07/31/2020

VIA ELECTRONIC SUBMISSION

Secretariat to the Financial Stability Board
Bank for International Settlements
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Re: Consultative document on *Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution*

To Whom It May Concern:

CME Group Inc. ("CME Group")[1] appreciates the opportunity to comment on the Financial Stability Board's ("FSB") consultative document on *Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution* (the "Consultation").[2]

Chicago Mercantile Exchange Inc. ("CME") is a wholly-owned subsidiary of CME Group. CME is registered with the Commodity Futures Trading Commission ("CFTC") as a derivatives clearing organization ("DCO"). "CME Clearing", a division of CME, offers clearing and settlement services for listed futures and options on futures contracts, as well as over-the-counter derivatives transactions, including interest rate swaps products. On July 18, 2012, the Financial Stability Oversight Council designated CME as a systemically important financial market utility ("SIFMU") under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. As a SIFMU, CME is also a systemically important DCO ("SIDCO").

I. INTRODUCTION

CME Group appreciates the work of international policymakers to develop standards that support the stability of the broader financial system. The work to-date to define international standards for central counterparties' ("CCPs") resiliency, recovery, and resolution by the FSB and the Committee on Payments and Market Infrastructures ("CPMI") and International Organization of Securities Commissions ("IOSCO") provides a strong framework that allows jurisdictions to enact legislative and regulatory requirements that are appropriately tailored to their local legal frameworks and CCPs. Going forward, additional work must take into account the improvements in CCP resilience and recovery following the global financial crisis of 2008 while avoiding any negative impacts on the resilience and recovery of CCPs in the future. This is particularly true

[1] As a leading and diverse derivatives marketplace, CME Group enables clients to trade in futures, cash and over-the-counter markets, optimize portfolios, and analyze data – empowering market participants worldwide to efficiently manage risk and capture opportunities. CME Group's exchanges offer the widest range of global benchmark products across all major asset classes based on interest rates, equity indexes, foreign exchange, energy, agricultural products, and metals. CME Group offers futures trading through the CME Globex platform, fixed income trading via BrokerTec, foreign exchange trading on the EBS platform, and central counterparty clearing services at CME Clearing, a division of Chicago Mercantile Exchange Inc. With a range of pre- and post-trade products and services underpinning the entire lifecycle of a trade, CME Group also offers optimization services through TriOptima, and trade processing and reconciliation services through Traiana.

[2] Financial Stability Board, Consultative document, *Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution* [hereafter, "*Consultation*"] (May 2020).

with resolution planning in light of the potential negative effects of any entity that plays an important role in the financial system being placed in resolution.

Following the work by global policymakers, local jurisdictions have implemented CPMI-IOSCO's *Principles for financial market infrastructures* ("PFMIs"),[3] which enhanced the already robust central clearing model that had repeatedly demonstrated its strength during past market stress events. Based on the strength of the central clearing model and the work by policymakers to-date, the guidance proposed in the Consultation seems unnecessary. And at a minimum, to the extent it is adopted, it should not undermine the strength of the model or local supervisory authorities' powers to design and enact regulatory requirements that are appropriate for their local legal frameworks and CCPs.

A CCP's core function is to manage the risks taken by its market participants by acting as a market risk-neutral, creditworthy counterparty to every buyer and seller of the contracts it clears. A CCP mitigates counterparty risk by netting down exposures on a multi-lateral basis and by employing risk mitigation tools, such as the collection of initial margin and default fund resources and the use of daily settlement variation cycles, among others. The franchise value of a CCP is dependent on the integrity of its markets, which is predicated on its success as a risk manager – i.e., the CCP's ongoing execution of its risk management policies and procedures. A CCP's clearing services are critical to supporting financial stability by providing a transparent market for participants to effectively manage their risks. Across the globe, CCPs have further enhanced their risk management tools and resources since the global financial crisis of 2008.

CCPs have a long history and a successful track record of managing sizeable and complex default events in periods of stress. SIDCOs, such as CME, and other CCPs maintain tools and resources to address a variety of stress scenarios – commonly referred to as a "default waterfall". Consistent with the PFMIs, a CCP's prefunded financial resources are sized to cover the simultaneous default of its two largest clearing members under a variety of extreme but plausible market conditions and additional tools are designed to address uncovered credit and liquidity shortfalls.[4] CCPs also generally contribute their own resources to the default waterfall to demonstrate their confidence in their risk management practices. The use of the resources and tools comprising the default waterfall has been carefully defined *ex ante* in a CCP's rulebook and has historically been demonstrated to support incentives for market participants to effectively manage their risks. These resources and tools are designed to promote effective risk management and participation in the default management process by market participants, in both business-as-usual and stressed market conditions. To that end, we agree with CPMI-IOSCO's report on *Recovery of financial market infrastructures*, which states that a CCP's "recovery tools should create appropriate incentives for an FMI's owners, participants and, where relevant, other stakeholders to (i) control the amount of risk that they bring to or incur in the system; (ii) monitor the FMI's risk-taking and risk management activities; and (iii) assist in the FMI's default management process."[5]

The carefully calibrated structure of the default waterfall provides appropriate incentives for clearing members and customers of clearing members[6] to manage their risks:

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[3] 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, *Principles for financial market infrastructures* [hereafter, "*PFMI*"] (Apr. 2012).

