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Submitted Electronically

Financial Stability Board
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Re: Consultative Document: *Guidance on Central Counterparty Resolution and Resolution Planning*

The Futures Industry Association (FIA), the Global Financial Markets Association (GFMA), the Institute of International Finance (IIF) and the International Swaps and Derivatives Association, Inc. (ISDA) (ISDA; and together with FIA, GFMA and IIF, the Associations) welcome the Consultative Document regarding *Guidance on Central Counterparty Resolution and Resolution Planning* recently published by the Financial Stability Board (FSB). The role and significance of central counterparties (CCPs) has increased in recent years as over-the-counter (OTC) derivatives have moved to clearing. Effective resilience, recovery and resolution mechanisms for CCPs are now more than ever critical to the efficient operation, stability and sustainability of the global financial markets. The Associations support the Consultative Document as another important step towards addressing the financial disruption that could occur in the unlikely event that a CCP fails and welcome the opportunity to provide the following comments.[1]

The Associations agree with many aspects of the Consultative Document and commend the FSB for incorporating a number of the points that the Associations and other industry participants raised in response to the August 2016 FSB Discussion Note on *Essential Aspects of CCP Resolution Planning*. In particular, the Associations support:

- Maximum possible transparency regarding the resolution authority's powers in the jurisdiction's legal framework and, to the extent appropriate, CCP rules and arrangements.
- Subject to the considerations discussed below, a presumption that the resolution authority continues to utilize the tools set forth in CCP rules and arrangements.
- CCP equity that is loss absorbing in resolution.

[1] Please note that CCP (and other FMI) members of FIA, IIF and ISDA do not necessarily support all of the views expressed herein. We understand that some CCPs will submit separate comments to the FSB expressing different views on certain issues.

- Subject to the concerns noted below, preservation of claims of clearing participants[2] that suffer losses in CCP resolution.
- Continued FSB work on financial resources for resolution and additional guidance on this topic.

The Associations do, however, have a number of concerns regarding other aspects of the Consultative Document and strongly encourage the FSB to address these issues before issuing final guidance. As discussed in greater detail below, the Associations maintain that:

- Forced allocation should never be utilized in recovery or resolution, even as a last-resort tool.
- Initial margin haircutting should never be utilized, even as a last-resort tool for non-bankruptcy remote initial margin.
- Clearing members should be obligated to satisfy one capped assessment, either in recovery or resolution. A resolution authority could call for this assessment if the CCP did not do so prior to resolution, but if a CCP exercises assessment powers in recovery, then a resolution authority should not have the right to call for additional assessments, even subject to caps. As discussed herein, the Associations believe that variation margin gains haircutting (VMGH)[3] over a minimal time period, CCP capital and allocation of losses to the CCP's ultimate equity holders would provide resolution authorities with sufficient resources and therefore additional assessments would not be necessary.
- In no event should non-default losses be allocated to clearing participants, whether through assessments or otherwise.[4]
- Key elements of CCP resolution plans and triggers for resolution must be available to clearing participants without exception. Clearing participants must understand such information on an *ex ante* basis so that they can measure, manage and control their exposure to the CCP and so that they can actively participate in the CCP's default management process.
- Clearing participants that suffer losses from the use of any tools beyond one capped assessment in recovery or resolution should retain claims that position them as senior to existing equity holders.

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[2] As used herein, "clearing participants" refers to clearing members and their direct and indirect clients.

[3] VMGH must not be used for anything other than allocation of a finite quantum of losses. That is, VMGH is inappropriate to keep the CCP operational unless a finite quantum of losses has been established at the time it is exercised. We also note that members' support for VMGH, and views on when VMGH should be applied, vary widely. While some members believe that VMGH is an effective loss allocation tool and would support its use prior to the CCP's ultimate equity holders bearing losses in a resolution, other members support VMGH only if it is administered by a resolution authority in resolution. Some of these members also maintain that VMGH should not be used unless CCP capital is exhausted. One member does not support any use of VMGH. *See* Letter from the Associations and The Clearing House (TCH) to the FSB dated October 21, 2016 at pages 4-6 & 20-22 for more a more detailed discussion regarding members views on VMGH. Finally, the Associations recognize that VMGH is not appropriate for certain non-derivative products, including repos and cash transactions.

[4] As discussed below, we realize that clearing participants would be creditors for any amounts the CCP owes them and may therefore bear losses in accordance with the applicable creditor hierarchy. Our concern is that clearing participants should not be contractually or statutorily liable for non-default losses outside of the applicable hierarchy of general creditors.

- The no creditor worse off (NCWO) counterfactual for default losses should not require assumptions that are inconsistent with the reality of what would happen if resolution did not occur. Accordingly, subject to the issues and considerations described below, the NCWO counterfactual for default losses should generally be liquidation or termination of the CCP in accordance with applicable insolvency laws.

Below we elaborate on these issues in greater detail and also raise some technical points regarding the Consultative Document.

Forced Allocation

Section 2.7 of the Consultative Document contemplates imposition of a forced allocation of open contracts if a resolution authority has the explicit power to do so under the legal framework and/or CCP rules and arrangements. Section 2.7 goes on to note that when considering forced allocation, resolution authorities should take into due account the impact on financial stability and should use such power only as a last-resort tool.

