

30 July 2020

Financial Stability Board  
Bank for International Settlements  
CH-4002 Basel, Switzerland

**Re: CCP12 response to FSB consultative document entitled “Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution”**

### Executive Remarks

The Global Association of Central Counterparties (“CCP12”) is pleased to provide its response to the consultative document released by the Financial Stability Board (“FSB”) for public consultation on May 4, 2020, entitled “Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution” (“the Guidance”).

CCP12 is a global association of 35 members who operate more than 50 individual central counterparties (“CCPs”) globally across the Americas, EMEA and the Asia-Pacific region. CCP12 aims to promote effective, practical and appropriate risk management and operational standards for CCPs to ensure the safety and efficiency of the financial markets it represents. CCP12 leads and assesses global regulatory and industry initiatives that concern CCPs to form consensus views and seeks to actively engage with regulatory agencies and industry constituents through consultation responses, forum discussions and position papers. CCP12 previously contributed input on the FSB’s papers on “Key Attributes of Effective Resolution Regimes for Financial Institutions”<sup>1</sup> and “Guidance on Central Counterparty Resolution and Resolution Planning,”<sup>2</sup> as well as on the more recent “Financial resources to support CCP resolution and the treatment of CCP equity in resolution.”<sup>3</sup>

As a general remark, we appreciate the significant work that has been done by the international policy makers since the global financial crisis of 2008 to enhance the resiliency of the financial system. International standards have provided a strong framework that allows jurisdictions to adopt legislative and regulatory requirements that are appropriately tailored to their local legal frameworks and CCPs. Notably, this includes the local implementation of CPMI-IOSCO’s *Principles for financial market infrastructures* (“PFMI”),<sup>4</sup> which enhanced the already robust central clearing model that had repeatedly demonstrated its strength during past market stress events. It is important to recognise how much work has been done by CCPs to enhance their resources and tools designed to ensure proper incentives for market participants to manage their risks and participate effectively and efficiently in the CCP default management and recovery process and, in turn, avoid resolution. These tools and resources stem from risk management models that are built on principles of optimal risk management, preservation of market integrity, and the avoidance of moral hazard through appropriate incentive alignment. Moreover, the hierarchy for the use of resources that comprise what is commonly referred to as the “default waterfall”, including the CCP capital contribution and mutualisable resources, is designed to incentivise market participants to: i) continually manage their risks by collateralising their own exposures; and ii) in the event of distress, promote the continuity of a CCP’s service through prioritising CCP recovery over resolution by participating effectively in the default management process, which mitigates the likelihood that default fund resources will be mutualised and other recovery tools will be used. Adjusting the treatment of CCP equity, particularly by making additional equity available in a manner that would alter the use of resources under default

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<sup>1</sup> Financial Stability Board (2014). [Key Attributes of Effective Resolution Regimes for Financial Institutions](#).

<sup>2</sup> Financial Stability Board (2017). [Guidance on Central Counterparty Resolution and Resolution Planning](#).

<sup>3</sup> Financial Stability Board (2018). [Financial resources to support CCP resolution and the treatment of CCP equity in resolution](#).

<sup>4</sup> Committee on Payment and Settlement Systems (later renamed the Committee on Payments and Market Infrastructures) and Technical Committee of the International Organization of Securities Commissions (2012). [Principles for financial market infrastructures](#) [hereafter, “PFMI”].

waterfall based on extreme and implausible scenarios, as the Guidance contemplates, and/or making additional equity first-loss absorbing in resolution, would undermine the current incentive structure in place that is focused on supporting financial stability by promoting successful default management and recovery processes.

Therefore, evaluation of existing resources and tools for recovery and resolution should bear in mind the preservation of this carefully constructed incentive structure. Furthermore, as elaborated on below, changing the treatment of CCP equity (e.g. by making overly large amounts of CCP equity available in the default waterfall, writing down the CCP equity, or exposing the entire CCP equity to losses in resolution) could have negative effects on financial stability by, in addition to potentially undermining the default management and recovery processes.