[4] *PFMI* at Principles 4 and 7.

[5] Committee on Payments and Market Infrastructures and Board of the International Organization of Securities Commissions, *Recovery of financial market infrastructures*, ¶ 3.3.8 (July 2017).

[6] Note, generally, for ease of reading, we refer to clearing members and customers of clearing members as "market participants" in this letter, unless otherwise specifically referenced.

- **Settlement Variation & Initial Margin**: The once daily, or more frequent, exchange of settlement variation and collection of initial margin by a CCP incentivizes market participants to understand and actively manage both their current risk exposures and their potential future risk exposures. Settlement variation limits the accumulation of losses by removing debt from the system through settling profits and losses, rather than allowing outstanding obligations to accumulate. Initial margin mitigates the likelihood of financial non-performance on open positions, since it is an *ex ante* risk-based tool that requires market participants to collateralize their potential future exposures. These practices are important for both clearing members and their customers, particularly where customer gross margin (i.e., the exposures of unaffiliated customers cannot offset each other) is collected by a CCP, because the timeliness of the obligations require clearing members and customers to actively manage their risk exposures.

- **Prefunded Mutualizable Default Fund Resources**: A CCP's collection of mutualizable default fund resources acts as another incentive for clearing members to manage their own risks and those of their customers. A clearing member's default fund requirement is determined using risk-based calculations that are a function of the total risk a clearing member and its customers bring to the CCP. As such, these prefunded mutualizable default fund resources incentivize clearing members to actively participate in the default management process, in order to reduce the likelihood of their default fund resources being utilized.

- **Assessment for Additional Mutualizable Resources**: A CCP's ability to assess non-defaulting clearing members for additional resources provides incentives for clearing members to actively participate in the default management process and avoid the costs associated with assessments and other recovery tools. Assessments are an additional rules-based financial resource obligation of clearing members that may be triggered depending on the size of losses associated with the defaulting clearing member(s). Assessments are designed to incentivize clearing members' active participation in the default management process, including by submitting quality bids, in order to avoid being assessed for such resources in the first place.

- **Other Recovery Tools**: A CCP's other recovery tools to address uncovered credit losses and liquidity shortfalls and to restore a matched book provide further incentivize participation in the default management process. Ultimately, they allow for the continuity of a CCP's critical clearing functions by enabling a CCP to recover and avoid resolution. In particular, these tools are appropriately punitive, while providing incentives for market participants to robustly participate in the default management process and recovery efforts, so that participants avoid these tools' use.

  By way of example, variation margin gains haircutting ("VMGH"), where utilized by a CCP in the recovery, allocates losses fully across all market participants with net residual portfolio gains to minimize the impact to any particular market participant and provides for continuity of a CCP's critical clearing functions. VMGH, as a recovery tool, incentivizes early participation in the default management process to avoid this tool's use. In particular, the potential of a haircut to net residual gains incentivizes the holdouts – those with potential gains on contracts opposite the defaulter's position – to actively participate in the default auction to realize accumulated gains. Similarly, partial tear-ups appropriately incentivize participants to actively participate in the default auction, while also providing a mechanism for the CCP to re-stablish a matched book with impacts only to a limited subset of the markets it clears. Tear-ups would have a material impact on participants' trading portfolios, which incentivizes participation in the default management process.

In contrast, tools such as initial margin haircutting ("IMHC"), are so predictable in effect and negative in result that they increase the likelihood that market participants will exit the cleared markets at the first sign of stress, similar to bank depositors worried about the failure of their bank. Additionally, IMHC leaves potential future exposures under-collateralized causing, in turn, a CCP to call for additional resources from its clearing members and putting a procyclical burden on market participants. The uncovered exposures resulting from IMHC can accelerate a CCP towards resolution, while undermining a CCP's recovery. The distinction between the incentive effects of IMHC and other recovery tools illustrate the need to carefully consider the incentive effects when contemplating any change to the existing central clearing model, whether in recovery or resolution.

Market participants must manage the risks they bring to the CCP. As such, any evaluation of existing resources and tools for recovery and resolution should recognize the role of CCPs and preserve the incentive structure of the central clearing model. Consistent with the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions* ("Key Attributes"), an effective resolution regime for CCPs should pursue financial stability and allow for the continuity of critical clearing functions without exposing taxpayers to loss.[7] Further, an effective CCP resolution should respect the hierarchy of claims under the CCP's rulebook and under the applicable insolvency regime and "no creditor worse off than in liquidation" ("NCWOL") principle. Inappropriately changing the treatment of CCP equity is inconsistent with these principles and could have negative effects on financial stability. In its capacity as a risk manager, a CCP's role is to guarantee the financial performance of the contracts it clears. A CCP's risk management supports the stability of broader financial system and reduces systemic risk. CCPs do not, and should not, protect or provide a guarantee against other types of risks that are outside of their clearing services function. Mandating changes to the size and availability of equity held by a CCP set aside for its recovery or resolution is troublesome, particularly where these changes to equity are driven by extreme and implausible scenarios (e.g., custodian and settlement bank failures) that are more appropriately addressed by institutions and mechanisms outside of central clearing. The incentive structure of the central clearing model must be maintained and thus, consistent with the Key Attribute's, resolution planning should not undermine recovery or increase systemic risk.