In the Associations' view, the impact on financial stability if clearing members are forced to take on positions that they may not be suited to risk manage in extreme market conditions would always be too great and therefore forced allocation should not even be contemplated. Forced allocation would not come into play until an auction or similar voluntary process had failed. In these circumstances, it would have been established that clearing participants are unable or unwilling to clear the problematic positions, for risk management or other reasons. Forcing clearing members to clear these positions regardless could have adverse consequences on individual clearing members and would almost certainly have adverse systemic consequences. Separately, any application of forced allocation that tried to address such concerns by allocating positions to those clearing members that "could bear them" would be completely unequitable and therefore should not be allowed.

Contrary to the foregoing, partial tear-ups return a CCP to a matched book in a way that more evenly distributes risk and exposure across clearing participants and does not require any clearing participants to clear positions that they are not able to risk manage. Instead, partial tear-ups affect only positions in products that clearing participants have elected to clear. Clearing participants that clear these products that could not be liquidated through the normal default management procedures bring the risk associated with them to the CCP and therefore it is appropriate for them to bear risks associated with their tear up in a last resort scenario.

Based on the foregoing, the Associations strongly disagree with any use of forced allocation, even as a last-resort. If a resolution authority cannot allocate positions necessary to return a CCP to a matched book by voluntary means, it should utilize partial tear-up as described in Sections 2.4-2.5 of the Consultative Document or, subject to the limitations in Section 2.6, full tear-up.

Initial Margin Haircutting

Section 2.11 of the Consultative Document contemplates haircutting of initial margin that is not bankruptcy remote if a resolution authority has the power to do so under the legal framework or the CCP's rules and arrangements. Section 2.11 goes on to note that when considering initial

margin haircutting, resolution authorities should account for the impact on financial stability and on incentives to centrally clear and should use initial margin haircutting only as a last-resort tool.

As consistently stated on previous occasions, the Associations strongly disagree with any use of initial margin haircutting, even as a last-resort.[5] Initial margin haircutting that applies to non-bankruptcy remote initial margin only is potentially even more problematic because it would create incentives to post non-cash collateral that is traditionally held in a bankruptcy remote manner, which could cause undue liquidity constraints in a CCP's day-to-day operations and therefore require larger liquidity facilities and additional sources of liquidity in the ordinary course. The foregoing could potentially result in a subset of initial margin that is subject to haircutting and a subset of initial margin that is not subject to haircutting at the same CCP, which would make it incredibly difficult for clearing participants to measure and manage their exposures to the CCP and would likely result in disparate treatment of similarly situated clearing participants based on the type of initial margin they post. Additionally, if initial margin haircutting is permitted in some jurisdictions, it could drive clearing participants to clear only through CCPs in jurisdictions that either prohibit initial margin haircutting or require initial margin to be held in a bankruptcy remote manner.

Among other things, the Associations believe that initial margin haircutting would be inconsistent with Section 1.2(iii) of the Consultative Document, which provides that CCP resolution should seek to "maintain continuous access by [clearing participants] to securities and cash collateral posted to and held by the CCP in accordance with its rules and that is owed to such [clearing participants]." More generally, initial margin haircutting would have knock-on effects in an already distressed market and is procyclical in that clearing participants would have to replenish haircut margin at the worst possible time (*i.e.*, in a severely distressed market). Initial margin haircutting could also incentivize clearing participants to close out of positions in order to reduce their initial margin requirements at the first sign of a CCP's distress and, by doing so, compete against the CCP for hedges required in the CCP's default management process. This would likely cause further disruption in the market and could impede the CCP's return to viability through recovery or resolution. Additionally, initial margin haircutting could disincentivize participation in the CCP's default management process, as clearing members may not want to bid on positions that would increase their initial margin requirements if additional initial margin posted to satisfy those requirements could be haircut. Finally, in many jurisdictions initial margin for uncleared derivatives must now be held with a third-party custodian to shield it from the insolvency of the receiving counterparty. Not providing the same degree of protection to initial margin for cleared derivatives could disincentivize central clearing, which would be contrary to the stated objectives of the G-20.

In the Associations' view, for the reasons stated above, the impact of initial margin haircutting on financial stability and incentives to centrally clear would always be too great and therefore initial margin haircutting should never be allowed. Upon exhaustion of a CCP's default waterfall (including one capped assessment over recovery and resolution), any remaining losses

[5] *See* Letter from the Associations and TCH to the FSB dated October 21, 2016 at page 21.

should be covered by VMGH[6] over a minimal time period, CCP capital and allocation of losses to the CCP's ultimate equity holders (as contemplated by Sections 4.1-4.3 of the Consultative Document). Allocation of losses to CCP capital and the CCP's ultimate equity holders would require removal of any non-recourse provisions that limit the exposure of a CCP's parent and such equity holders to so-called CCP "skin-in-the-game." Some members support the removal of such provisions as crucial to ensuring that resolution authorities can allocate losses comprehensively.[7]

Moreover, the Associations maintain that CCPs in all jurisdictions should be required to hold initial margin in a bankruptcy remote manner. This would avoid the possibility of any initial margin haircutting, including the problematic disparate application of initial margin haircutting discussed above.[8]

Clearing Member Assessments

Section 2.9 of the Consultative Document contemplates resolution authority cash calls or assessments, *i.e.*, resolution authorities would have an explicit statutory power to require non-defaulting clearing members to make contributions in cash to the CCP up to a specific limit. While the Associations support caps on assessments and fully agree with the sentence at the end of Section 2.9, which provides that clearing members should be able to assess at all times the maximum amount that they may be required to contribute under any assessments or cash calls, the Associations absolutely do not support an additional resolution authority assessment if the CCP already exercised assessment powers in its rulebook. For clarity, the Associations do not support statutory assessments powers or any assessment powers beyond those in the CCP's rulebook under any circumstances. Moreover, the Associations strongly believe that assessment powers in the CCP's rulebook should apply across recovery and resolution, without differentiation or duplication. It is crucial that clearing members have the ability to estimate their exposure to a CCP based on the CCP's rulebook. Introducing additional contingent exposure in resolution statutes would be hugely problematic from a risk-management perspective and would likely be procyclical.

