



110 Bishopgate  
19th Floor, Suites 19-06 and 19-07  
London EC2N 4AY, UK  
+44 (0) 207 961 0830  
www.iciglobal.org

Suite 715–717, Level 7  
Two Exchange Square  
8 Connaught Place  
Central, Hong Kong  
+852 2168 0882

1401 H Street, NW  
Suite 1200  
Washington, DC 20005, USA  
+001 202 326 5800  
www.ici.org

October 17, 2016

*Via Electronic Mail*

Secretariat of the Financial Stability Board  
c/o Bank for International Settlements  
CH-4002  
Basel, Switzerland

Re: *Essential Aspects of CCP Resolution Planning—Discussion Note*

Dear Sir or Madam:

ICI Global<sup>1</sup> appreciates the opportunity to comment on the Financial Stability Board's ("FSB") discussion note on resolution planning for central counterparties ("CCPs").<sup>2</sup> We applaud the FSB for encouraging effective strategies for the resolution of a failed CCP. The Discussion Note considers a range of strategies to enable a distressed CCP to continue providing clearing services or to wind down or recapitalize. We caution, however, against promoting a "resolution" strategy that would enable a distressed CCP to continue to provide critical services for a protracted period of time before a wind down or recapitalization. Allowing a distressed CCP to operate without recapitalizing for more than short period of time could magnify uncertainty and the risk of loss to market participants. Moreover, we strongly believe that resolution strategies for CCPs must protect the assets of non-defaulting customers of clearing members—including margin and positions.

Some of the strategies described in the Discussion Note would fail to protect non-defaulting customers by allowing CCPs and resolution authorities to appropriate customer assets through margin haircuts or contract tear-ups. Haircutting the margin or tearing-up the contracts of non-defaulting customers of clearing members would impose unfairly the costs of CCP resolution

---

<sup>1</sup> The international program of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US\$20.1 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

<sup>2</sup> See FSB, *Essential Aspects of CCP Resolution Planning, Discussion Note*, August 16, 2016, available at <http://www.fsb.org/wp-content/uploads/Essential-Aspects-of-CCP-Resolution-Planning.pdf> ("Discussion Note").

on entities that did not contribute to the CCP's failure and do not have the ability to manage the risks of the CCP. Using customer assets to resolve a CCP also would create inappropriate incentives for owners and clearing members of CCPs. Rather than using customer funds to resolve a failed CCP, we urge the FSB to recommend that other resources be available to a CCP for this purpose.

We also suggest that the FSB encourage CCPs and the authorities responsible for their resolution to provide public guidance on the time at which a recovery effort will turn to resolution of a failed CCP. We believe that providing market participants with transparency into the timing and process for resolving a CCP will result in fairer treatment for all stakeholders and reduce uncertainty during a stressful time.

## **I. Background**

Our members—investment companies that are registered under the Investment Company Act of 1940 and other regulated funds in jurisdictions around the world (collectively, “regulated funds”)<sup>3</sup>—use derivatives in a variety of ways. Derivatives are a particularly useful portfolio management tool in that they offer regulated funds considerable flexibility in structuring their investment portfolios. Uses of derivatives include, for example, hedging positions, equitizing cash that a regulated fund cannot immediately invest in direct security holdings, managing a regulated fund's cash positions more generally, adjusting the duration of a regulated fund's portfolio, or managing a regulated fund's portfolio in accordance with the investment objectives stated in a regulated fund's prospectus. ICI Global members, as market participants representing millions of investors, generally support the goal of promoting efficient and transparent derivatives markets.

In particular, we have supported the G-20 commitments to reform the derivatives markets, including clearing standardized derivatives contracts. As regulators globally implement this objective through domestic legislation, significant classes of derivatives have been (and will be) required to be cleared through CCPs. We believe that clearing standardized derivatives contracts can mitigate effectively counterparty credit risk and reduce the likelihood that systemic risk will build undetected by regulators. The increased reliance on clearing as a risk mitigation technique means, however, that regulators must provide effective oversight of CCPs and ensure that there is an appropriate regulatory framework governing CCPs that is consistent with mutually agreed international standards.<sup>4</sup> As the prevalence of central clearing increases—and clearing requirements

---

<sup>3</sup> For purposes of this letter, the term “regulated fund” refers to any fund that is organized or formed under the laws of a nation, is authorized for public sale in the country in which it is organized or formed, and is regulated as a public investment company under the laws of that country. Generally, such funds are regulated to make them eligible for sale to the retail public, even if a particular fund may elect to limit its offering to institutional investors. Such funds typically are subject to substantive regulation in areas such as disclosure, form of organization, custody, minimum capital, valuation, investment restrictions (*e.g.*, leverage, types of investments or “eligible assets,” concentration limits and/or diversification standards). Examples of such funds include: US investment companies regulated under the Investment Company Act of 1940; EU “Undertakings for Collective Investment in Transferable Securities,” or UCITS; Canadian mutual funds; and Japanese investment trusts.