As discussed during the recent FSB virtual events held on June 25<sup>th</sup> and 30<sup>th</sup>, CCPs have brought predictability to the derivatives markets, and their resilience has been tested during real-world stress events along with scenario analysis, sensitivity analysis and stress testing. For example, in Q1 2020, CCPs remained resilient despite double the financial pressure observed during the day after the Lehman Brothers fall in 2008.<sup>5</sup> Implying that CCPs should have in place resources for resolution for extreme and implausible scenarios is inconsistent with current international standards that are designed to promote central clearing in a safe and sound manner, whereby a CCP maintains pre-funded resources to address “extreme but plausible market conditions”.<sup>6</sup> Given the potential negative consequences on financial stability of changes to CCP equity and the robust framework already established by international policy makers to promote CCP resiliency, CCP12 questions if the Guidance is necessary in such a granular level. However, to the extent the FSB moves forward with the Guidance, at a minimum CCP12 recommends that the FSB conducts a separate and transparent analysis of the effect of adjusting the treatment of CCP equity, including by altering the default waterfall and making it a first loss-absorbing resource in resolution, prior to the release of any final guidance on the matter.

### **Key Points**

CCP12 appreciates this opportunity to comment on the Guidance and offers the following key points, as summarised for convenience in bullet form below, for the FSB’s consideration:

- First and foremost, while we do not believe this was the intention of the FSB, CCP12 urges the FSB to avoid undermining the incentives structure of the central clearing model that supports robust CCP risk management practices, default management processes and recovery measures that are already in place. Guidance issued collectively by the FSB and CPMI-IOSCO sets out a framework that promotes the resilience of CCPs in the face of default and non-default losses, which are designed to support recovery over resolution in the unlikely event losses arise that exceed defined resources. Given this, CCP12 would caution against any further guidance that unnecessarily reopens international standards that have already been agreed-upon by policy makers, and that could undermine legislation and regulation that has been implemented locally.
- Secondly, to further enhance the objective of current international standards to support the stability of the broader financial system, the Guidance must work cohesively with those existing standards. Broadly, CCP12 is concerned that the granular level at which the Guidance has defined scenarios for assessment of a CCP’s equity could conflict with, or create confusions regarding, existing standards and the local implementation of such standards.<sup>7</sup> The CCP’s local resolution authority, in cooperation with its primary supervisory authority, maintains the sole responsibility for identifying scenarios to address as a part of its resolution planning.<sup>8</sup> Local authorities are most familiar with the

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<sup>5</sup> See CCP12 paper on [“CCPs Again Demonstrate Strong Resilience in Times of Crisis”](#) (2020).

<sup>6</sup> PFMI at Principle 4.

<sup>7</sup> See, for example, PFMI at Principles 4, 7, and 15.

<sup>8</sup> We further disagree with the proposal that “[t]o the extent it finds that the CCP has not implemented resources and tools called for by the existing standards, the resolution authority should coordinate with the relevant supervisory and/or oversight authorities.” The resolution authority, rather than duplicating efforts, should instead be relying upon the supervisory authority’s judgment when it comes to

unique characteristics of the CCPs they oversee and the legal framework under which they operate, which is critical for identifying appropriate scenarios. Generally, as a matter of practice, CCP12 believes that focusing on a small defined set of major and common default and non-default scenarios that are relevant to the CCP being assessed, based on the likelihood of them occurring and level of risk posed to the specific CCP, is likely the most useful approach. While CCP12 does not believe the FSB intends to undermine local resolution authorities' responsibilities, it is concerned that as drafted, the Guidance could lead to such an outcome. Notwithstanding CCP12's concerns regarding the granular nature of the scenarios identified in the Guidance, the extreme and implausible nature of some of the scenarios proposed are also difficult to reconcile with current international standards. Implying that a CCP should have resources in resolution to address such extreme and implausible scenarios is inconsistent with current standards and risks upsetting the well-calibrated incentives created by the central clearing model.

- Lastly, CCP12 does not support guidance that contemplates pre-emptively exposing further equity to losses in the name of resolution planning, beyond what is stipulated ex-ante in a CCP's rulebook and relevant local regulation and legislation. Further, CCP rulebooks have been designed consistent with the no creditor worse off than in liquidation ("NCWOL") safeguard, while considering impacts on market participants' incentives and through engaging with key market stakeholders. Consequently, creating policies where equity adjustment could be readily available beyond what is stipulated ex-ante undermines the NCWOL safeguard and risks materially disrupting critical incentives for market participants to effectively manage their risks, thus potentially compromising financial stability during times of stress.

