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VIA ELECTRONIC MAIL
Financial Stability Board
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Re: Essential Aspects of CCP Resolution Planning

CME Group Inc. (“CME Group”) appreciates the opportunity to provide comments on the design of effective resolution strategies as outlined in the Financial Stability Board’s (FSB) Discussion Note dated August 16, 2016. CME Group wholly owns two central counterparties (“CCPs”). Chicago Mercantile Exchange Inc. (“CME Inc.”) is a derivatives clearing organization (“DCO”) registered pursuant to the Commodity Exchange Act and regulated by the Commodity Futures Trading Commission (“CFTC”) in the United States. CME Clearing Europe Limited (“CMECE”) is an authorized central counterparty under the UK Financial Services and Markets Act of 2000 and is regulated by the Bank of England. These CCPs offer clearing and settlement for all products traded on the CME Group Exchanges¹ and provide clearing and other services to third parties. The CME Group Exchanges provide trading platforms for futures, options on futures, derivatives, and spot contracts and offer a wide range of products, including those based on interest rates, equities, foreign exchange and commodities.

Introduction

CME Group supports efforts to develop standards to guide the development of principles based resolution strategies and plans for CCPs. An effective CCP resolution should have the following objectives: (i) the stability of the broader financial markets; (ii) continuity of critical services as defined by IOSCO; (iii) preservation of the CCP’s recovery and wind-down options, thereby reducing the risk of further need for any government involvement; and (iv) preservation of the hierarchy of claims under the rules of the CCP and under the applicable insolvency regime.

A well run CCP has a default management plan to address one or more clearing member defaults. Additionally, CCPs in several jurisdictions, including the United States, are required to have recovery plans to address uncovered credit losses, liquidity shortfalls and other general business risks. In the United States, systemically important DCOs, including CME Inc., are also required to maintain wind-down plans. CFTC regulations define “wind-down” to mean “the actions of a systemically important derivatives clearing organization...to effect the permanent cessation or sale or transfer or one or more services.”² CME Group believes that a CCP should exhaust its default management plan, recovery plan, and wind down plan before a resolution authority takes control of and resolves the CCP.

2008 Financial Crisis

At the time of the 2008 financial crisis, over-the-counter derivatives (“OTC”) trading and certain swap markets lacked supervision, risk controls and transparency regarding the interconnectedness of the counterparties and markets, resulting in actual or perceived substantial systemic risk. Exposures were concentrated within a few very large financial institutions. While defaults in the uncleared markets led to disorder and financial panic, the cleared markets performed well. CCPs satisfied clearing member default

¹ The CME Group Exchanges include Chicago Mercantile Exchange Inc., Board of Trade of the City of Chicago, Inc., New York Mercantile Exchange Inc., Commodity Exchange, Inc. and CME Europe Limited.

² See CFTC Regulation 39.39(a)(2).

losses by utilizing only the defaulter's pre-funded financial resources held by the CCP, thereby contributing to the stability of the financial markets. As a result of their transparency and prudent risk management, cleared markets were more resilient than the bilateral OTC markets.

In the aftermath of the 2008 financial crisis, the United States Congress ("Congress") recognized the systemic risks OTC trading presented to financial stability. Congress determined that requiring expanded use of CCPs would reduce systemic risk.

Resolution Regime in the United States

Congress also responded to the 2008 financial crisis by adopting a resolution framework which recognizes that systemically important entities should not be "too big to fail." US financial regulators have been active in developing the resolution framework in the United States. It is important that any standards developed by the FSB not conflict with the legislation and regulations already in effect in the United States.

In the United States, CME Inc. is primarily regulated by the CFTC. Congress has provided the Federal Deposit Insurance Corporation with resolution authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Although that authority does not explicitly apply to DCOs, the FDIC believes it would be the resolution authority for DCOs.

CME Inc.'s primary regulator, the CFTC, requires CME Inc. to have in place a recovery plan and a wind-down plan. As discussed in greater detail below, Dodd-Frank makes clear that the FDIC cannot step in as CME Inc.'s resolution authority if either plan is still available to prevent CME Inc.'s default. If clearing members expect that a resolution authority might enter earlier, they would not be incentivized to participate in default management or recovery. CME Group believes the FSB should adopt a similar approach regarding the timing of a CCP's entry into resolution.

Furthermore, the Commodity Exchange Act provides the CFTC with broad emergency powers that it may exercise before a resolution authority takes control.³ CME Group believes that the CFTC's broad power limits the likelihood a DCO resolution authority would need to exercise its authority and should temper any impulse to rush to resolution. CME Group recognizes that not all countries provide a CCP's primary regulator with such broad authority, making it necessary to equip a resolution authority with additional tools. CME Group respectfully requests that such differences in the balance of power among primary regulators and resolution authorities be considered by the FSB and accounted for in any guidance regarding CCP resolution.