<sup>4</sup> See Principles for financial market infrastructures, Committee on Payment and Settlement Systems and Board of the International Organization of Securities Commissions (April 2012), *available at* <http://www.bis.org/publ/cpss101a.pdf>.

make the use of CCPs mandatory for market participants—global regulators must carefully consider the systemic risks posed by CCPs and plan for a recovery or an orderly resolution in the event of a failure of a CCP’s most fundamental function—risk management. We emphasize, however, that regulators must continue to focus first and foremost on proper regulatory oversight, which is critical to reducing the need for the recovery or resolution of a CCP. Given that the FSB contemplates a continuum of resolution strategies—from permitting a failing CCP to continue its services (which may be more akin to recovery) to a wind down or recapitalization, we discuss our concerns about the use of some of these tools both in the context of recovery and resolution.<sup>5</sup>

## **II. Assets of Non-Defaulting Customers Should Not Be a Tool for Recovery and Resolution of CCPs**

### **A. The Discussion Note Encourages Resolution Strategies that Would Appropriate Customer Assets**

In the FSB’s view, an effective resolution plan must address how to: (1) return the CCP to a matched book if necessary; (2) allocate fully any outstanding losses; (3) ensure the replenishment of the financial resources of the CCP to a sufficient level; and (4) support the continued and timely operation of critical functions. The Discussion Note recognizes that the funds required to finance each of these steps could originate from a variety of sources, including non-defaulting customers of clearing members.

We strongly object to supporting the recovery or resolution of a failed CCP by tearing-up contracts or haircutting margin of non-defaulting customers of the CCP’s clearing members. Both of these tools would allocate losses to parties that have not contributed to the CCP’s distress but merely have resources available that the CCP could use to fund its operations. We urge the FSB to reject the temptation to use these customer funds. The Discussion Note suggests that a CCP or resolution authority could tear-up a contract by cancelling some or all of the exposure associated with that contract, reducing the CCP’s exposure and helping it return to a matched book. A tear-up, however, comes at the expense of the contract holder, which loses the rights that it had negotiated and paid for when the CCP accepted the contract for clearing.<sup>6</sup>

Similarly, margin haircutting, which can occur either with variation margin or initial margin, could involve seizing assets from non-defaulting customers. Variation margin haircutting contemplates reducing pro rata the amount that the CCP would be obligated to pay participants with in-the-money (net) positions while continuing to collect in full from those participants with out-of-the money (net) positions. Initial margin haircutting would require the CCP to write down

---

<sup>5</sup> We believe that a strategy to respond to financial distress at a CCP should be considered a “recovery” strategy (rather than a “resolution” strategy) if it permits the failing CCP to continue operations beyond a few hours.

<sup>6</sup> As discussed in more detail in Section III below, a CCP also could liquidate all of its outstanding contracts, causing contract holders to recognize a gain or a loss on their trades. We do not object to tear-ups that occur as a result of the wholesale liquidation of a CCP, provided that contracts are torn-up quickly and in an orderly fashion and that non-defaulting customers of clearing members receive promptly all proceeds due to them following the liquidation of their contracts. We object to the implication in the Discussion Note that a CCP could tear-up contracts held by non-defaulting customers as a means to balance its book following the default of one of its clearing members and the failure of the CCP’s risk management process.

initial margin provided by non-defaulting participants who then would be required to replenish the initial margin.

## **B. Seizing Customer Assets Would Discourage Voluntary Clearing and Incent Questionable Risk Management Practices**

ICI Global strongly disagrees with any suggestion that customer assets should finance the recovery or resolution of a CCP. Haircutting the margin or tearing-up the contracts of non-defaulting customers of a clearing member would put at risk the assets of these market participants when regulatory efforts should be designed to protect funds of non-defaulting customers to encourage central clearing of derivatives contracts. We have supported efforts to promote central clearing of standardized derivatives but consistently have advocated for ensuring the protection of customer collateral provided by regulated funds and held at CCPs and their clearing members.<sup>7</sup> Regulated funds and other customers of clearing members can control their risk exposure to a CCP only by reducing or ceasing entirely their use of the CCP. A system that sanctions seizure of assets of non-defaulting customers to facilitate the resolution of a CCP would run counter to the goals of G-20 commitments to promote central clearing of standardized derivatives by discouraging voluntary clearing of standardized derivatives by customers such as regulated funds or encouraging the use of derivatives not offered for clearing in lieu of standardized derivatives.

Moreover, a resolution strategy that permits a CCP or resolution authority to seize customer assets would present a risk of moral hazard by providing inappropriate incentives to clearing members and owners of CCPs. CCP owners and clearing members have the ability to control the amount of risk that they bring to or incur in a CCP and can influence directly the risk management and business operations of the CCP. Making customer assets—particularly variation margin and initial margin—available to fund recovery or resolution, could incent CCPs and their clearing members to take risks that they would not otherwise take if only their assets were available in the event of a failure. This misalignment of incentives is somewhat similar to bailouts using public funds, which policymakers want to avoid. By contrast, if CCPs and their owners and clearing members know customer assets will not be available, they will more likely adopt risk management policies that reflect the risks they are realistically willing to accept.