Ultimately, CCP12 is supportive of a flexible approach that allows each jurisdiction's resolution authority based on its own legal framework and market singularities to undertake its resolution planning, including evaluating a CCP's resources for adequacy in resolution. Establishing a "one-size-fits-all" approach, including by defining granular and implausible scenarios, ignores the intrinsic differences between ownership mechanisms, markets and jurisdictions. In sum, the Guidance, as proposed, appears to enforce a lengthy analysis of extreme and implausible scenarios that does not benefit resolution planning.

The following pages detail our response to the themes outlined in Part I and Part II of the consultation.

### **Part I: Financial resources for CCP resolution**

In regard to Part I, while CCP12 recognises that additional high-level guidance that provides a tool to help inform a CCP's local resolution authority on how to engage in the process of resolution planning may be useful, any such guidance should respect local authorities' responsibilities and powers by focusing on providing, if anything, a conceptual framework to support local resolution authorities in identifying the necessary information and inventorying a CCP's tools for resolution planning. This framework could foster regulatory transparency and facilitate the adoption of the FSB's current guidance, which could allow local authorities and CCPs to engage in a rational and consistent discussion on how the application of financial resources could function in a CCP resolution based on standards established ex-ante, thus supporting financial stability.

Providing a conceptual framework could further allow local resolution authorities to deepen their knowledge base when establishing a resolution framework for their local CCPs without undermining the sole responsibility a local resolution authority has to undertake resolution planning, including identifying appropriate scenarios for consideration, in a manner that is appropriate for the CCPs it oversees. Noting that, CCP12 is hopeful that a conceptual framework for resolution planning, including evaluating resources and tool, would:

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whether a CCP has implemented resources and tools called for by the existing recovery and resilience standards. Similarly, assuming that scenarios are appropriately designed, in the extreme, unlikely event, that potential substantial funding gaps are identified, resolution authorities should undergo a discussion with a CCP and its supervisory authority to determine the best course of action based on that specific local jurisdiction.

- (i) **Rely on CCP readily available internal data to the maximum extent practicable;**  
To streamline the process and reduce time and costs, resolution authorities should leverage the information and data already present within and created by the CCP itself, working alongside other local authorities to fill any data gaps when conducting quantitative analysis. For example, for default losses one can use data from the CCP on size and positions to calculate potential resolution costs, with the focus being on calculations CCPs have already conducted (i.e. “cover” scenarios, stress testing). Additionally, authorities should consider whether pertinent information on scenarios and their impact on members and indirect participants can be best obtained from the market participants themselves.
- (ii) **Consistent with current FSB guidance, as explained below, assume the resources and tools defined in the CCP rulebook and the recovery plan will generally be utilised prior to the resolution authority intervening;**  
In particular, the defaulters’ resources, mutualised default fund resources, assessment for additional mutualisable resources and other recovery tools should generally be utilised prior to a resolution authority intervening. Such tools and resources have been carefully designed by a CCP to support the right incentives for market participants to actively participate in the default management and recovery processes and address stress events in a prudent and efficient manner.
- (iii) **Not create an unduly prescriptive approach upon CCP operations, as any process would likely need to be adapted to local jurisdiction circumstances and CCP ownership structures.**

Overall, the current use of extreme and implausible scenarios for a financial resources assessment in the Guidance risks weakening the well-calibrated incentives created by the central clearing model by failing to consider the role of CCPs in the financial system and neglecting the obligations and safeguards CCPs have in place under CPMI-IOSCO’s resiliency and recovery standards – e.g. stress-testing requirements, robust reserve safeguards, et cetera. This makes the purpose and objective of the Guidance difficult to understand and reconcile with the already adopted international standards.