Impact of Bank Resolution on CCP Resolution

CCP resolution will be significantly impacted by the bank resolution framework. Apart from war or other destruction of the basic infrastructure of the financial system, the most likely cause of a failure of a systemically important CCP is the simultaneous failure of four or more globally systemic important banks that are clearing members of the CCP. Bank regulators and resolution authorities will likely have advanced knowledge of distress at a major bank and an understanding of how that distress will impact CCPs, non-defaulting clearing members, market participants and the broader financial markets. What regulators do with that knowledge will be critical in determining the outcome of the stress, but it is unclear to the market how they will approach this situation. Bank resolution authorities should share relevant information with CCPs in conjunction with their regulatory authorities for better coordination and management of the stress event. It is essential that the resolution authorities for any failing banks prioritize the well-being of markets and financial stability, to prevent contagion of the bank stress to CCPs,

³ See Section 8a(9) of the Commodity Exchange Act.

non-defaulting clearing members, market participants and the broader market and public interests that derivatives markets serve.

By way of example, the United States has a coordination process that brings together market regulators and CCPs when a broker dealer or futures commission merchant encounters financial stress or is non-compliant with certain regulatory requirements. This coordination process has proven very useful and enabled market regulators and CCPs to work together to resolve a number of failures without impacting the markets. We encourage bank resolution authorities to join this coordination process and share information with both market regulators and CCPs to enable market regulators and CCPs to minimize the impact of a default of a bank on the markets.

Overview of Relevant Elements

CME Group requests the FSB consider the following relevant elements to the core strategies for effective CCP resolution planning:

- Timing of entry by the resolution authority should be when: (i) the CCP is in default or in danger of default and (ii) there is no viable private sector alternative available to prevent the default of the CCP.
- CCPs should be permitted by law to take actions pursuant to their rule books, recovery plans and wind down plans before intervention by a resolution authority.
- Resolution authorities for banks and CCPs must cooperate, transmit relevant information relating to potential risks and prioritize financial and market stability while minimizing the transmission of losses from bank and bank affiliates to CCPs.
- The possibility of pre-emptive resolution of a CCP would impair the ability of clearing members and market participants to measure, manage, and control their exposures and could destroy the prospect of a successful CCP recovery.
- In jurisdictions where the prudential regulator with expertise in the CCP and the resolution authority differ, the resolution authority should work closely with the prudential regulator having such expertise.
- Resolution authorities for banks and resolution authorities for CCPs should promote the best outcome for the system and financial stability.
- Incentives must be evaluated from the perspective of what will create order and bring the markets back in balance quickly. Incentives should be designed to align the objectives of regulators, trading markets, CCPs, clearing members, market participants and other relevant stakeholders. Incentives should be designed to encourage clearing members to participate early in default management.
- Resolution authorities should have no involvement with respect to recovery, including with respect to compensation schemes for clearing members and market participants affected by the use of recovery tools.

General

Q1. Does this discussion note identify the relevant aspects of CCP resolution that are core to the design of effective resolution strategies? What other aspects, if any should authorities address?

Comments: The discussion note does not address all relevant aspects of CCP resolution. Additional aspects that are core to the design of effective resolution strategies are; (i) the communication between resolution authorities for banks and bank related clearing members and CCPs; (ii) processes to minimize

conflicts of interest between resolution authorities for banks and resolution authorities for CCPs; and (iii) regulatory incentives and concessions to promote recovery.

Incentive effects of resolution strategies

Q2. What is the impact on incentives of the different aspects of resolution outlined in this note for CCP stakeholders to support recovery and resolution processes and participate in central clearing in general? Are there other potential effects that have not been considered?

Comments:

Resolution authorities and regulators must evaluate incentives to promote participation in auctions and in porting and quickly rebalance trading books. Resolution planning strategies and incentives should not undermine CCP recovery.

Shareholder Incentives

Removal of Management and Change in Ownership

- In a systemic scenario, CCPs would be the **recipient** of losses resulting from multiple clearing member defaults in a short time frame, not the source of losses. In such a systemic stress scenario, incentives that provide for change of ownership and removal of management would be misplaced.
- If the CCP is the **source** of losses impacting clearing members and market participants and the losses are the result of CCP risk management failure, then a case could be made that new ownership may be warranted if the markets it serves and continuity of its critical functions are worth preserving.
- CCP shareholders have every incentive to promote CCP recovery over resolution. Resolution strategies and potential incentives should not undermine and or promote resolution over recovery.
- Resolution authorities should evaluate both the impact and costs of resolution strategies for all relevant stakeholders.
- Resolution authorities should not determine the CCP's legal, business and operating model or require changes to that structure to address a hypothetical stress scenario that is extremely remote.

