See Section 2.1 *supra*.

²³ We note that some commentators suggest that VMGH on a net basis incentivizes market participants to enter into the directional positions that the clearinghouse needs to return to a matched book and that VMGH does not deliver that result on a gross basis. We believe that such contentions should be assessed in the further study of these tools.

While we understand and agree that losses must be covered by resources other than a taxpayer bailout and the risk of a CCP failure must be considered in the context of the health of the broader financial system, we do not believe that loss mutualisation should be arbitrarily distributed or disturb fundamental reasons why cleared positions are entered into by customers.

For these reasons, AMG responds and recommends as follows:

- 3.2.1. In response to FSB Discussion Note Question 1 (“Does this discussion note identify the relevant aspects of CCP resolution that are core to the design of effective resolution strategies? What other aspects, if any should authorities address?”), AMG believes that CCP resolution strategies set forth in Section 2 of the FSB Discussion Note should include the following:

“CCP resolution strategies and plans need to take into account the impact upon non-defaulting clearing member customers. Due to customer protection regimes present in all major jurisdictions and the negative effects of loss mutualisation upon stabilizing a failing CCP, resolution plans should use loss mutualisation tools as a last resort. Any mutualisation of loss must fairly allocate losses across all open contracts held at the CCP and should not apply arbitrary discounts upon payments to customers that result in certain customers sharing a disproportionate amount of losses.”

- 3.2.2. In further response to FSB Discussion Note Question 1, AMG believes that further study is required of loss mutualisation tools to be used in a resolution. A subsequent consultation should seek comment on the forms of loss mutualisation in order to determine a fair, ratable distribution of losses if loss mutualisation becomes a necessary part of CCP resolution.
- 3.2.3. In response to FSB Discussion Note Question 7 (“What factors should the resolution authority consider in choosing and exercising tools to return the CCP to a matched book? Is one (or more) of the tools for restoring a matched book preferable over others and if so, why?”), AMG believes that auction should be expressly available as a tool for a resolution authority should the resolution authority believe that an auction run in recovery has a likelihood to return the CCP to a matched book. Under such circumstances, auction followed by partial tear-up is preferable to full tear-up and loss mutualisation to non-defaulting customers. AMG believes that the FSB should provide guidance that an auction should be open to as wide a group of market participants as manageable without imposition of unnecessary barriers, such as requirements to put up risk capital. As such, AMG recommends that Section 5 of the FSB Discussion Note include this tool as more than just a “voluntary” measure and set forth standards by which auctions will be open to a broad range of market participants.
- 3.2.4. In response to FSB Discussion Note Question 8 (“Should any tools for restoring a matched book only be exercisable by resolution authorities? If so, which tools and subject to what conditions?”), AMG agrees with the FSB Discussion Note’s

statement in 5.3 that “Participants’ perception of tools may differ depending on whether they are exercised by the CCP or by authorities in resolution.” CCP management should not be able to utilize tools such as partial tear-up and loss mutualisation of non-defaulting customer assets during recovery. These tools are extraordinary measures and conflict with the CCP’s interests in protecting its own assets and serving its equity holders.

- 3.2.5. In response to FSB Discussion Note Question 9 (“What are in your view effective tools for allocating default and non-default losses and what are the pros and cons of these tools? Should initial margin haircutting be considered as a tool for the allocation of losses in resolution? Is one or more of the tools preferable over others? What are your views on the use of tools to restore a matched book as a means of loss allocation?”), AMG’s response regarding non-default losses is provided in section 3.4 below. With respect to default losses, AMG believes that mutualisation of loss to non-defaulting customers in resolution should be a tool of last resort to either return the CCP to a matched book or to wind up the CCP. AMG believes that the details of how losses would be allocated and mutualized to customers in resolution, whether by margin haircutting or other means, have not been sufficiently studied. The use of such tools has not been assessed on the basis of fairness or distribution of losses. AMG strongly recommends that further consultation and analysis of this issue be presented for review and comment.

3.3. Allocation of Losses in Resolution Should Be Fixed

AMG believes that allocation of losses should not be flexible. Insolvency laws are built on priority of repayment so that creditors will have certainty priced into the risk presented by the financial instrument they chose to utilize. We agree with the FSB Discussion Note’s statement in paragraph 6.5 that certainty as to exposures and obligations to the CCP “enable the participants to better manage the attendant risks and price of those risks into contracts,” and believe that such certainty should be preserved. Likewise, AMG believes that CCP rulebooks should not contain emergency measures that undo this certainty.

For these reasons, AMG responds and recommends as follows:

- 3.3.1. In response to FSB Discussion Note Question 11 (“How much flexibility regarding the allocation of losses is needed to enable resolution authorities to minimise risks to financial stability? For example, to what extent should a resolution authority be permitted to deviate from the principle of *pari passu* treatment of creditors within the same class, notably different clearing members in resolution? What would be the implications of a resolution strategy based primarily or solely on a fixed order of loss allocation in resolution set out in CCP rules vs. a resolution strategy that confers discretion to the resolution authority to allocate losses in resolution differently to CCP rules?”), AMG disagrees that the resolution authority should, as stated in 6.2 of the FSB Discussion Note, “retain some defined flexibility within the constraints of the NCWO safeguard to deviate from that order [of loss allocation] in the execution of a resolution.” Creditors need *ex ante* certainty regarding how their claims will be

treated in resolution and flexibility undermining this certainty will reduce the rights of creditors and increase risks to the system. As such, AMG recommends removing the concept of flexibility of loss allocation from paragraphs 6.2, 6.3 and 6.4. AMG further recommends including an express prohibition in Section 6 on CCP rulebooks containing emergency measures that undo the checks and balances imposed by other sections of the CCP rulebooks.