### **Scenarios**

Scenarios in the Guidance that are particularly troublesome are those that incorrectly presume the following:

- **That a CCP’s shareholders would not support recovery actions;**  
The presumption that a CCP’s shareholders would not support recovery actions is contrary to the primary objective of shareholders to preserve shareholders’ long-term value. A CCP’s value is the integrity of its markets and, as such, predicates on supporting the stability of the broader financial system through the continuity of its services (i.e., risk management offering). Consequently, shareholders’ oversight function of the CCP encompasses supporting actions that promote the continuity of the CCP’s risk management offering, which could include taking recovery actions. Further, consistent with the PFMI, a CCP must design an appropriate plan for recovery, which would include determining recovery actions that could reasonably be taken under the scenarios identified by the CCP that may potentially prevent it from being able to provide its critical services.<sup>9</sup>
- **That a CCP cannot use its recovery tools;**  
The presumption that a CCP cannot use its recovery tools is inconsistent with the PFMI, which sets out that a CCP is required to operate within a well-founded and enforceable legal framework.<sup>10</sup> This encompasses that a CCP must be able to use its recovery tools. Further, as noted above, consistent with the PFMI, CCPs are required to design an appropriate plan for recovery, which would include determining recovery actions that could reasonably be taken.

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<sup>9</sup> PFMI at Principle 3.

<sup>10</sup> PFMI at Principle 1.

- **That a CCP bears all non-default losses.**

The broad presumption that a CCP bears all non-default losses is inappropriate and inconsistent with the CPMI-IOSCO guidance on recovery<sup>11</sup>, as the risk that causes each type of non-default loss must be independently evaluated and the appropriate loss allocation determined.<sup>12</sup> In particular, the presumption under the Guidance that a CCP bears losses related to settlement bank and custodian is highly inappropriate. It is inconsistent with the role of a CCP and general financial market practice and, consequently, inappropriately suggests that CCPs are guarantors for the overall financial system. By way of example, a clearing member typically disclaims liability for depositing customer funds with a third-party depository, similar to how a custodian disclaims liability for its use of third-party sub-custodians and a bank disclaims liability for its use of third-party correspondent banks, notwithstanding the customer's lack of control over such use. Assuming that a CCP would provide a guarantee against settlement bank and custodian losses is an inequitable responsibility that undermines a CCP's role to provide stability to the financial system as a market risk neutral intermediary. In particular, the failure of these institutions would likely be a systemic event, as these institutions provide their services to entities across the financial system and, as such, if a CCP is uniquely burdened with guaranteeing these institutions' performance, the ability of the CCP to continue to provide its clearing services could be undermined.

Additionally, the Guidance does not clearly recognise the safeguards that are in place for a resolution authority to step-in under current FSB guidance. By way of example, multiple clearing member defaults are scenarios for which a CCP plans for in recovery, but yet, this is a proposed scenario in the Guidance. The proposed scenarios for both default and non-default losses in the Guidance effectively imply that a resolution authority could step-in in advance of CCP's recovery tools having the opportunity to be used in full. To the extent any further guidance is adopted and where it includes specific scenarios, it must recognise that resolution is triggered where: i) a CCP is no longer viable or no longer able to meet applicable legal or regulatory requirements on a continuing basis, and applicable recovery measures have been exhausted; or ii) financial stability is likely to be compromised.<sup>13</sup> The resolution authority should not step-in where the CCP's rules and arrangements could still provide a viable option for recovery. This is consistently ignored in the Guidance.

More broadly, setting out a granular set of scenarios that "**should**" be considered,<sup>14</sup> as the Guidance proposes, as a part of a resolution authority's resolution planning may conflict with the prerogative of a local resolution authority to appropriately undertake the resolution planning for the CCPs under its purview. Current FSB guidance focuses on actions a local resolution authority must take as a part of resolution planning, including addressing default and non-default loss scenarios, but rightfully so, does not attempt to define granular scenarios for consideration. A CCP's local authority, in cooperation with the CCP's primary supervisory authority, is most appropriately suited to identify default and non-default loss scenarios that are relevant to the CCP being assessed, based on the likelihood of them occurring and level of risk posed to the specific CCP, and should therefore maintain the sole discretion for defining the scenarios considered in resolution planning.

In conclusion, CCPs have in place comprehensive tools and loss allocation arrangements for addressing a variety of stress scenarios that could result in default and non-default losses that are consistent with local implementations of the PFMI. While we assume the intention of the FSB was to provide guidance on potential scenarios that **could** be considered for assessing a CCP's tools and resources that are consistent with the circumstances for which a CCP is required to have tools and resources to address under recovery, the implausible nature of the identified scenarios in the Guidance undermines this approach. As noted above, a CCP is required under the PFMI to have resources to address "extreme but plausible" market conditions, but the Guidance is proposing a framework for assessing a CCP's resources against extreme and implausible scenarios. Moreover,

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<sup>11</sup> Committee on Payments and Market Infrastructures and Board of the International Organization of Securities Commissions (2017). [Recovery of financial market infrastructures](#).