It is also critical that local supervisory and resolution authorities retain their autonomy in adopting regulatory requirements for the CCPs they oversee. In the context of resolution, local authorities must maintain the primary authority to design and adopt resolution plans that are appropriate to their CCPs. Local authorities are most familiar with the unique characteristics of their CCPs and the legal framework under which they operate. These unique characteristics, such as products cleared, market participants served, customer protection regime, and ownership structure, among others, cannot be adequately taken into account by international policymakers. Local authorities' expertise is critical for undertaking resolution planning that preserves the incentive structure of the central clearing model and, in turn, provides for continuity of critical clearing functions and supports financial stability. While we do not believe it was the FSB's intention, the proposed guidance could be misinterpreted as eliminating local authorities' flexibility by prescribing granular scenarios for adjusting the treatment of a CCP's equity.

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[7] Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* [hereafter, "*Key Attributes*"], FMI Annex ¶ 1.1 (Oct. 2014).

In particular, the Consultation defines a series of specific default loss and non-default loss ("NDL") scenarios that the resolution authority "***should***" consider as a part of its resolution planning.[8] This "one size fits all" approach of setting out scenarios that should be considered by a resolution authority to assess the adequacy of a CCP's financial resources to support resolution is inconsistent with the role of international policymakers, including the FSB, and is not in the best interests of financial stability. In contrast, current FSB guidance appropriately focuses on actions a local resolution authority should take as a part of resolution planning, including identifying potential default loss and NDL scenarios, but respects local authorities' responsibilities to define the specific scenarios for consideration. This is the correct approach because local authorities are best suited to identify default loss and NDL scenarios relevant to the CCPs they oversee, in accordance with the unique characteristics of local law and each CCP.

II. Extreme and Implausible Nature of Scenarios

CME Group is concerned that the Consultation prescribes extreme and implausible scenarios – which, in some cases, presume early intervention by the resolution authority – to arbitrarily adjust the treatment of a CCP's equity. We believe that utilizing these scenarios in this manner will have negative effects on financial stability. Moreover, this approach upsets the well-calibrated incentives of the central clearing model for market participants to manage their risks. The Consultation's scenarios fail to recognize the role of CCPs in the financial system and obligations CCPs have under local regulations implementing the PFMIs. By way of example, the custodian and settlement bank failure scenarios effectively assume that a CCP's role is to guarantee the broader financial system. No entity that utilizes third-party custodial and banking services provides such a guarantee. Arbitrarily placing this obligation on CCPs is not appropriate and risks undermining financial stability, since a CCP's primary function is to guarantee the financial performance of the contracts it clears. We also note that these scenarios inappropriately presume the failure of regulatory regimes in other parts of the financial system to function as intended, since the continuity of access to assets and protection of depositors is designed to be safeguarded under the regulatory regime for custodians and banks (e.g., bank living wills). This faulty assumption and other aspects of the scenarios in the Consultation that are extreme and implausible are troublesome, as the scenarios and resulting losses form the basis by which a CCP's equity could be adjusted. Furthermore, increasing the use of a CCP's equity in resolution, including where such equity is used as compensation, reduces incentives for market participants to appropriately manage their risks and actively participate in the default management process and recovery efforts, thus promoting CCP resolution over recovery.

We note that the Consultation's guidance recognizes that "the circumstances leading to a CCP resolution are likely to be beyond the extreme but plausible market conditions for which a CCP should hold sufficient prefunded financial resource." Unfortunately, some of the scenarios suggest a CCP could enter resolution in an extreme but plausible event which is inconsistent with this statement and CFTC regulations for SIDCOs. Pursuant to CFTC Regulation 39.33, SIDCOs are required to maintain prefunded financial resources to cover the default of the two clearing members creating the largest combined loss under "extreme but plausible market conditions." In addition, SIDCOs are required to have other tools and/or resources, pursuant to CFTC Regulation 39.35, to allocate uncovered credit losses and liquidity shortfalls. These tools and resources are established *ex ante* in SIDCOs' rulebooks. Our reading of the Consultation's proposed scenarios for assessing a CCP's financial resources is that they fail to take these resources and recovery tools into account, while contemplating early intervention, which could undermine financial stability. Our concerns are further explained below:

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[8] *Consultation* at pgs. 4-6.