The Associations have previously expressed concerns regarding caps on the overall liability of clearing members across default fund replenishment requirements and assessments, as well as across recovery and resolution.[9] The Associations maintain that CCP rules and arrangements should provide for a standard capped liability framework that limits the amount of total resources that could be required of clearing members across single and multiple defaults during the longer of a defined period (*e.g.*, 30 days for cleared OTC derivatives)[10] or the end of the default

[6] Please refer to footnote 3 for a discussion of members' varying views on VMGH.
[7] Other members do not believe that the value of the CCP's existing equity should necessarily be reducible to zero and therefore do not support removal of all non-recourse provisions.
[8] A requirement to hold all initial margin in a bankruptcy remote manner would also facilitate an equitable exercise of NCWO protections because clearing participants would not suffer losses in respect of their initial margin in insolvency proceedings or in resolution.
[9] *See* Letter from the Associations and TCH to CPMI-IOSCO dated October 18, 2016 at pages 14-16.
[10] The Associations support additional work to determine whether the correct time period is 30 days and to determine whether different time periods should apply to different products.

management process (whether in recovery or resolution and irrespective of the number of defaults). This cap would apply to the replenishment requirements contemplated by Section 2.12 of the Consultative Document, as well as assessments.

The Associations believe that CCPs should be required to size their funded default fund appropriately to ensure that they have access to sufficient resources in the event of a member default. And once the default fund has been used, the number of assessments should be capped to one times the default fund irrespective of the number of defaults that occur during the defined period (*e.g.*, 30 days for cleared OTC derivatives), and irrespective of whether resolution commences, to ensure a clear and consistent cap on member liability. This cap should be applied consistently for both withdrawing and continuing clearing members to ensure that there are no incentives to exit the market, which could potentially cause a run on the CCP and aggravate market instability.

Assuming that a CCP holds "cover 2" resources,[11] additional resources equal to one times the default fund would cover defaults of clearing members that would cause the four largest losses. Based on CPMI-IOSCO public quantitative disclosures for CCPs that clear listed products, the largest clearing member loss is generally two to three times the size of the second largest clearing member loss. In these situations, additional resources equal to one times the default fund would generally cover losses from four additional clearing members (*i.e.*, six clearing members in total). Also based on the quantitative disclosures, losses from the top five members account for 50% of total potential losses. The Associations maintain that coverage for such losses would be sufficient across recovery and resolution. Losses beyond these would suggest extreme market moves and/or clearing members failing at a rapid and unprecedented rate. Under these circumstances, an additional resolution authority assessment would likely be procyclical and even further destabilizing.

As noted above, upon exhaustion of a CCP's default waterfall (including one capped assessment over recovery and resolution), any remaining losses should be covered by VMGH[12] over a minimal time period, CCP capital and allocation of losses to the CCP's ultimate equity holders (as contemplated by Sections 4.1-4.3 of the Consultative Document).

Non-default Losses

A previously stated, the Associations strongly believe that non-default losses should not be allocated to clearing participants, either contractually through the CCP's rulebook or otherwise outside of the general creditor hierarchy.[13] Only the CCP's management is able to control and mitigate the CCP's exposure to non-default losses (*e.g.*, losses from custodial, investment, credit,

[11] If a CCP does not hold "cover 2" resources, the appropriate default fund multiple for the cap on additional resources should be considered in light of the quantum of resources that the CCP does hold.
[12] Please refer to footnote 3 for a discussion of members' varying views on VMGH.
[13] Please note that, notwithstanding the foregoing, some members strongly believe that publicly disclosed strategies should clearly articulate how non-default losses should be allocated. The concerns we raise here relate solely to anything that would contractually or legally allocate non-default losses to clearing participants outside of the general creditor hierarchy in a resolution or insolvency regime, not to public disclosure of how non-default losses would be allocated.

liquidity,[14] market, operational, legal, general business and cyber risks). CCPs and their shareholders must bear the risk of these losses so that they are properly incentivized to exercise prudent risk management and focus on CCP risk management. Accordingly, the Associations strongly disagree with Section 2.14 of the Consultative Document, which contemplates an assessment on clearing members if non-default losses are not fully absorbed by extinguishing[15] CCP equity and applying any other loss allocation measures available under the CCP's rules and arrangements for non-default losses. In absolutely no event should resolution authorities have a statutory power to call for assessments from clearing participants to cover non-default losses.

Many members believe that CCP regulatory capital should be right-sized to cover credit, liquidity, market, operational, legal, general business and cyber risks and that CCPs should bear the burden on demonstrating to their regulators and clearing participants that their capital covers these risks. Other members believe that CCPs should hold dedicated reserves (that are not funded by clearing participants) outside of regulatory capital for this same purpose. In either case, this amount should be completely separate from a CCP's "skin-in-the-game" or other resources to cover default losses. In the unlikely event that regulatory capital (or, as some members prefer, a separate right-sized quantum of dedicated reserves to cover non-default losses) does not cover non-default losses, additional losses should be covered exclusively by CCP equity and/or a parent company of the CCP (as opposed to loss allocation measures imposed on clearing participants). The Associations support formal guarantees from CCP parents to cover non-default losses. Under any such guarantees, CCP parents should be prohibited from paying any dividends until payment in full of all claims arising out of the CCP's recovery and resolution. In order to ensure the foregoing and also create the right incentives for the CCP and its management, CCP rulebooks should unambiguously indicate that default "waterfalls" do not apply to non-default losses.