CCP incentives

Resolution strategies should not alter the incentive structures currently established by CCP rule books; CCP rules and the incentives provided therein are critical to the active participation of clearing members in CCP default management, restoring a matched book and protecting the stability of the broader financial markets. The premature intervention of a resolution authority would destroy the incentive structure that the CCP rulebook has established.

Regulatory incentives

In times of systemic market stress events, regulators should provide regulatory incentives that promote market stability and continuity of a CCP's critical functions. Regulators could consider an incentive that

would provide temporary relief of 90 days from the supplemental leverage ratio and/or capital requirements for risk weighted assets, to clearing members that participate early in the CCP's default management process. Examples of participation include providing good bids in the auction and accepting the porting of the defaulted clearing members customers.

The benefit of providing this type of incentive is that it aligns and incentivizes CCPs, clearing members and regulators to proactively address the stress scenario and protect market participants and markets. It reinforces good market behavior of clearing members that act in the best interest of the market, does not require taxpayer funds, is not pro-cyclical, may alleviate potential liquidity constraints resulting from forced liquidation, and promotes recovery of the CCP over resolution.

Equity compensation

Some market participants have suggested that they be offered equity or debt instruments of a CCP as incentive to participate sufficiently in recovery efforts to avoid resolution of the CCP. We disagree with the notion that the offering of equity or debt instruments would create the proper incentives to promote recovery. Moreover, in a jurisdiction with a primary regulator, whether to offer equity or debt instruments in recovery is a decision to be made by the CCP itself subject to regulatory oversight and not the resolution authority. In such jurisdiction, the resolution authority should play no role in recovery.

Equity is a dangerous compensation tool, as it would disrupt the careful, intended balance between CCP management, clearing members who participate in the risk committees, and the CCP Board. This balance ensures the CCP meets the needs of the broader financial market, rather than any one group of participants. Providing equity for clearing members at any point in the process will create a disincentive to participate in earlier stages of the default management process. Providing equity to clearing members in resolution may create disincentives for clearing members to participate in recovery of the CCP, if there is greater value in resolution for ownership of the CCP. Equity compensation may result in a small group of clearing members controlling the CCP, which may impact risk management and access to the CCP by smaller clearing members and market participant.

Compensation for use of recovery tools

Resolution authorities should recognize that CCPs are working together with their regulators to incorporate recovery tools into CCP rulebooks for the purpose of preventing a sudden and disorderly failure of the CCPs, which could lead to severe systemic disruptions⁴. CCPs are adding these tools to enable the CCPs to fully allocate losses and restore a matched book. Use of these tools by a CCP, as needed, support the stability of the financial system and promote continuity of critical services. Recovery tools are not for the use of resolution authorities and the resolution authorities should play no role in determining whether any compensation is provided in the connection with the use of recovery tools.

Timing of entry into resolution

Q3. What are the appropriate factors for determining timing of entry into resolution? How might a presumptive timing of entry (or range of timing), if any, be defined in light of the criteria set out in the FMI Annex to the Key Attributes? If defined, should the presumptive timing of entry be communicated to the CCP and its participants?

⁴ See CPMI-IOSCO, Board of International Organization of Securities Commissions Report, Recovery of financial market infrastructures (October 2014) ("CPMI-IOSCO Report") at p1 ¶¶1.

Comments:

In 2010, the United States enacted legislation that provides a government agency—the Federal Deposit Insurance Corporation (“FDIC”)—with resolution authority.⁵ Although Title II of the Dodd-Frank Act does not explicitly apply to CCPs, the FDIC believes that it would be the resolution authority for a systemically important DCO after a specific statutorily-required high-level government authorization process is completed. By law, the Secretary of the Treasury must consult with the President of the United States and then make a number of formal determinations regarding the likelihood of a DCO default and the systemic risk it would engender.⁶ CME Group believes that the approach taken in Title II of the Dodd-Frank Act with respect to the timing of take-over by the resolution authority is sound.

Title II specifies that before the FDIC may exercise any resolution authority for a CCP, the Secretary of Treasury must determine, among other things, that the affected CCP is in default or in danger of default and that no viable private sector alternative is available to prevent the default of the CCP.⁷ As applied to a systemically important DCO regulated by the CFTC, the FDIC cannot and should not step in as the DCO's resolution authority if the DCO's recovery plan or wind down plan is available to prevent the default of the DCO. The CFTC's involvement in the development and implementation of such DCO's recovery and wind-down plans underscores the important role of a primary regulator in that process.