- ***Implausible Treatment of NDLs***;
  The Consultation includes scenarios that inappropriately presume "[i]n general, CCP equity bears non-default losses."[9] This "one size fits all" approach is a generalization that is inaccurate and should not drive policymaking, considering the variety of types of NDLs. In particular, this approach fails to consider the facts and circumstances of different types of NDLs and the contractual allocation of the risk of loss. For example, CCPs should not be obligated to guarantee the performance of third-party custodians and banks, including by holding resources to address their failure, as described further in Section II.A of this letter. This is not the role of a CCP and is not a requirement placed on any other institution in the chain of custody and management of non-cash and cash collateral. In particular, the Consultation specifically includes a custodial loss scenario, where a CCP "could lose timely access to its assets."[10] The Consultation further notes that costs for custodian and settlement bank failures scenarios should be estimated "as the average and maximum amounts held at each custodian or depository, or processed by each payment bank, together with appropriate assumptions on the amounts that could be recovered over time."[11] These aspects of the Consultation exacerbate the troubling nature of creating a CCP guarantee of the performance of these third-party institutions. In effect, these custodian and settlement bank failure scenarios would constitute the failure of the resolution regimes for these institutions, which are designed to ensure ongoing collateral access and services, making these scenarios extreme and implausible.[12] The failure of these institutions to provide custodial and banking services would not be idiosyncratic to a CCP, as these institutions provide these services to entities across the financial system. Given that CCPs are merely one of many users of custodians and banks, it would be inconsistent and inappropriate for CCPs to be required to guarantee their performance, including by maintaining financial resources to absorb losses resulting from these institutions' failures.

  In addition, consistent with the Consultation's recognition that there are different types of risks that could give rise to NDLs, the guidance should make clear that each NDL must be evaluated and treated separately and distinctly based on the risk attendant to the NDL, financial industry practice, and the CCP's rules. In many cases, for DCOs such as CME, CFTC regulations make it implausible that certain NDLs could trigger resolution. By way of example, pursuant to CFTC Regulation 1.29, all DCOs are required to bear market value investment losses related to its investment of customer funds, but DCOs are also required to maintain extremely conservative investment portfolios pursuant to CFTC Regulation 1.25, making the risk of investment losses triggering a DCO's recovery, let alone resolution, implausible.

- ***Implausible Assumptions Regarding Recovery Actions***;
  The Consultation includes scenarios that make incorrect assumptions around the CCP's ability to use its recovery tools and resources, which may result in early intervention by a resolution authority, which we discuss in Section II.B of this letter. In particular, the Consultation outlines scenarios for default losses and NDLs where a CCP's "planned resources or tools are not, or not sufficiently, available at the time of recovery."[13] The

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9 *Consultation* at pg. 16.
10 *Consultation* at pg. 5.
11 *Consultation* at pg. 11.
12 *See* 12 CFR 243.2 and 243.3(a)(1)(ii), 12 CFR 381.2 and 381.3(a)(1)(ii), and 84 FR 1438 (noting, the resolution planning for "critical operations" and those material entities that are significant to those operations).
13 *Consultation* at pgs. 4 and 6.

Consultation acknowledges that although a CCP should have comprehensive loss allocation arrangements, such scenarios effectively contemplate that a CCP's loss allocation arrangements have failed.[14] Effectively, these scenarios inappropriately assume that a CCP would not be able to utilize its recovery tools and resources, which conflicts with a CCP's regulatory obligations. Consistent with the PFMIs, a CCP is generally required to operate under a well-founded and enforceable legal basis, which for DCOs is an obligation established under CFTC Regulation 39.27.[15] A CCP's recovery tools are included as rules in its rulebook when they directly impact market participants' financial resources or obligations, whereas they are contained in the recovery plan where they do not directly impact market participants' financial resources or obligations.[16] The PFMIs set out that "[t]here should be a high degree of certainty that actions taken by the FMI under such rules and procedures will not be voided, reversed, or subject to stays."[17] Consequently, assuming that a CCP's recovery tools and resources would not be available effectively suggests that the legal framework under which the CCP operates is not valid and enforceable, which directly contradicts the CCP's legal and regulatory obligations.

Further, by making such an assumption, the enforceability of the CCP's rulebook is called into question, which in addition to the presumption of early intervention, creates a disincentive for market participants to actively participate in what, without legal certainty, may be viewed as an opaque and uncertain default management process. The certainty provided by a CCP's rulebook on an *ex ante* basis creates one of the core incentives for clearing members' active participation in this process. And clearing member participation in the default management process, where determined necessary or advisable by the CCP, improves the likelihood of minimizing losses, recovering the CCP and reducing the spread of systemic risk.

- ***Implausible Assumptions Regarding CCP Shareholders***.
  The Consultation sets out an NDL scenario that incorrectly presumes a CCP's shareholders would not support recovery actions, even where there is a contractual commitment by the CCP to do so.[18] Assuming a CCP's shareholders may not support the CCP's recovery actions implausibly ignores the fundamental link between a CCP's franchise value and shareholder value. Unlike its market participants who may accrue commercial benefits from their directional positions, a CCP and its owners are solely focused on the integrity of the markets it clears, since that integrity dictates the franchise value of the CCP. If this franchise value is diminished, the shareholders in the CCP and/or its parent company will experience a degradation of the value of their ownership stake. This link between a CCP's franchise value and shareholder value makes clear that a CCP's shareholders have the incentives to maintain the continuity of a CCP's critical clearing functions in the event of its distress.