Based on the foregoing, the Associations support Section 2.13 of the Consultative Document, which contemplates extinguishing CCP equity, and potentially other unsecured liabilities in accordance with the creditor hierarchy in insolvency, to cover non-default losses. However, the Associations believe that Section 2.13 should further clarify that equity should be completely extinguished before any non-default losses are allocated to other creditors. Additionally, as noted above, the Associations believe that Section 2.13(i) should further clarify that any loss allocation measures available under the CCP's rules and arrangements for non-default losses are explicitly for non-default losses only and are therefore completely separate from the CCP's rules or any other contractual arrangements between the CCP and its clearing members.[16]

Additionally, we realize that in resolution, clearing participants would be creditors for any amounts the CCP owes them and may therefore bear losses, potentially at an early point in the creditor hierarchy. In light of this, we believe it is critical that non-recourse provisions do not

[14] Liquidity risk could be associated with default losses and/or non-default losses. In the context of non-default losses, liquidity risk includes, *e.g.*, the risk that a liquidity provider defaults and the CCP experiences liquidity stresses that are unrelated to a clearing member default.

[15] Note that we interpret "writing down equity" to be "extinguishing equity interests in CCP and ensuring that equity holders bear losses."

[16] Please refer to footnote 13 regarding *ex ante* public disclosure of how non-default losses would be allocated.

shield CCP shareholders from non-default losses as such losses should not be passed along to clearing participants in the creditor hierarchy until all equity is extinguished such that equity holders are no longer entitled to any value or payment of any additional amounts (including in respect to recoveries, NCWO compensation or otherwise). To ensure that shareholders bear non-default losses, it is also important that any intercompany debt owing to a CCP's parent is junior to claims for non-default losses.

Transparent Resolution Plans

Section 7.7 of the Consultative Document provides that resolution authorities should consider the merits of publicly disclosing some elements of the resolution plan. The Associations maintain that it is crucial for resolution authorities to disclose certain key elements of resolution plans and therefore believe that Section 7.7 should take a more definitive position and provide that resolution authorities *must* publicly disclose certain elements of the resolution plan. Moreover, CCPs should be required to disclose additional elements to clearing participants who will be called upon to support the CCP's recovery prior to resolution and, in many cases, resolution. It is imperative that clearing participants have transparent and predictable information regarding the expected resolution strategy so that they can measure, manage and control their potential exposures in these circumstances. At an absolute minimum, clearing participants must understand triggers for resolution and any separate level of regulatory intervention and/or coordination among regulators and resolution authorities (including whether such triggers are discretionary or automatic), resources available to the resolution authority, tools that the resolution authority would utilize and any restrictions on the use of such resources and tools. We also believe that clearing participants should have access to information regarding the resolvability assessments contemplated by Section 8 of the Consultative Document. With regard to triggers, the Associations maintain that Section 3.3 of the Consultative Document should also take a more definitive position and provide that resolution authorities *must communicate* publicly the indicators that would inform their determination to trigger resolution.

Greater public disclosure of key elements of resolution plans would also help to ensure a higher level of consistency among CCP resolution frameworks across jurisdictions. This is particularly pertinent given that, under the approach proposed by the FSB, local authorities would be responsible for developing the resolution frameworks for their jurisdictions in accordance with the principles set forth in the Consultative Document. Disclosure of key elements and, hopefully, consistency across such elements (to the extent appropriate given differences in legal frameworks and CCP structures), would mitigate opportunities for regulatory arbitrage.

Separately, as noted above, we support the beginning of Section 2 of the Consultative Document, which contemplates incorporation of a resolution authority's powers in the CCP's rules and arrangements and Section 2.2 of the Consultative Document, which provides for a presumption that the resolution authority continues to follow unused provisions of the CCP's rules and arrangements. However, we think it is crucial to disclose more specifically when a resolution authority would deviate from a CCP's rules and arrangements. Moreover, we believe that any such deviations should be subject to explicit limitations. We also think that it is crucial to ensure

that CCPs themselves would not have the power to exercise any of their rules and arrangements that are intended only for use by a resolution authority.

Claims for Clearing Participants Suffering Losses

As previously stated, the Associations strongly believe that CCP rulebooks must provide for clearing participants to retain senior claims in respect of losses they suffer beyond the CCP's funded (*i.e.*, default fund) and unfunded (*i.e.*, one capped assessment)[17] default resources, in CCP recovery and resolution.[18] Therefore, the Associations commend the FSB for contemplating compensation in Section 2.15 of the Consultative Document. However, the Associations have strong concerns about the limitations on such compensation in Section 2.15 and, specifically, the limitation that equity or debt would only be awarded to clearing members that contribute financial resources to a resolution in excess of their obligations under the CCP's rules and arrangements. First, we believe such claims should be awarded to all clearing participants suffering losses beyond the CCP's funded and unfunded default resources in both recovery and resolution. Separately, we strongly believe that such claims should not be limited to contributions in excess of what is contemplated in the CCP's rules and arrangements. Finally, we do not believe that the resolution authority should have any discretion with regard to whether clearing participants retain claims.