When a CCP's primary regulatory authority exercises such authority, it eliminates the need for a resolution authority to step in before a CCP uses all available recovery tools or while the CCP still has available wind-down strategies. Any intervention by a resolution authority while a CCP still has available recovery tools or wind-down strategies would undermine the efforts of the CCP and primary regulator to effectuate recovery or wind-down. Furthermore, certainty is achieved only when the tools as laid out in the CCP's rulebook are exhausted.

CME Group recommends that the FSB adopt a similar approach with respect to timing of CCP resolution. The appropriate factors for determining timing of entry into resolution would thus be (i) whether the CCP is in default or in danger of default and (ii) whether any viable private sector alternative is available to prevent the default of the CCP. We recommend that the language in the discussion note that is inconsistent with this approach (including the language in sections 3.2, footnote 12 and section 4.10) be revised accordingly.

Presumptive vs constrained flexibility

Resolution authorities should not have flexibility to enter before the two criteria discussed above are satisfied. These criteria should be set forth clearly in the guidance. Such notice to market participants will incentivize them to participate in the CCP's default management process and recovery efforts.

⁵ See Title II of the Dodd Frank Act.

⁶ The CFTC has confirmed that it shares the FDIC's view that the FDIC's resolution authority would apply to a DCO provided that the Secretary of Treasury consults with the President of the United States and makes the critical determinations pursuant to Title II.

⁷ See Section 203 of Dodd Frank. The FDIC may initiate the process for the Secretary of Treasuring to consider making these determinations. Determinations that the Secretary of Treasury must make regarding systemic importance include (i) a determination that the failure of the CCP and its liquidation through a Chapter 7 bankruptcy would have serious adverse effects on financial stability in the United States and (ii) a determination that the FDIC, acting as receiver for the CCP would avoid or mitigate such adverse effects, taking into consideration the effectiveness of the action in mitigating potential adverse effects on the financial system, the cost to the general fund of the Treasury, and the potential to increase excessive risk taking on the part of creditors, counterparties, and shareholders of the CCP.

Adequacy of financial resources in resolution

Q4. Should CCPs be required to hold any additional pre-funded resources for resolution, or otherwise adopt measures to ensure that there are sufficient resources committed or reserved for resolution? If yes, what form should they take and how should they be funded?

Comments:

CCPs should not be required to hold additional pre-funded financial resources for resolution. The purpose of pre-funded financial resources is to enable a CCP to recover from a stress event. In the United States, systemically important DCOs are required to meet the regulatory requirements of maintaining pre-funded financial resources to cover a default of the two largest clearing members of the CCP in extreme but plausible market conditions. In the United States, a systemically important DCO is also required to maintain a recovery plan and a wind-down plan that address all extreme but plausible stress scenarios that could threaten the CCP's viability as a going concern and sufficient funding for the CCP to implement these plans.⁸

Some have suggested that a CCP maintain an additional tranche of pre-funded resources. Requiring a CCP to maintain additional pre-funded resources would be detrimental; this requirement would trap resources that could otherwise be better used to support default management and/or recovery. Added costs to clearing could, in effect, exclude smaller clearing members from the markets resulting in concentration of risk in fewer clearing members. Access to clearing and a diversity of clearing members and market participants is critical to the stability of the broader financial markets.

Q5. How should the appropriate quantum of any additional CCP resources be determined? In sizing the appropriate quantum, what factors and considerations should be taken into account? Do your answers vary for default and non-default losses?

Comments:

Given our answer to Question 4, we do not believe there is an appropriate quantum of additional CCP resources for default losses or non-default losses.

Q6. Should resolution funds external to the CCP be relied upon? If so, how should such funding arrangements be structured so as to minimise the risk of moral hazard, including for CCPs with significant cross-border participation? Where these are pre-funded, how should the target size be determined and which entities should be required to contribute?

Comments:

Resolution funds external to the CCP should not be relied upon. The best way to address the risk of moral hazard that would be created by relying upon funds external to the CCP is to not do so. For further discussion, see our response to question 4.

Clearing members are already incentivized to control the risks they bring to the CCP through collection of initial margin and contribution to the pre-funded financial safeguards by the CCP. Those who bring the risk should pay for the risk.

⁸ This funding is independent of, and in addition to, the funding to cover the default of the two largest clearing members.

Tools to return to a matched book

Q7. What factors should the resolution authority consider in choosing and exercising tools to return the CCP to a matched book? Is one (or more) of the tools for restoring a matched book preferable over others and if so, why?