  We also note that consistent with the PFMIs, a CCP must define appropriate recovery tools in its rulebook, which would include determining recovery tools that could reasonably

[14] *Consultation* at pgs. 4 and 5.
[15] *PFMI* at Principle 1, Key Consideration 4.
[16] By way of example, CME's recovery plan describes CME's internal deliberative processes, personnel information, financial resources and commercial information, which CME appropriately treats as confidential information consistent with standard business practices of other systemically important financial institutions. All CME's recovery actions that directly impact clearing members and customers of clearing members are established in CME's publicly available rulebook.
[17] *PFMI* at Principle 1, Key Consideration 4.
[18] *Consultation* at pg. 6.

be employed.[19] Without shareholder support, these tools could not reasonably be incorporated into the CCP's rulebook and in turn utilized by the CCP. The incorporation of these tools into the rulebook reflects the shareholders' implicit support for the CCP's recovery actions. Without this support, the CCP could not reasonably employ these tools and the CCP would be failing to meet its *ex ante* regulatory obligations. Consequently, we view this scenario as extreme and implausible.

Extreme and implausible scenarios cannot and should not be used to require a CCP to maintain additional financial resources, including adjusting the treatment of a CCP's equity. By using scenarios for which a CCP is not, and should not be, expected to hold prefunded resources to address to require additional resources from a CCP and/or to change the mechanisms for who bears losses, policymakers will create negative incentive effects for market participants by reducing the cost of their risk-taking. In short, this approach creates systemic risk, rather than reducing it. As would be expected, market participants generally prioritize their own commercial interests unless required or incentivized to behave otherwise pursuant to a CCP's rules. In contrast, given a CCP's core offering and role within the financial system, its sole incentive is to support the stability and soundness of the broader financial system. To avoid actions by market participants that conflict with the CCP's financial stability interests, the structure of the central clearing model must incentivize market participants to support financial stability by actively participating in the default management process and recovery efforts.

A. Non-Default Losses for Custodian and Settlement Bank Failures

As explained above, the proposed NDL scenarios outlined in Section 1.2 of the Consultation inaccurately presume that all types of NDLs should be borne by a CCP. In particular, the presumption that a CCP should bear all, or even a portion of, losses related to custodian and settlement bank failures suggests that a CCP should be the guarantor for the broader financial system. This should not be the case. NDLs stemming from the systemic failures of custodians and banks and by implication, their respective resolution regime(s), cannot and should not be borne by a CCP. The failure of a custodian or settlement bank would not be idiosyncratic to CCPs and would also impact clearing members and their customers, as well as any other user of those institutions. Placing a burden uniquely on CCPs to guarantee these institutions' performance increases systemic risk by distracting from the CCPs' core function to support the stability of the broader financial system by netting down exposures as a market risk-neutral, creditworthy counterparty to the buyers and sellers of the contracts they clear. By way of example, in the unlikely event where a clearing member's assets posted to a CCP are impaired because a custodian has failed, and if a derivatives CCP is burdened with guaranteeing access to such assets, the ability of the CCP to continue to provide its clearing services is likely to be undermined. Financial stability would already be challenged with a large custodian failure and the creation of additional CCP stress by forcing it to guarantee the failed custodian's performance would only exacerbate the negative impacts on financial stability created by the custodian's failure. Placing this burden on a CCP could, and should, be avoided by treating CCPs consistently with every other financial institution in the chain of custody and allowing a CCP to disclaim liability for the failure of a third-party institution, where the CCP does not act negligently.

Moreover, considering the significant policymaking efforts that support the current bank capital and resolution regimes for U.S. and global systemically important banks, its troubling that the scenarios proposed in the Consultation imply that CCPs should act as a backstop against the failure of these highly regulated third-party custodians and banks providing standard custodial and banking services. A CCP's primary role is to guarantee the financial performance of the contracts it clears, not to act as a backstop to the banking system. CCPs are one of many

[19] *PFMI* at Principle 3, Key Consideration 4.

customer types that rely on third-party custodians and banks to protect and manage collateral. CCPs are provided custodial and banking services on the same terms as other entities that use their services, such as institutional customers, third-party banks and custodians, and clearing members. That being said, a CCP, such as CME Clearing, conducts extensive due diligence reviews in selecting and on an ongoing basis monitors the third-party custodians and settlement banks it engages for services. But this due diligence is hardly a predicate for the CCP being tasked with guaranteeing against the failure of such custodians and banks, where it has not acted negligently.