The introduction to Section 2 of the Consultative Document provides that, to the extent appropriate, the resolution authority's powers should be set out in the jurisdiction's legal framework *and reflected in the CCP's rules and arrangements.* Accordingly, unlike the contractual relationship between a non-CCP financial entity and its counterparties and other creditors, it is contemplated that the contractual relationship between a CCP and its clearing members would cover resolution and potential losses to clearing members (and their clients) in resolution. If a counterparty of a non-CCP financial entity suffered losses in, or prior to, a resolution, it would have a claim against the entity in resolution. The situation should not be different solely because CCPs are expected to contemplate resolution in the rules and arrangements that form the contractual relationship between the CCP and its clearing members.

Based on the foregoing, we strongly believe that Section 2.15 of the Consultative Report should require[19] claims for *clearing participants* that contribute financial resources to a resolution[20] in excess of their *funded contribution and one capped assessment in order to establish such clearing participants as creditors of the CCP* (changes italicized).[21] Such claims would:

[17] We note that some members also support senior claims for assessments.
[18] *See* Letter from the Associations and TCH to the FSB dated October 21, 2016 at pages 9-10, 19-21, 26-29. We note that at least one member would also support senior claims for default fund contributions and assessments.
[19] Absent a requirement in FSB guidance that is implemented by national regulators, we believe it would be very difficult, if not impossible, for clearing participants to negotiate rights to claims in CCP rulebooks.
[20] The Associations also believe that any claims arising in recovery should be retained. However, we have focused on resolution as it is the topic of the Consultative Document.
[21] For the avoidance of doubt, clearing participants that provide liquidity in recovery or resolution and already retain a right to repayment for such liquidity would not be entitled to the claims we describe here.

- Ensure that clearing participants suffering losses beyond such contributions are "creditors" for the amounts of such losses in resolution. In particular, clearing participants must be creditors for these amounts in order to benefit from creditor protections in resolution such as NCWO.
- Mitigate moral hazards associated with allocating losses or positions among clearing participants and thereby protecting equity holders of for-profit CCPs.
- Incentivize CCPs to focus on resilience in order to avoid exhaustion of funded and unfunded default resources, and subsequent use of tools that would entitle clearing participants to claims.

In general, claims should be senior to existing CCP equity in the creditor hierarchy,[22] not be extinguishable in resolution or post-resolution and should entitle holders to future CCP profits before the CCP or its parent pays any dividends. If structured as debt, such claims should be able to be "bailed-in" if necessary and appropriate pursuant to the applicable resolution strategy.

The form of new instruments to be issued to clearing participants entitled to claims may differ from jurisdiction to jurisdiction and CCP to CCP. The most important objectives in structuring compensation claims and related instruments should be that (1) clearing participants losses are repaid in full prior to distribution of any amounts or value to the CCP's parent or other affiliates in respect of equity or debt of the CCP that they may hold at the commencement of resolution and (2) neither the claims nor the related instruments should render the resolved entity insolvent. Some members also believe that a third important objective should be that the claims and related instruments do not result in resolution or insolvency prior to the point in time at which resolution or insolvency would have otherwise occurred.

A number of members believe that compensation claims should always be bailed in, or exchanged for, new equity or debt issued by the resolved entity. Of these members, some also believe that the new instruments should be issued as equity in the resolved entity, and the equity of the failed CCP should be extinguished, so that the resolved CCP is separated from the control of the failed CCP's parent. Other members are concerned that a bail-in or exchange resulting in clearing participants owning the resolved CCP could negatively affect incentives for participation in a CCP's recovery efforts, as well as potentially raise regulatory issues associated with certain clearing participants holding equity in a CCP.

Some members also have concerns that claims structured as debt could render the resolved entity balance sheet insolvent and therefore impede an orderly resolution.

To address the concerns articulated above, some members specifically support further consideration of nil paid "preference share" or similar instruments. Such instruments would provide a right to accumulated earnings in excess of regulatory capital requirements until they are paid in full. Based on preliminary work, such claims could be structured as either true shares

[22] Any intercompany debt of the CCP should be converted into equity upon the commencement of resolution so that it is junior to claims of clearing participants in the creditor hierarchy.

or a contractual right. Consistent with the principles stated above, neither the CCP nor its parent would be permitted to pay dividends until the instruments were paid in full.

Finally, some members believe that i an inflexible requirement to bail-in or exchange claims for equity (or debt) of the resolved entity may not be necessary, provided that clearing participants' claims against the failed CCP remain outstanding and entitled to received recoveries (if any) and NCWO compensation payments senior to the CCP's equity in accordance with the creditor hierarchy.

The Associations also have some concerns regarding the statement at the end of Section 2.15, which provides that, alternatively, the resolution authority may have the power to award clearing participants with claims on the parent of the group to which the CCP is affiliated. We believe that claims would not be appropriate unless the resolution authority is executing a strategy pursuant to which it enters at such parent and the claims completely extinguish the parent's existing equity holders.[23]

NCWO Counterfactual

Section 5 of the Consultative Document covers the NCWO counterfactual and, in several instances, contemplates that the assessment of the losses that would have been incurred and of the recoveries that would have been made by CCP participants, equity holders and creditors if the CCP or relevant clearing service had been liquidated or terminated *should assume the full application of the CCP's rules and arrangements and any other contractual agreements subject to the applicable insolvency law* (emphasis added). The Associations believe that clarification is necessary to confirm the meaning of the italicized language and address scenarios in which the CCP's rules and arrangements and/or applicable insolvency law would apply to a different segment, entity or scope of contracts than resolution.