---

<sup>7</sup> See e.g., Letter from Dan Waters, Managing Director, ICI Global, to Olivier Guersent, Director-General, Directorate-General for Financial Stability, Financial Services and the Capital Markets Union, European Commission, dated October 26, 2015, available at <https://www.ici.org/pdf/29447.pdf> (urging the European Commission not to permit variation or initial margin haircutting as a tool for CCP recovery); Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 4, 2013, available at <http://www.ici.org/pdf/26967.pdf> (advocating for the adoption of margin requirements for uncleared derivatives that would protect investors as well as derivatives dealers); Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Sauntia S. Warfield, Assistant Secretary, Commodity Futures Trading Commission, dated January 14, 2013, available at <http://www.ici.org/pdf/26872.pdf> (supporting the adoption of more stringent risk management programs for intermediaries that handle customer funds); Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated August 8, 2011, available at <http://www.ici.org/pdf/25388.pdf> (suggesting the adoption of regulatory standards that protect cleared swaps customer collateral).

Regulated funds and other customers, as indirect participants of CCPs, do not have the ability to monitor a CCP's risk-taking and management activities.<sup>8</sup> Effective resolution strategies should allow a CCP to wind down or recapitalize quickly, ensure that the failure does not create systemic risk, and protect customers that did not contribute to the failure. Resolution strategies that allow CCPs to tear-up customer contracts or haircut customer margin would fail this standard.

### **C. CCPs and Regulators Should Develop Other Tools to Facilitate CCP Recovery and Resolution**

The FSB should recommend that CCPs and resolution authorities adopt resolution strategies that allocate losses and provide for replenishment of financial resources by those market participants that caused or contributed to a CCP's failure, that can control the amount of risk they bring to or allow in the CCP (as clearing members or owners), and those with the ability to monitor or manage the CCP's risk-taking and management activities. The Discussion Note identifies a variety of funding mechanisms that would not involve seizing customer assets, including imposing losses on CCP owners, enhancing CCP contributions to recovery efforts, and setting aside additional pre-funded resources for use in resolution beyond those already stipulated in the regulatory requirements for CCPs.<sup>9</sup> Although we recognize that each of these tools presents certain challenges, we believe these options appropriately require those that failed to manage adequately the risks of the CCP to bear the financial consequences of its failure.

### **III. Resolution Plans Should Provide Guidance on the Timing of Entry into Resolution**

We agree with the Discussion Note's suggestion that CCPs and resolution authorities should have some discretion to determine the point at which a CCP recovery effort should become a resolution exercise.<sup>10</sup> We also agree that resolution authorities for a CCP should consult closely with other relevant authorities to ensure that that recovery or resolution of a CCP occurs in as orderly and efficient a manner as possible.<sup>11</sup> Providing a degree of certainty in unsettling times through guidance regarding the point in time at which a CCP would enter resolution would improve the chances of a smooth wind down of a CCP. If market participants have no guidance on when recovery will turn into resolution, they are likely to curtail interaction with the CCP at the first signs of distress, which could diminish the opportunity for the CCP to recover.

We encourage the FSB to recommend that CCPs and resolution authorities establish ex ante transparency around the timing of a CCP's entry into resolution. Establishing a clear threshold for commencing resolution proceedings will ensure that authorities can focus exclusively on the task of winding down a failed CCP. For CCP failures that result from the default of one or more clearing members, resolution authorities can minimize losses by commencing the resolution

---

<sup>8</sup> We recognize that the European Union requires CCPs to include buy-side participants on their risk committees. We have a strong interest in ensuring adequate and diverse stakeholder representation on risk committees as well as transparency as to the committee's decision-making processes to control conflicts of interest that may exist. We do not believe, however, that participation on such committees would give individual indirect participants, such as regulated funds, the ability to monitor and manage the risks of a CCP to their satisfaction.

<sup>9</sup> See Discussion Note at 16, 23-24.

<sup>10</sup> See *id.* at 13.

<sup>11</sup> See *id.* at 13-14.

process immediately after the CCP exhausts its waterfall and recovery funds provided by its owners, clearing members, or the CCP itself. At this time, the CCP should be nearly risk neutral, with a matched book, except for a finite number of defaulted positions. If resolution authorities rapidly liquidate matched positions and auction defaulted positions, they should be positioned to return margin to non-defaulting customers of clearing members with minimum market loss. This would minimize customer losses and allow regulated funds and other customers of clearing members to establish quickly and efficiently replacement positions if desired.

\* \* \*

We appreciate the opportunity to provide input on the Discussion Note. If you have any questions on our letter, please feel free to contact the undersigned, Jennifer Choi, Associate General Counsel, at (202) 326-5876, or George Gilbert, Counsel, at (202) 326-5810.

Sincerely,

/s/ Dan Waters

Dan Waters  
Managing Director  
ICI Global  
+44 (0) 207 961 0831