Comments:

CME Group and the industry believe in CCP recovery over resolution. The recovery tools adopted by CCPs in their recovery plans are for the CCPs themselves to implement, not the resolution authority. Execution of the recovery tools by the CCP itself (as opposed to the resolution authority) promotes recovery by encouraging market participants to actively participate in default management and recovery efforts. Recovery plans are required by the CPMI-IOSCO Principles for financial market infrastructures, because a disorderly failure could lead to severe systemic disruptions. The CPMI-IOSCO Report provided guidance to CCPs in developing recovery plans. As provided in the guidance, a CCP's recovery plan should have a set of recovery tools to fully allocate any uncovered credit losses, cover liquidity shortfalls and include a plausible means of addressing unbalanced positions.⁹ The intent of these tools is to enable the CCP to address uncovered credit losses and liquidity shortfalls without government intervention.

CCP Default Management

In the event of a clearing member default, a CCP would implement its default management process and would move quickly to restore a matched book through liquidation, hedging, porting of customers of the defaulter, and transfer of defaulter's positions through competitive auctions. Clearing members are incentivized to participate early in CCP default management by participating in auctions, providing good bids, and accepting ported customers. In some clearing services, failure to participate in an auction could result in juniorization of guaranty fund contributions.

Resolution authorities should not interfere with CCP default management. The public rulebooks of CCPs set forth the rules for default management, including the incentives and implications for clearing members and market participants. Default management is intended to be implemented by the CCP, not by the resolution authority. If a resolution authority intervenes prematurely, the entry by the resolution authority would disrupt the contractual arrangement agreed up by the CCP and its clearing members and market participants. Rather, the CCP should be allowed to default manage with the oversight of its primary regulator.

Partial Tear Ups

CCPs have a regulatory and legal obligation to consider the stability of the broader financial markets. CME Group believes that partial tear-up, where utilized in the CCP- led recovery process, provides an efficient and risk prudent way for a CCP to manage a recovery scenario. Partial tear-up also preserves and creates the appropriate incentives that ultimately allow for the continuity of the CCP's critical services.

Partial/Full Tear Up is the only appropriate tool to re-establish a matched book, as it immediately nets – down open positions and only impacts market participants that have positions in the impacted contracts and are very familiar with their risks.

Forced Allocation

⁹ CPMI-IOSCO Report at p. 17

CME Group does not view forced allocations as an effective loss allocation tool to restore a matched book. Forced allocation would allocate the non-liquidated defaulter positions across a wider universe of clearing members and market participants. By allocating positions to clearing members and market participants at exactly the same time when the markets are not functioning, forced allocations impose uncertainty on clearing members and market participants. This uncertainty of risk can be destabilizing and could cause further defaults.

Q8. Should any tools for restoring a matched book only be exercisable by resolution authorities? If so, which tools and subject to what conditions?

Comments:

There should be no tools to restore a matched book that are exercisable only by resolution authorities. CCPs have the requisite skills and knowledge to manage the default of a clearing member and have successfully restored a matched book. CCPs have the benefit of the day-to-day risk management of the markets impacted by a clearing member default; the market will not benefit by limiting the tools available to the CCP, who is best positioned to execute these tools. CCPs should execute all recovery tools available to restore a matched book.

Reserving recovery tools to a restore a matched book for use only by a resolution authority does not promote recovery and accelerates resolution.

Allocation of losses in resolution

Q9. What are in your view effective tools for allocating default and non-default losses and what are the pros and cons of these tools? Should initial margin haircutting be considered as a tool for the allocation of losses in resolution? Is one or more of the tools preferable over others? What are your views on the use of tools to restore a matched book as a means of loss allocation?

Comments:

Allocation of default losses

CME Group understands the negative impacts the use of recovery tools may have on clearing members and market participants. There are limited tools available to fully allocate uncovered credit losses. All of the available tools to fully allocate losses would have negative impacts to clearing members and market participants. CME Group believes that of all the available tools to fully allocate uncovered credit losses, use of Variation Margin Gains Haircut's ("VMGH") has the least negative impacts. VMGH is a recovery tool that may act as an incentive to motivate clearing members and market participants with positions in the affected contracts to participate in the default auctions to protect their gains from VMGH. VMGH promotes recovery by incentivizing auction participation.

Allocation of Non-default losses

The appropriate allocation of non-default losses varies depending upon whether the non-default losses could impact clearing members and market participants or solely impact shareholders. Non-default losses that could be allocated to clearing members and market participants should be clearly stated in CCP rule books.

Non-default losses that could impact clearing members and market participants may result from investment decisions, use of a settlement bank and use of a custodian bank. Non-default losses

impacting clearing members and market participants can result from exposure to market risk, exposure to idiosyncratic risks of the settlement bank or custodian bank and exposure to systemic risks.

If clearing members and/or market participants select the investment vehicle to be used for funds posted to CME, clearing members and/or market participants should then bear risk of loss for any decrease in value and those non-default losses should be allocated to clearing members and market participants. If clearing members and/or market participants choose a settlement bank and/or custodian bank and there is a settlement bank or custodian bank failure, clearing members and/or market participants should then bear risk of loss associated with that failure and those non-default losses should be allocated to clearing members and market participants.