Subject to the concerns noted below, the Associations believe that the NCWO counterfactual for both default and non-default losses should generally be liquidation in accordance with the applicable insolvency regime and applicable CCP rules and arrangements at the time of resolution.[24] The foregoing is consistent with the underlying objective of a NCWO protection, which is to protect creditors from suffering losses that they would not have occurred absent resolution. Upon entry into insolvency, the applicable insolvency regime would dictate how contractual provisions in the CCP's rules and arrangements (including claims of clearing participants that have suffered losses) would be enforced. We interpret the "subject to the applicable insolvency law" qualifier at the end of the italicized language above, as meaning that a resolution authority should not be required to separately account for anything *different* than what would actually occur in accordance with the CCP's rules and arrangements in a liquidation

[23] Some members also believe that if the resolution authority enters at the CCP, then the Associations maintain that in order to allocate losses to the CCP's ultimate equity holders, as contemplated by Section 4 of the Consultative Document, CCP equity must be extinguished and ownership of the CCP must transfer from the CCP's parent.
[24] For the avoidance of doubt, the Associations absolutely expect the resolution authority to continue to follow the steps and processes under the CCP's rules and arrangements, as contemplated by Section 2.2 of the Consultative Document.

under the applicable insolvency regime if resolution did not occur.[25] An assumption regarding different application of such rules and arrangements would be contrary to the reality of the situation.

Consistent with the foregoing, we believe that "and the extent" should be deleted from Section 5.2 of the Consultative Document. As noted above, the objective of a NCWO safeguard is to protect creditors from suffering losses that they would not have occurred if resolution had not commenced. Accordingly, the safeguard should apply regardless of whether the resolution authority departs from the CC's rules and arrangements, if the outcome to clearing participants and other creditors differs from what it would have been absent resolution.

Relatedly, the Associations also believe that as part of resolution planning, regulators should ensure that, notwithstanding their rules and arrangements, CCPs are eligible for insolvency proceedings under applicable law at the time that resolution is expected to be triggered. If a resolution authority contemplates commencing resolution at an earlier time, then presumably absent resolution, recovery would proceed in accordance with the CCP's rules and arrangements. Some members do not think that this scenario should be contemplated and have serious concerns about a counterfactual that does not contemplate insolvency proceedings, but other members support additional work to determine the appropriate NCWO counterfactual in any jurisdiction in which the scenario may arise.

Separately, we believe that additional work is necessary to address situations in which a CCP's rules and arrangements and/or applicable insolvency law would apply to a different scope of contracts than resolution. For example, in some jurisdictions we understand that CCP resolution could apply to a clearing service whereas in other jurisdictions resolution would apply at the legal entity level, regardless of whether all clearing services or silos in the legal entity were affected by the contagion. However, contrary to Section 5.5 of the Consultative Document, we are not aware of any insolvency regimes that apply to anything other than a legal entity, which would result in a disconnect between the resolution of a clearing service and the application of relevant insolvency law. Moreover, we note that some CCP rulebooks provide for a close out across multiple clearing services upon insolvency or liquidation, again, regardless of the scope of the contagion. Such provisions in CCP rulebooks would also lead to a disconnect in applying the contemplated NCWO counterfactual. The Associations support additional work to address these disconnects and ensure that the NCWO counterfactual does not conflict with the reality of what would occur absent resolution.

The Associations also have concerns regarding the effect of certain existing non-recourse provisions on NCWO protections. Section 5.5(iii) of the Consultative Document provides that when computing the NCWO counterfactual, the resolution authority should take into consideration any limited recourse provisions in the CCP's rules, and the CCP's rules and

[25] For example, if an auction or similar mechanism to return a CCP to a matched book failed, it would be extremely difficult, if not impossible, to accurately calculate what would have happened if the default management process played out and re-established a matched book at the CCP. Moreover, if a CCP entered insolvency after a failed auction, the insolvency court would not make any such assumptions when determining amounts owed to creditors. Incorporation of resolution powers in CCP rulebooks only further complicates and exacerbates these issue.

arrangements for loss allocation, including the tear up of contracts. CCPs have limited recourse provisions for a variety of purposes, including among siloed clearing services[26] as well as between a CCP and its parent and ultimate equity holders. The latter could significantly limit (and in some cases reduce to zero), the amounts that a CCP owes clearing participants that suffer losses. Currently, clearing participants are not creditors of the CCP entitled to CCP protection except with respect to a return of their initial margin and, subject to non-recourse provisions, any net amounts that the CCP owes them.

Non-recourse provisions at CCPs today generally restrict clearing participants' recoveries to a limited amount of financial resources allocated to a particular clearing service of the CCP. If these resources are exhausted prior to payment in full of clearing participants' claims against the CCP, the unpaid portions of such claims are extinguished. Thus, limited recourse provisions in effect represent an agreement between a CCP and its clearing participants that the clearing participants will not be creditors of the CCP to the extent their claims are extinguished. For these amounts clearing participants are therefore subordinated not only to the CCP's other general unsecured creditors (which may include the CCP's parent or other affiliates that hold intercompany debt issued by the CCP), but also the CCP's shareholders. Without a more meaningful status as creditors, NCWO does not protect clearing participants in the way that it protects other creditors of the CCP or creditors of other types of financial entities that could be in resolution. Moreover, absent removal of limited recourse provisions between a CCP and its parent and ultimate equity holders, equity holders could be more likely to receive recoveries in insolvency while losses allocated to clearing participants would remain unreimbursed, which is problematic on principle and for purposes of applying NCWO.