As a matter of course, entities relying on the services of third-party custodians and banks for collateral that has been posted to them often disclaim all liability for the failure of those third-party institutions, where they have not acted negligently. This is normally the case for customer relationships across the financial industry. By way of example, futures commission merchants (i.e., CFTC-regulated entity permitted to provide client clearing services) broadly disclaim liability for depositing customer funds with a third-party depository unless that futures commission merchant has acted in bad faith, 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. As described above, putting a unique onus on CCPs to guarantee the broader financial system is an inequitable responsibility counter to the role and obligations of a CCP and would have negative impacts on cleared derivatives markets. In addition, requiring this guarantee could create unintended consequences in times of stress during which market participants place additional collateral at a CCP, due to enhanced protections mandated by regulation, which could reduce the availability of collateral elsewhere in the system. Policymakers should continue to focus their efforts on enacting and preserving regulatory regimes for custodian and banks that provide for the continuity of collateral access and services, as well as support related risk management practices, rather than placing inimical burdens on CCPs who are end-users of these services.

B. Early Intervention

The proposed scenarios for both default losses and NDLs outlined in Sections 1.1 and 1.2 of the Consultation generally imply that a resolution authority could intervene in advance of a CCP's ability to use its recovery tools in full.[20] These scenarios blur the lines between recovery and resolution and early intervention by a resolution authority which would, by definition, preclude the CCP from recovering as set forth in its rulebook and recovery plan. The Consultation does not clearly recognize the safeguards that have been established under current FSB guidance for a resolution authority's intervention. Consistent with the FSB's Key Attributes, the entry into resolution should be triggered where a CCP is, or is likely to be, 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 financial stability is likely to be compromised.[21] The resolution authority should not step-in where the CCP's rules and arrangements could still provide a viable option for recovery.[22]

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[20] Note, CME Group recognizes that Sections 1.1 and 1.2 of the Consultation for default losses and NDLs, respectively, specifically contemplate scenarios where the relevant authority determines that applying remaining recovery tools may threaten financial stability. However, financial stability is not an explicit consideration in the other scenarios noted in the Consultation.

[21] *Key Attributes* at FMI Annex ¶ 4.3.

[22] CME Group notes that, in order to provide legal certainty and transparency on how the default management process and recovery tools impacting market participants would operate under a CCP's rulebook, it is intended that a CCP would execute its recovery tools. Given that the CCP has the greatest and most relevant expertise in the markets and market participants it serves, including managing past sizeable and complex default events, it is best situated to execute the tools provided under these rules in a manner that supports financial stability. The resolution authority's powers should be provided separately under applicable legislation and regulation, which should include imposing appropriate safeguards for intervention. It would be contradictory to the financial stability objectives of resolution if the resolution authority intervened early and took actions (e.g., those defined under the CCP's rulebook) that a CCP is best situated to take, given its extensive familiarity with and expertise in the markets it clears. This

While we appreciate the FSB's ongoing focus on financial stability, the Consultation does not explicitly state for each scenario that financial stability risk is a consideration for the resolution authority to step-in. By way of example, multiple clearing member defaults are scenarios a CCP plans for in recovery, but the Consultation lists this as a proposed scenario for assessment.[23] If this further guidance is adopted, it should make clear, consistent with current FSB guidance, that the resolution authority should only intervene where the tools and resources defined *ex ante* under a CCP's rulebook and recovery plan have the opportunity to be used in full or financial stability is likely to be compromised. In particular, it is critical for financial stability that the conditions, triggers and point of non-viability for CCP entry into resolution are clear and transparent and do not pre-empt the execution of a CCP's recovery plan. This collectively provides market participants with the greatest level of certainty, as to how a recovery event will operate, and preserves the incentives for market participants to actively participate in the default management process and recovery efforts. In contrast, early intervention by the resolution authority could indicate that the authority itself lacks confidence in the CCP and would signal to market participants that recovery of the CCP has failed. This can create disincentives for market participants to continue to satisfy their obligations to the CCP and participate in the default management process and recovery efforts. Early intervention by the resolution authority also could create uncertainty as to how a CCP's recovery tools will or will not be executed, which could have negative implications for market participants whose participation in the CCP is rightfully based on *ex ante* legal obligations.

Adjusting the treatment of a CCP's equity on the basis of a scenario that inappropriately provides for early intervention by the resolution authority is inconsistent with the objective to support financial stability in the event of resolution. The very action of the resolution authority intervening has negative impacts on incentives for market participants to actively participate in the default management process and recovery efforts. The negative incentive effects of early intervention would be further exacerbated if the treatment of a CCP's equity was adjusted as a result of a scenario that inappropriately provides for early intervention, in particular where a CCP's equity is one of the first available resources in resolution.