Non-default losses where CME makes the investment decision should be allocated to shareholders as well as all other non-default losses resulting from general business, legal or operational risk.

Initial Margin Haircuts

We do not consider haircutting initial margin to be an alternative means of default loss allocation. CME Group is strongly opposed to haircutting initial margin, whether during recovery, wind-down or resolution. Haircutting initial margin of customers is unlawful in certain jurisdictions, including the United States. Furthermore, haircutting initial margin would have a destabilizing impact on markets by (i) increasing the risk that the clearing house is under-protected against a future default of a clearing member and (ii) creating a pro-cyclical liquidity requirement for all clearing members and their customers to reestablish their full amount of margin, which could increase the likelihood that a clearing house would enter recovery, wind-down and/or resolution.

Haircutting market participant initial margin would likely precipitate clearing member failures or defaults as market participants withdraw funds from their clearing members for protection or in fulfillment of contractual or fiduciary duties. Further, clearing member defaults would increase the odds of a clearing house entering recovery, resolution and/or wind-down.

In particular, the prospect of initial margin haircutting would incentivize clearing members to not take part in the auction process due to the potential for increased losses if a haircut of initial margin occurs after a portfolio has been acquired. Any tool that would increase the chances of a clearing house entering recovery, resolution and/or wind-down presents risk to all stakeholders, including regulators, clearing members, market participants and potentially even taxpayers.

In a scenario where initial margin has been haircut, the clearing house would be under-protected and thus, have even greater exposure to future clearing member defaults because those clearing members would no longer be fully collateralized, which would also increase the odds of a clearing house entering recovery, resolution and/or wind-down.

Finally, haircutting initial margin would also limit the effectiveness of a clearing house's default management plan.

Q10. Which, if any, loss allocation tools should be reserved for use by the resolution authority (rather than for application by a CCP in recovery)?

Comments:

No loss allocation tools should be reserved for use by a resolution authority. Due to a CCP's expertise and experience in the market, the CCP should be responsible for executing all loss allocation tools. Regulators have full insight into the actions taken by the CCP for their use of loss allocation tools and therefore, have insight into scenarios that could potentially lead to a recovery or resolution.

If the resolution authority reserved loss allocation tools, CCPs may face a risk that the market participants may view the intervention of the resolution authority as a failure of the CCP and may be less likely to participate in the CCPs default management process and therefore, will add additional pressures to the recovery of the CCP.

The objectives of resolution are the pursuit of market stability and continuity of critical functions. CCPs should be able to execute their recovery plans and be permitted to utilize all of its recovery tools to allocation losses to recover the CCP. All recovery efforts should be exhausted before entry into resolution.

Q11. How much flexibility regarding the allocation of losses is needed to enable resolution authorities to minimise risks to financial stability? For example, to what extent should a resolution authority be permitted to deviate from the principle of pari passu treatment of creditors within the same class, notably different clearing members in resolution? What would be the implications of a resolution strategy based primarily or solely on a fixed order of loss allocation in resolution set out in CCP rules vs. a resolution strategy that confers discretion to the resolution authority to allocate losses in resolution differently to CCP rules?

Comments:

Resolution authorities should define what is meant by flexibility. Resolution authorities should not be able to change the ex-ante distribution of losses or deviate from the principle for pari passu treatment of creditors within the same class. CCP Rules and treatment of clearing members and customers of clearing members under insolvency laws are fundamental and allow clearing members and customers of clearing members to measure, manage and control their risk. Clearing members expect a CCP to use the tools in its rulebook as set forth therein; these tools are for use by *the CCP* and are not for use by a resolution authority. If a resolution authority brings funds when it enters as a CCP's resolution authority, the resolution authority should not disclose this funding in advance as knowledge of such funds could hinder recovery efforts.

Q12. What are your views on the potential benefits or drawbacks of requiring CCPs to set out in their rules for both default and non-default losses:

- (i) The preferred approach of the resolution authority to allocating losses;
- (ii) An option for, or ways in which, the resolution authorities might vary the timing or order of application of the loss allocation tools set out in the rules?

Comments:

CCP rulebooks should be clear and transparent on default and non-default losses that may impact clearing members, and or market participants. CCP rulebooks are a critical component of the active involvement of clearing members in the CCP's default management process to ensure recovery and restore a matched book and to maintain the soundness of the broader financial markets; the resolution authority should not interfere with the established incentive structures considered in the CCP rulebooks. These incentive structures are designed to meet market demands while strengthening the incentive of clearing members to contribute to a successful recovery.