The Associations do not believe that the requirement to consider limited recourse provisions in CCP rulebooks is at all strong enough to address the foregoing issues. We believe that to address these issues fully and ensure that CCP equity holders are in a true first-loss position and do not receive amounts that could otherwise be applied to reimburse clearing participants for losses allocated to them, CCPs should be required to (1) remove non-recourse provisions from their rulebooks (subject to certain exceptions for product silos provided that assets of a parent company are available to clearing participants in the affected silo)[27] and (2) adopt rules that would permit retention of senior claims by clearing participants in respect of losses from the application of loss allocation tools utilized after exhaustion of default fund resources and one capped assessment in recovery or resolution.

Other Points

Partial Tear-Ups. Section 2.5(ii) of the Consultative Document provides that the price of a partial tear-up should be based, as far as possible on a fair market price determined on the basis of the CCP's own rules and arrangements or other appropriate price discovery method. We view this language as somewhat vague and therefore potentially problematic. At this time, the

[26] Some members support these non-recourse provisions, which are separate from the problematic non-recourse provisions that we discuss herein.

[27] We believe that regulators and resolution authorities should require removal of such provisions as part of the resolvability assessments contemplated by Section 8 of the Consultative Document.

Associations strongly support ongoing industry work to establish appropriate pricing for partial tear-ups, which will differ across CCPs and across product types.

In general, based on work to date, the Associations believe that the most important issues to consider when establishing pricing for partial tear-ups include: (1) liquidity in the market for the contracts to be torn up; (2) potential to hedge exposure on the open positions; and (3) time elapsed since the most recent margin call or settlement price valuation and market movements since that time. In addition, the CCP's available resources should in no event influence pricing for partial tear-ups. We also believe that one approach to pricing for partial tear-ups likely would not work for all products and/or all market participants. The Associations and their members continue to explore the advantages and disadvantages of several different approaches and look forward to discussing this work with regulators and resolution authorities.

The Associations also strongly agree with Section 2.5(i) of the Consultative Document, which provides that partial tear-up should be used for the purpose of returning the CCP to a matched book and not to allocate losses. However, we think that the statement at the beginning of Section 2.5 regarding use of partial tear-up if, *inter alia*, market-based actions to return to a matched book would likely result in losses that exceed the prefunded and committed financial resources that are available under the CCP's rules and arrangements to cover those losses should be amended. If partial tear-up is utilized under these circumstances, it is important that it be accompanied by a loss allocation tool such as VMGH.[28] Additionally, we note that some members do not believe that the quantum of expected losses from market-based actions should be a trigger for partial tear-ups. Finally, it is crucial for clearing participants affected by partial tear-up to receive claims in the manner discussed above that establish them as creditors. Such claims should be for the amount of losses suffered by the clearing participants as a result of the partial tear-up.

Separately, the Associations support clarification in final guidance that partial tear-ups should apply to the smallest portion of illiquid contracts possible, recognizing that the scope of contracts may need to expand in certain circumstances and/or may be affected by financial stability concerns. Any decisions regarding the scope of contracts to be torn up should be subject to strict governance procedures that are established and disclosed to clearing participants on an *ex ante* basis and that account for the views of clearing participants whose positions could be torn up. Importantly, in no event should partial tear-ups take the form of an "invoicing back" that would apply only to those contracts that the defaulting clearing member entered into at inception. Such a scenario would affect only those non-defaulting clearing members that were the original counterparties to the relevant contracts and would therefore mean that such clearing members ultimately remained exposed to bilateral counterparty risk towards another clearing member instead of the CCP. This would in turn challenge the principle of a CCP as the buyer to every seller and the seller to every buyer, which could have adverse regulatory and capital requirements for clearing participants.

[28] Please refer to footnote 3 for a discussion of members' varying views on VMGH.

Finally, Section 2.3 of the Consultative Document provides that the resolution authority should have the power to restore the CCP to a matched book by soliciting voluntary actions, conducting auctions or by tearing up or otherwise terminating contracts. The Associations strongly agree that the resolution authority's primary objective should be to return the CCP to a matched book as expeditiously as possible. On this point, we anticipate that resolution authorities will need to act very quickly during the first approximately two days of a resolution to restore market confidence, and therefore may not have time to evaluate different potential courses of action. While, as noted above, most members strongly support a presumption that the resolution authority will continue to follow any unused provisions of the CCP's rulebook, we believe that, upon resolution, the resolution authority must weigh that presumption against the need to return to a matched book quickly and the likelihood that auctions or other voluntary mechanisms would achieve this objective in two business days or less.

Full Tear-Up. Section 2.6 contemplates a full tear-up in certain situations. The Associations recognize that either a CCP resolution or a CCP liquidation would be an extreme event and likely involve drastic measures. We support full tear-up and liquidation of a CCP or, to the extent possible under applicable law, clearing service, *provided that the CCP or clearing service is not critical, such full tear-up would not have systemic consequences and affected clearing participants retain claims that preserve their status as creditors.*[29] However, we request clarification regarding how resolution authorities would make such a determination and support FSB guidance regarding criteria to be considered. We also believe that if a resolution authority believes that full tear up of a CCP would be the best course of action, the resolution authority should consider not intervening and allowing the full tear up to proceed in insolvency or in accordance with the CCP's rulebook outside of resolution or insolvency proceedings. Some members believe that resolution should not replace insolvency if the latter would not be systemically destabilizing.