<sup>12</sup> Guidance at pg. 16.

<sup>13</sup> Key Attributes at FMI Annex 4.3.

<sup>14</sup> Guidance at 1.1 and 1.2.

the CCP model establishes a hierarchy where the use of the CCP's default loss waterfall must remain preferable to recovery, and recovery preferable to resolution. Therefore, any evaluation of existing resources and tools available in resolution should bear in mind the preservation of the incentive structure of the central clearing model, especially in the case of CCP equity and other financial resources from the CCP or its affiliates. Further, regarding the use of financial resources from a CCP entity that operates within a group structure (e.g. the CCP entity is a subsidiary within the exchange group), the CCP entity should be regarded as a separate, distinct entity to avoid the risk of contagion to the other entities within the group. In addition, any evaluations of CCP resources and tools should rely on assessments conducted by the CCP's supervisory authority to the maximum extent practicable, instead of duplicating efforts, when it comes to whether a CCP has implemented resources and tools called for by the existing recovery and resilience standards.

## **Part II: Treatment of CCP equity in resolution**

In regard to Part II, CCP12 believes that shifting the burden from clearing members onto CCPs by increasing CCP equity at risk, including altering the composition of the default waterfall and/or making it the first tool available in resolution, would undermine market participants' incentives to actively participate in recovery and, consequently, reduce financial stability.<sup>15</sup> As noted above, this is particularly concerning in an early intervention scenario or where the scenarios identified in the Guidance are extreme and implausible.

Consistent with the PFMI and local regulatory requirements, as noted above, CCPs maintain pre-funded financial resources in their default waterfall to address a variety of stress scenarios capturing extreme but plausible market conditions. Further, as a best practice, CCPs typically position a tranche of pre-funded resources in the default waterfall before the mutualisation of losses across clearing members to demonstrate their confidence in their risk management practices, while appropriately incentivising clearing members to manage the risks they bring to the CCP. The amount of a CCP's financial resources that may be used, and the timing of their use, is defined in a CCP's rulebook and is designed to incentivise the continuity and recovery of the distressed market while supporting the stability of the broader financial system. Consequently, any deviation from the CCP rulebook could have grave impacts on the incentives of clearing members to actively participate in the default management, recovery, and resolution processes.

De-capitalising a CCP at a time of market distress or requiring a CCP to hold additional pre-funded resources for the sole purpose of resolution could also impair, if not undermine, attempts to restore market stability. Both these actions create incentives for market participants to consider pre-emptively forcing the CCP into resolution, over supporting recovery, at the prospect of the availability of additional funds. Concomitantly, putting a CCP in a less capital solvent position limits its flexibility by restraining operational funding capacity and might compromise the *de minimis* capital standards that need to be strictly followed. This is counter to the objectives of international standard setters, which is to support the continuity of a CCP's critical services and, in turn, support financial stability.

CCP12 agrees that the resolution authority should have the requisite legal powers and enforcement provisions to effectively undertake resolution and that these powers should be sufficiently broad. However, such powers should focus on actions that would be available after the tools and resources defined in the CCP rulebook, and after allowing the CCP's recovery plan, have the opportunity to be exhausted by CCP prior to the resolution authority stepping in. To avoid putting a CCP into liquidation, CCP12 suggests the powers to be utilised in this order: (i) non-equity adjustment provisions which are readily available; (ii) equity adjustment provisions consistent with NCWOL; and (iii) worst-case scenarios such as bridging, liquidation, et cetera. Any write-down or bail-in of equity or unsecured debt should be done in a manner that respects the insolvency

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<sup>15</sup> Equity treatment has been defined by the FSB in its Key Attributes and elaborated on in the FMI Annex and the corresponding CPMI-IOSCO recovery report. The CCP rulebooks have already taken into account the usage of equity and have designed such usage consistent with: i) regulatory guidance; ii) stakeholder engagement; iii) key considerations of transparency; and iv) the NCWOL safeguard. As aforementioned, opening the door for a modification in this aspect would materially disrupt critical incentives and undermine financial stability.

claims hierarchy in the local jurisdiction without disincentivising or interfering with the provision of credit or liquidity to the CCP. CCP12 believes this to be the best approach from a high-level view and that any future FSB guidance does not need to go further; however, discussions need to continue to be undertaken in each local jurisdiction.