III. Adjusting the Treatment of CCP Equity

We also have concerns with attempts to change the treatment of CCP equity from what has already been established *ex ante* by a CCP's rulebook under the oversight of a CCP's local supervisory authority in a manner consistent with the PFMIs. The minimum amount of equity a CCP maintains, as well as the additional financial resources it has for addressing clearing member defaults, are designed to recognize a CCP's role in the financial markets. In this role, CCPs are guarantors of the financial performance of the contracts they clear, acting as creditworthy counterparties that manage the risks brought by their market participants. The PFMIs recognize the importance of a CCP being able to continue to perform this function and thus, size a CCP's equity appropriately.[24] In the case of SIDCOs, CFTC Regulations 39.11 and 39.39 require SIDCOs to have financial resources to cover at least 12-months of operating costs.

scenario could create uncertainty as to how a CCP's rules would be executed and more broadly, indicate the resolution authority lacks confidence in the CCP.

[23] We note that early intervention by the resolution authority under this scenario is troubling because if a resolution authority is permitted to place a CCP into resolution as a result of clearing members losing confidence in the CCP, clearing members would be further disincentivized from satisfying their obligations to actively contribute to the default management process and recovery efforts. In particular, in the context of what is being proposed in Part II of the Consultation, clearing members may be incentivized to have the resolution authority place the CCP into resolution, resulting in the write-down and use of CCP equity to absorb losses, instead of satisfying their obligations to the CCP.

[24] *PFMI* at Principle 15.

Adjusting the treatment of CCP equity or requiring that additional equity be at risk in resolution or otherwise undermines the role a CCP plays in supporting financial stability by reducing the incentives for market participants to manage their risks. While our comments to Part I of the Consultation primarily focus on the NDL scenarios, many of our comments on Part II of the Consultation focus on adjusting the treatment of CCP equity relative to default losses. In particular, we have concerns that such adjustments to CCP equity could compromise existing incentives that support a CCP's resilience in the face of manageable default events. Creating disincentives for market participants to manage their risks undermines the likelihood of a successful recovery, potentially promoting resolution over recovery. As noted above, the default waterfall's structure has been carefully calibrated to provide incentives for market participants to effectively manage their risks and participate in the default management process and recovery efforts. Altering this incentive structure creates unnecessary risks without any attendant financial stability benefits.

In the case of default losses, overly large contributions from a CCP subsidize the risk of clearing members, creating moral hazard.[25] Such contributions reduce incentives for clearing members to actively participate in the default management process by reducing mutualization risk, particularly where a CCP's contributions are used in advance of the mutualizable resources contributed by clearing members. Similarly, the risk of using recovery tools is reduced with overly large CCP contributions, depending on when they would be used, which would also have negative incentive effects on clearing members. Below are two examples highlighting the incentive impacts of a CCP's contribution to manage a clearing member's default where the CCP provides its resources on a first loss basis:

Example of Clearing Member Default – Appropriate Incentive Alignment	
Number of Clearing Members	24
CCP Contribution to the Default Fund (First Loss)	$150,000,000
Total CCP Default Fund Prefunded Resources from Clearing Members	$2,400,000,000
Total CCP Default Fund Resources	$2,550,000,000
Clearing Member's Default Loss Amount[26]	$(1,000,000,000)
Clearing Member's Contribution to the CCP Default Fund	$490,000,000
Remaining Loss for Mutualization After Utilizing CCP Contribution	$(360,000,000)
Proportion of Clearing Member Loss Amount to be Mutualized Across Non-Defaulting Clearing Member	**36%**
During a clearing member default, the CCP will communicate the portfolios for auction to its clearing members participating in the auction. Therefore, these clearing members by design will already know the estimated losses on the defaulting clearing member's portfolio. As such, they will take into account the fact that if they fail to provide a good bid, they will be subject to the risk of loss mutualization for a material amount, thereby, they are incentivized to provide good bids. In this example, there is a potential for 36% utilization of their mutualized default	

[25] *See* CME Group, *Balancing CCP and Member Contributions with Exposures* (Aug. 2017), *available at* https://www.cmegroup.com/education/files/balancing-ccp-and-member-contributions-with-exposures.pdf.

[26] Note, this is the assumed remaining loss amount after using the defaulted Clearing Member's margin.

fund contributions. The CCP contribution to address the losses in this context is appropriately designed, since it will incentivize clearing members to appropriately participate in the auction, given the material risk of mutualized losses.

Example of Clearing Member Default – Inappropriate Incentive Alignment	
Number of Clearing Members	24
CCP Contribution to the Default Fund (First Loss)	$490,000,000
Total CCP Default Fund Prefunded Resources from Clearing Members	$2,400,000,000
Total CCP Default Fund Resources	$2,890,000,000
Clearing Member's Default Loss Amount[27]	$(1,000,000,000)
Clearing Member's Contribution to the CCP Default Fund	$490,000,000
Remaining Loss for Mutualization After Using CCP Contribution	$(20,000,000)
Proportion of Clearing Member Loss Amount to be Mutualized Across Non-Defaulting Clearing Member	**2%**
During a clearing member default, the CCP will communicate the portfolios for auction to its clearing members participating in the auction. Therefore, these clearing members by design will already know the estimated losses on the defaulting clearing member's portfolio. As such, they will take into account the fact that if they fail to provide a good bid, they will be subject to the risk of loss mutualization for a de minimis amount, thereby, they are disincentivized to provide good bids. In this example, there is a potential for only a 2% utilization of their mutualized default fund contributions. The CCP contribution to address the losses in this context is inappropriately designed, since it will not necessarily incentivize clearing members to appropriately participate in the auction, given the minimal risk of mutualized losses.	