Resolution tools for use by a resolution authority should not be included in CCP rulebooks.

Non-default losses

Q13. How should non-default losses be allocated in resolution, and should allocation of non-default losses be written into the rules of the CCP?

Comments:

CCP rulebooks should be clear and transparent with respect to allocation of non-default losses. Non-default losses that would be allocated to clearing members and market participants should be clear and transparent as to who bears risk of loss and how losses will be allocated.

Non-default losses arising from the CCP's general business, legal or operational risk should be allocated to CCP shareholders.

Q14. Aside from loss allocation, are there other aspects in which resolution in non-default scenarios should differ from member default scenarios?

Comments:

No.

Application of the “no creditor worse off” (NCWO) safeguard

Q15.1 and 2. What is the appropriate NCWO counterfactual for a resolution scenario involving default losses? Is it the allocation of losses according to the CCP's rules and tear-up of all the contracts in the affected clearing service(s) or liquidation in insolvency at the time of entry into resolution, or another counterfactual?

Comments:

For a resolution scenario resulting from default losses, the appropriate counterfactual varies depending on whether the CCP has limited recourse.

Key Attribute 5.2 defines NCWO by referencing what creditors would receive in a liquidation of a CCP under the insolvency regime that would apply if resolution authorities did not intervene. But if a CCP has limited recourse, the CCP may never reach insolvency as a result of default losses; if the NCWO definition in Key Attribute 5.2 is read literally, it would not apply to a CCP with limited recourse that never reaches insolvency.

In Section 8.1 of the Discussion Note, the FSB provides that "To assist with interpreting the NCWO safeguard, authorities should clearly set out in advance the relevant counterfactual and the assumptions and valuation principles that should apply in **assessing the losses that participants and other creditors would have borne had the authorities not intervened**. This is particularly relevant where a resolution authority wishes to depart from the order of loss allocation set out in the CCP's rules" (emphasis added). We read the emphasized language as expanding the concept of NCWO to address a situation in which the CCP would not reach liquidation due to the presence of limited recourse or otherwise.

Because a resolution authority should not step in until a CCP has exhausted all tools available under the CCP's rulebook (including all financial safeguards) and all available recovery tools, none of these costs should be considered in the counterfactual. Additionally, costs incurred when exploring wind-down strategies up until the point at which it becomes clear that the wind-down strategies are not available would also be incurred; none of these costs should be considered in the counterfactual either.

In an instance in which the CCP has adopted a non-recourse framework to fully address all losses of clearing members and their customers that may result from the default of one or more clearing members outside of a CCP bankruptcy proceeding, to the extent that the non-recourse framework is enforceable, the resolution authority need not play any role with respect to default losses. It is essential that resolution authorities respect the non-recourse provisions included in CCP rulebooks. These provisions enable clearing members and their customers to measure, manage and control their risks of exposure.

If a non-default loss is substantial enough that the loss places the CCP in default or in danger of default, the resolution authority should step in once the CCP exhausts all available recovery tools and wind-down strategies.

...

Q16. What is the appropriate NCWO counterfactual for a resolution scenario involving non- default losses? Is it the liquidation of the CCP under the applicable insolvency regime, assuming the prior application of any relevant loss allocation arrangements for non-default losses that exist under the CCP's rules or another counterfactual?

Comments:

The appropriate NCWO counterfactual for a resolution scenario involving non-default losses would be liquidation under the applicable insolvency regime after any relevant loss allocations arrangements under the CCP's rulebook.

Q17. How should the counterfactual be determined in cases that involve both default losses and non-default losses?

Comments:

As discussed in Q15, Section 8.1 of the FSB paper, the FSB suggests that the counterfactual for NCWO should assess the losses that "participants and other creditors would have borne had the authorities not intervened."

If a CCP experiences a default loss and a non-default loss simultaneously, a CCP would address each of these losses independently as if they were not simultaneous up until any point at which the CCP would become subject to a bankruptcy proceeding. Thus, prior to CCP becoming subject to a bankruptcy proceeding, CME would address the losses arising from the default loss as described in Q15 and the non-default loss as described in Q16.

Equity exchange in resolution

Q18. Should CCP owners' equity be written down fully beyond the committed layer of capital irrespective of whether caused by default or non-default events?

In a systemic scenario, CCPs would be the **recipient** of losses resulting from multiple clearing member defaults in a short time frame, not the source of losses. In such a systemic stress scenario, a forced exchange of equity is inappropriate.

An equity write down should be governed by the local bankruptcy laws and not by a resolution authority.

Investors in CCP

In an instance where a CCP has adopted limited recourse rules, the CCP's owners should not be allocated losses or have their equity written down beyond the committed layer for stress scenarios resulting from multiple clearing member defaults.