VMGH.[30] Section 2.10 provides that resolution authorities should have an explicit power to haircut variation margin payable to non-defaulting clearing participants. The Associations support VMGH in resolution over a minimal time period.[31] As noted above, some members support such a use of VMGH only after CCP capital has been exhausted and the CCP's equity holders are not entitled to any further amounts or value in respect of their equity interests (as a result of recoveries, NCWO compensation payments or otherwise). Other members of the Associations also support a limited use of VMGH prior to resolution in recovery, subject to safeguards, and want to ensure that section 2.10 would not preclude such a limited use of VMGH in recovery. These members support section 3.1 of the Consultative Document, which provides that a CCP's recovery plan should be designed to address comprehensively any uncovered credit

[29] As with partial tear-up, such claims should be for the amount of losses suffered by clearing participants affected by the full tear-up. Also like partial tear-up, the Associations believe that the most important issues to consider when establishing pricing for full tear-up include (1) liquidity in the market for the contracts to be torn up; (2) potential to hedge exposure on the open positions; and (3) time elapsed since the most recent margin call or settlement price valuation and market movements since that time. Again, the CCP's available resources should have no influence on the pricing for full tear-up.

[30] Please refer to footnote 3 for a discussion of members' varying views on VMGH.

[31] Please refer to footnote 3 for a discussion of members' varying views on VMGH.

losses, and believe that a limited amount of VMGH should be permitted in recovery to accomplish such loss allocation.

Departure from Pari Passu *Treatment of Creditors.* Section 5.3 provides that a resolution authority should not be prohibited from departing from the general principle of *pari passu* treatment of creditors within the same class and order of loss allocation in accordance with the CCP's rules and arrangements, if necessary to achieve the resolution objectives or maximize value for all creditors. The Associations continue to have serious concerns about any such deviations and maintain that any non-*pari passu* treatment of similarly situated creditors should be subject to explicit and pre-defined limitations.[32] .

Moreover, while it could be tempting to a resolution authority, allocation of losses to seemingly more financially stable clearing participants would be extremely inequitable and should not be permitted.

Recovery of Temporary Funding. Section 6.5 of the Consultative Document provides that resolution authorities should recover any available temporary public funding from the assets of the CCP, its participants and/or other market participants. While the Associations understand that political pressure may require resolution regimes to provide for recovery from market participants generally, a recovery from clearing participants is potentially problematic and we request clarification regarding how that would work. Among other things, any such recovery should not violate caps on clearing participant assessments, as discussed above.

Financial Resources for Resolution. The Associations strongly support the additional work contemplated by Section 6 of the Consultative Document. We specifically believe that such work should consider the appropriate levels of (1) CCP capital and (2) additional resources necessary to facilitate immediate recapitalization of the successor or resolved CCP and replenishment of its "skin-in-the-game" contributions. In analyzing and considering appropriate levels of CCP capital, we believe it is crucial to consider and stress-test specific non-default loss scenarios to ensure that CCP capital would cover any potential non-default losses. As part of this work, we support additional guidance and transparency regarding the "appropriate prudent assumptions about financial resources that may be required to achieve the resolution objectives and the resources that it expects to remain available under the CCP's rules and arrangements at the time of entry into resolution," as provided in the introduction to Section 6 of the Consultative Document.

Resolvability Assessments. The Associations strongly support resolvability assessments and powers of resolution authorities to require changes to CCP rulebooks, including some of the changes discussed above. As CCP resolution strategies will likely differ jurisdiction to jurisdiction and CCP to CCP, resolvability assessments for individual CCPs serve a crucial role in CCP resolution planning. Among other things, some members believe that resolution

[32] As an example, *see* the limitations on when the U.S. Federal Deposit Insurance Corporation (FDIC) could deviate from *pari passu* treatment of creditors under Section 210(b)(4) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. These generally include scenarios in which the FDIC determines that such deviation is necessary to maximize value, minimize losses or continue essential operations.

authorities should have the power to require structural and organizational changes by CCPs, their parents and their other affiliates if necessary to achieve resolvability. Notwithstanding the foregoing, the Associations urge regulators and resolution authorities to ensure that any rule changes are subject to a CCP's standard clearing member review and approval process.

Structuring Resolution Strategies. Resolution authorities should have flexibility to structure CCP resolution strategies, including among other things, point of entry for resolution, in the manner best suited for the applicable legal framework and structure of the particular CCP. Among other things, FSB guidance should not preclude resolution authorities in certain jurisdictions from entering at a CCP's holding company (including an intermediate holding company) if that is the most appropriate strategy for the particular CCP under the applicable resolution regime.

CCP Interoperability. The Associations support additional work by resolution authorities and other regulators to address CCP interoperability. We support the acknowledgment of the effects that intra-group dependencies, interoperability arrangements and links with other financial market infrastructures in Section 7.5(viii) and Section 10.1(i) of the Consultative Document, as they relate to CCP resolution planning. However, given the relatively high likelihood that stress at one CCP could jeopardize the functioning of other CCPs, we believe that more work is necessary to ensure protections for clearing members of all linked CCPs.

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We very much appreciate your consideration of our comments. If we may provide further information, please do not hesitate to contact the undersigned or staff at any of the Associations.

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