The success of the CCP's default management process and recovery efforts depend on clearing members' active participation. Thus, putting all, or even additional, CCP equity at risk would effectively reward the risk-taking behavior of clearing members, particularly those that stand to benefit from not participating in the default management process and recovery efforts because losses are allocated to the CCP and/or clearing members may be provided equity stakes in future profits of the CCP.

In addition to employing tools to manage the risks relating to NDLs (e.g., risk monitoring practices, insurance, etc.), a CCP carefully sizes its resources to cover potential business losses that are not related to clearing members' defaults so that it can continue to provide its critical clearing functions as a going concern even where it faces such NDLs. In evaluating CCP equity relative to potential NDLs, it is of the utmost importance to consider the unique facts and circumstances that could cause the NDL and the treatment of such NDL under the CCP's rulebook. A CCP's rulebook recognizes that a CCP cannot, and should not, be responsible for NDLs relating to systemic events that originate outside of the markets it clears (e.g., custodian and settlement bank failures). Requiring CCP equity to be adjusted to address these types of events places a CCP in the inappropriate position of being called upon to guarantee against losses outside of

[27] Note, this is the assumed remaining loss amount after using the defaulted Clearing Member's margin.

providing its critical clearing functions, which could undermine its ability to support financial stability in its primary role of guaranteeing the financial performance of the contracts it clears.

A. No Creditor Worse Off Than in Liquidation

Consistent with international standards and best practices in bankruptcy law, the NCWOL safeguard should apply in CCP resolution. In particular, the use of CCP equity in resolution must be evaluated against the NCWOL counterfactual, as deviation from what has been established *ex ante* in a CCP's rulebook or the inappropriate use of CCP equity under an early intervention scenario could give rise to claims by CCP equity holders under the NCWOL safeguard. Like market participants, a CCP's equity holders' claims would be subject to a credit hierarchy established under local insolvency law. Consistent with the FSB's Key Attributes, the NCWOL assessment to determine if creditors, in this case the CCP's shareholders, would have been worse off under resolution should evaluate: i) the losses that would have been incurred or the recoveries that would have been made if the CCP had been subject to liquidation, pursuant to local insolvency law; and ii) should assume the full application of the CCP's rules and arrangements for loss allocation.[28] It is concerning that the application of the NCWOL safeguard to the use of a CCP's equity is being questioned in the Consultation, as deviations from a CCP's rulebook should be recognized and treated consistently with well-established insolvency law principles.

B. Compensation

CME Group supports appropriate compensation for clearing members and customers of clearing members consistent with the NCWOL safeguard and via recoveries from the defaulter's estate. Under CME's rulebook, any recoveries from the defaulter's estate are paid to clearing members and their customers on a pro-rata basis in reverse order of the default waterfall – i.e., compensation from any recoveries would first be provided to those that contributed voluntarily and then to those impacted by portfolio gains haircutting, assessments, and mutualization of the default funds (i.e., guaranty funds).[29] Generally speaking, however, we have concerns with the negative incentive effects of other forms of compensation and particularly claims on future profits or equity. These, and other similar types of compensation, disincentivize market participants from actively participating in the default management process and recovery efforts and discourage a private recapitalization of the CCP, thus potentially promoting CCP resolution over recovery.

We also note that the Consultation appears to be reopening settled discourse on compensation that current FSB guidance already addresses. In particular, the FSB's Key Attributes state that "[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."[30]

IV. Conclusion

CME Group appreciates the ongoing policy focus on supporting financial stability. As the FSB has set out, CCP resolution should pursue financial stability and ensure the continuity of a CCP's critical clearing functions without exposing taxpayers to losses. CCP resolution planning should prioritize preserving the incentives inherent to the central clearing model for market participants to manage their risks and continue to manage such risks, even in a stress event, by actively participating in the CCP's default management process and recovery efforts. CCP resolution should also preserve the hierarchy of claims established under a CCP's rulebook and the applicable insolvency law.

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[28] *Key Attributes* at ¶ 5.2 and FMI Annex ¶ 6.1.
[29] *See* CME Rules 802.B.10(b) and 8G802.B.7(b).
[30] *Key Attributes* at ¶ 5.2.

At this juncture, we encourage the FSB to again consider if further guidance is necessary on financial resources to support CCP resolution and treatment of CCP equity in resolution. Based on the strength of the central clearing model and the work by policymakers to-date, we do not believe that it is needed. However, to the extent that such guidance is issued, it should ensure that CCP equity is not adjusted in a manner that would undermine the incentives-based success of the central clearing model.

We would be happy to further discuss our comments with the FSB. If any comments or questions regarding this submission arise, please feel free to contact me at sunil.cutinho@cmegroup.com or Sean Downey at sean.downey@cmegroup.com.

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