The use of this tool should consider the impacts to the incentive structure that is established by the inherent nature of a CCP's role in the marketplace and any write-down of equity needs to preserve (rather than harm) that structure. Incentives must not be created for market participants to force the CCP into expedited resolution.

If a default event occurs, the limit of CCP shareholder responsibility is the amount of money committed in the form of the CCP contribution to the relevant financial safeguards package. Additional compensation could have the perverse effects of encouraging risk taking by market participants and reducing the incentive of market participants to participate in auctions and other default management efforts.

Q19. Should new equity or other instruments of ownership be awarded to those clearing participants and other creditors who absorb losses in resolution?

Comments:

Resolution authorities should be careful in designing compensation schemes. Any form of compensation must not challenge the incentive structure established by the CCP or diminish interest in good default management behavior. Undermining the CCP's incentive structure or diminishing interest in good default management behavior could unnecessarily force a CCP into recovery and/or resolution.

Equity in a CCP

Allocation of equity to clearing members creates an incentive structure built on ownership in a market stress event. If clearing members gain equity interest in the CCP by the CCP entering resolution, this equity interest may encourage clearing members to limit their participation in the default management process and hasten the CCP's resolution.

Cross border cooperation

Q20. What are your views on the suggested standing composition of CMGs? Should resolution authorities consider inviting additional authorities to the CMG on an ad-hoc basis where this may be appropriate?

Comments:

The home authority of the CCP should play a leading role in the Crisis Management Groups. Resolution authorities must be mindful of the potential for inefficiencies should any relevant group grow beyond a manageable size, as efficiency and quick responses to the circumstances will be crucial in a CCP resolution.

Q21. What should be the nature of engagement with authorities in jurisdictions where the CCP is considered systemically important, for the purpose of resolution planning and during resolution implementation?

Comments:

CME and its Supervisory Regulator (the CFTC) are in constant contact on a variety of issues that could impact clearing members and stability of the markets. CME maintains continuous communication with the appropriate regulatory bodies and CCPs during market stress events, which allows for stress events to be effectively managed.

During a default event there may be challenges across CCPs and on a jurisdictional basis, in regard to legal, operational, logistical, and regulatory standards. However, we believe these can be overcome by communication and coordination in advance of (and during) a stress event. Regulators need to take into account potential hurdles posed by capital requirements and other regulatory requirements.

We believe there is a strong basis for communication and coordination between CCPs and the appropriate regulatory authorities as well. It is important that regulatory authorities share the necessary information with CCPs, regarding their plans and views, where a CCP's market participants, a market participant's affiliates, or even the broader CCP's markets are subject to a stress event. This type of information sharing allows a CCP, in conjunction with the regulatory authorities, to efficiently and effectively manage a stress event and coordinate with each other from an operational, legal, and logistical perspective. Given the confidential nature of information being shared, it is important that confidentiality protections be considered and put in place, as needed, in advance to protect clearing members, market participants and the stability of the broader financial system.

As noted above, bank regulators and resolution authorities will likely have advanced knowledge of distress at a major bank and an understanding of how that distress will impact CCPs, non-defaulting clearing members, market participants and the broader financial markets. What regulators do with that knowledge will be critical in determining the outcome of the stress, but it is unclear to the market how they will approach this situation. Bank resolution authorities should share relevant information with CCPs in conjunction with their regulatory authorities for better coordination and management of the stress event. Furthermore, the resolution authorities for the failed banks should prioritize the well-being of markets and financial stability, to prevent contagion of the bank stress to CCPs, non-defaulting clearing members, market participants and the broader market and public interests that derivatives markets serve.

Q22. Should CCP resolution authorities be required to disclose basic information about their resolution strategies to enhance transparency and cross-border enforceability? If so, what types of information could be meaningfully disclosed without restricting the resolution authority's room for manoeuvre?

Comments:

It is important that regulatory authorities share information with CCPs, regarding their plans and views, where a CCP's market participants, a market participant's affiliates, or even the broader CCP's markets are subject to a stress event. This type of information sharing allows a CCP, in conjunction with the regulatory authorities, to efficiently and effectively manage a stress event.

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Cross border effectiveness of resolution actions

Q24. What should be the role, if any, of the suspension of clearing mandates in a CCP resolution and how should this be executed in a cross-border context?

Comments:

The suspension of the clearing mandate in a crisis would not promote the objectives of effective CCP resolution and should not play a role in a CCP resolution.

We would be happy to further discuss and clarify any of the above issues with the FSB. If any comments or questions regarding this submission arise, please feel free to contact Sunil Cutinho, President, CME Clearing at +1 312 634-1592 and sunil.cutinho@cmegroup.com.

Sincerely,



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