3.4. Non-Default Losses Should Be Covered by the CCP and Its Parent or Third Party

AMG believes that non-default losses should be the sole responsibility of the clearinghouse and its parent company. As such, the waterfall for default losses should not apply for non-default losses, such as operational failures. The CCP is one hundred percent responsible for managing operational risks and the potential losses must be aligned with that responsibility. Customer assets should not be put at risk for a CCP's failure to manage operational risks. Nor should bail-in tools be used to write down the CCP's liabilities.

For these reasons, AMG responds and recommends as follows:

- 3.4.1. In response to FSB Discussion Note Question 5 ("How should the appropriate quantum of any additional CCP resources be determined? In sizing the appropriate quantum, what factors and considerations should be taken into account? Do your answers vary for default and non-default losses?") and Question 6 ("Should resolution funds external to the CCP be relied upon? If so, how should such funding arrangements be structured so as to minimise the risk of moral hazard, including for CCPs with significant cross-border participation? Where these are pre-funded, how should the target size be determined and which entities should be required to contribute?"), AMG believes that Section 4 of the FSB Discussion Note should include as "Additional resolution resources or reliance on resources within the CCP waterfall" a guarantee from the CCP's parent company or third party to cover shortfalls relating to non-default losses.
- 3.4.2. In response to FSB Discussion Note Question 9 ("What are in your view effective tools for allocating default and non-default losses and what are the pros and cons of these tools? Should initial margin haircutting be considered as a tool for the allocation of losses in resolution? Is one or more of the tools preferable over others? What are your views on the use of tools to restore a matched book as a means of loss allocation?") and Question 13 ("How should non-default losses be allocated in resolution, and should allocation of non-default losses be written into the rules of the CCP?"), AMG believes that operational losses are entirely the responsibility of the CCP and its parent company. To do otherwise, would risk the CCP not properly addressing operational issues such as cybersecurity. For this reason, AMG recommends that this responsibility be set forth in section 7 of the FSB Discussion Note. AMG further believes that contrary recommendations in section 7, including the use of statutory bail-in tools to write down liabilities, should be removed. AMG disagrees that "imposing losses on all creditors in this way could be considered an equitable way of replicating the insolvency counterfactual set out in the NCWO

safeguard and would present the resolution authority with a pool of financial resource from which to draw on.” Rather, non-default losses should be risk managed by the CCP on the basis that it will be responsible for covering all losses. This responsibility is the best means to effectively incentivize risk management with the result that the CCP will hopefully avoid having to cover such risks.

- 3.4.3. AMG further recommends that paragraphs 7.2.1 and 7.2.2 of the CPMI-IOSCO Consultative Report should be strengthened to require additional lines of resource to be made available from the CCP’s parent company or a third party to cover non-default losses. We agree with paragraph 7.2.2’s recommendation that the CCP have sufficient capital to absorb general business losses in addition to CCP skin-in-the-game; however, the CPMI-IOSCO Consultative Report does not address fully the resources that will be used to “recover from an extraordinary one-off loss or recurring losses from general business, custody, and investment risk.” These losses must be borne by the CCP responsible for operational management and customer assets must be protected by clearly identified resources that will cover this risk.

4. CONCLUSION

For the reasons set forth above, AMG believes that the measures provided in the table below, deployed during specific phases of a CCP lifecycle will promote the integrity of CCPs while balancing customer protections.

Ordinary Course Resiliency	Recovery	Resolution Reorganization*	Resolution Wind Up
	Strong CCP Governance		
	Strong CCP Risk Management		
	Margin Resizing for Volatility and Risk in System		
Regulatory Oversight		Control and Oversight of Resolution Authority	
		Write Down of CCP Equity and Grants of New Equity for Recapitalization of CCP	
		No Creditor Worse Off Safeguards	
Standardized Formula for Risk-Based Skin-in-the-Game Prefunded with HQLA			
Prefunded/Committed Credit and Liquidity Resources (Cover 2 as minimum standard with more as required)			
	Open Auction (clearing member and non-clearing member participants)		Full Tear-up / Liquidation
		Partial Tear-up**	
		Loss Mutualisation to Customers (Further study required)	

* If return to a matched book is viable

** If aids restoration of a matched book

In making the recommendations set forth above, AMG hopes that the CPMI, IOSCO and FSB continues to strengthen CCP resilience, recovery and resolution standards and protect the customers of clearing members when it finalizes this crucial guidance. Should you have any questions, please do not hesitate to contact Tim Cameron (+1 202-962-7447 / tcameron@sifma.org) or Laura Martin (+1 212-313-1176 / lmartin@sifma.org).

Respectfully submitted,



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