### ***NCWOL and Other Forms of Compensation***

The NCWOL safeguard requires the counterfactual calculation of the result of a CCP's insolvency to be established. Consistent with the FSB's Key Attributes, an appropriate NCWOL counterfactual should be: (a) based on what would actually have occurred in a liquidation process if resolution had not commenced and all similarly situated creditors had been treated equally; and (b) a scenario in which hypothetical losses to creditors could be calculated with a high degree of certainty.<sup>16</sup> Therefore, the counterfactual requires an ex-post assessment of the losses that would have occurred under liquidation, assuming at least the full application of the CCP's loss allocation arrangements as defined under its rulebook and recovery plan. Consequently, under the NCWOL safeguard, if the resolution authority departs from the CCP's rules and arrangements, participants to whom losses are allocated should be covered by the safeguard where the losses incurred in resolution exceed the losses that would have been incurred in liquidation from the full application of the CCP's loss allocation arrangements consistent with applicable insolvency law.<sup>17</sup>

However, as part of "the assessment of the losses that would have been incurred or the recoveries that would have been made if the CCP had been subject to liquidation", the FSB guidance should clarify that these losses go well beyond those incurred only by the full application of CCP's rules and loss allocation arrangements, but also result from the applicable insolvency law (e.g. closing trades, replacing them, CCP going under the local insolvency procedure).

CCP12 appreciates that the FSB recognises the importance of considering the NCWOL safeguard relative to the use of CCP equity given the dependence on local jurisdictional insolvency laws and individual CCP creditor circumstances and since any adjustment of CCP equity beyond what is stipulated in CCP rulebooks may give rise to legal claims dependent on the jurisdiction. While CCP12 believes that the treatment of CCP equity under a CCP's rulebook should be respected, where the treatment of equity is adjusted in resolution in deviation of the rulebook, the impact to the NCWOL safeguard must be considered in a manner that respects the insolvency claims hierarchy. Appropriately understanding and defining the NCWOL safeguard helps understand the economic value of continuity of clearing for all participants, compared to the cost of closing down the CCP, and hence help question allegations that participants would need to be compensated in a situation where they would be economically better off.

Against this background, CCP12 disagrees with the principle of compensating clearing members for tools utilised as a part of CCP recovery and resolution, particularly with equity in the CCP, beyond what is provided under the NCWOL safeguard. The introduction of compensation beyond the NCWOL safeguard has the potential to undermine the effectiveness of a CCP's recovery process, by, in part, creating an incentive on members to reduce the resources available in the CCP's waterfall and recovery process and hence precipitate the CCP into resolution. Such actions may skew the incentives of the participants to support the recovery in a way which limits the effectiveness of the recovery process. Similarly, it may adversely affect the efficacy of the resolution plan, where participants are not incentivised to act with a focus on financial stability. We also note that the Guidance appears to be reopening settled conversations on compensation that current FSB guidance already addresses. In particular, FSB guidance states, "[c]reditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the firm under the applicable insolvency regime."<sup>18</sup>

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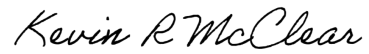
<sup>16</sup> Key Attributes at 5.2 and PFMI Annex 6.1.

<sup>17</sup> Indeed, in the extreme circumstance where the resolution authority shall exercise its powers, the only possible mechanism that would achieve the desired outcome of protecting the market where the CCP operates and respect the NCWOL safeguard is "(iii) transferring critical CCP operations to a bridge entity".

<sup>18</sup> Key Attributes at 5.2.

CCP12 greatly appreciates the opportunity to comment on the Guidance. CCP12 is highly interested to discuss these further and to elaborate on any of the comments described in our response. For further information, please send an email to [office@ccp12global.com](mailto:office@ccp12global.com).

Sincerely,

A handwritten signature in black ink that reads "Kevin R. McClear".

**Kevin McClear,**  
Chairman of CCP12

A handwritten signature in black ink that reads "Marcus Zickwolff".

**Marcus Zickwolff,**  
CEO of CCP12