THE FOUNDATION FOR SECURE MARKETS

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Via Electronic Submission (fsb@fsb.org)

Secretariat to the Financial Stability Board
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Re FSB Consultation report on Financial Resources and Tools for Central Counterparty Resolution

The Options Clearing Corporation ("OCC") appreciates the opportunity to provide comments on the Financial Stability Board's ("FSB's") consultative report titled Financial Resources and Tools for Central Counterparty Resolution, issued September 19, 2023 (the "Report"). As a systemically important central counterparty ("CCP") and the sole US CCP for listed equity options, OCC is keenly interested and deeply engaged in FSB's ongoing dialogue with regulators, CCPs, and the industry on CCP resiliency, recovery, and resolution. As a member of CCP Global ("CCPG") and the World Federation of Exchanges ("WFE"), OCC embraces the responses to the Report found in the letters submitted to the FSB by those organizations. In this letter, OCC provides additional responses based on OCC's unique structure and position in the market.

Summary and Overall Comments

The Report follows a series of earlier consultations and reports examining various aspects of resolution planning for CCPs, and comes in the context of extensive work by regulators and standard-setting bodies on CCP resilience and recovery-related matters. In 2020, FSB issued its "Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution" ("2020 Guidance").[1] At the time, OCC[2] and other CCPs provided feedback reflecting concerns with the possibility of prescriptive requirements for resolution-specific resources in light of the unique incentive structure of CCPs, the sufficiency of existing CCP resources, and the need for CCPs and local supervisory and resolution authorities to retain sufficient flexibility in planning for resolution in light of the potential systemic consequences of a CCP failure. Subsequent work by FSB and CPMI-IOSCO following the 2020 Guidance resulted in the issuance of a joint report with CPMI-IOSCO in 2022[3] which further underlined the already-strong financial foundations of CCPs, finding that the systemically important CCPs it studied were well positioned to address losses using pre-funded resources, and in only a few cases existing recovery tools, without entering resolution, except under the most extreme and implausible stress scenarios.

[1] FSB, Consultative document, Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution (May 2020*), available at* https://www.fsb.org/2020/11/guidance-on-financial-resources-to-support-ccp-resolution-and-on-the-treatment-of-ccp-equity-in-resolution/.
[2] Letter from OCC to FSB, dated July 31, 2020, *available at* https://www.fsb.org/wp-content/uploads/OCC.pdf ("OCC 2020 Comment Letter").
[3] FSB, CPMI, IOSCO, Consultative document, Central Counterparty Financial Resources for Recovery and Resolution (March 2022), *available at* https://www.fsb.org/2022/03/central-counterparty-financial-resources-for-recovery-and-resolution/. ("2022 Joint Report").

In light of this history, we appreciate that the Report avoids prescriptive requirements for resolution-specific resources. We believe the Report comprehensively identifies the criteria by which potential tools should be assessed, though in our view it would be appropriate to prioritize the maintenance of incentives for participation in default management and recovery and the preservation of systemic stability. We further appreciate that the Report recommends a toolbox approach, recognizing that one-size-fits-all requirements are inappropriate and a flexible approach is necessary given differences among individual CCPs in the markets they serve and products they clear, as well as their ownership structures and the regulatory regimes within which they operate.

Nevertheless, we have significant concerns about the potential impacts of many of the tools discussed in the Report, particularly if they are implemented in a prescriptive manner that does not appropriately account for the likely knock-on effects of their adoption. Such effects could include the possibility of increased costs for clearing members and end-users, reduction in hedging activity, movement of trading activity away from cleared markets, and increased potential for market failure due to unsuccessful recovery processes at CCPs. Moreover, certain of the tools are particularly inappropriate for CCPs such as OCC that operate as utilities, are not publicly traded and do not have profit-driven affiliates. The Report's qualitative analysis does not provide the transparent, empirical basis for changes to international guidance that the 2022 Joint Report suggested would underpin further work in this area.

To echo our comments in 2020, over the decade-and-a-half since the financial crisis, CCPs have strengthened their risk management framework, increased their resources and carefully designed rules and processes to incentivize clearing member risk management and participation in the CCP default and recovery processes. Any disruption to this thoughtfully calibrated framework risks altering the fundamental risk management principles that underpin the continued resilience of global CCPs. Indeed, we are concerned that the Report's emphasis on the need for a resolution-specific toolbox may create pressure to institute resolution without letting recovery measures fully play out, which could lead to significantly negative outcomes. Recovery and resolution exist on a continuum, and certain tools (some of which CCPs already have in place) can appropriately be viewed as applicable to both. We therefore urge that the FSB make abundantly clear that CCPs, their supervisors, and relevant resolution authorities should work carefully and collaboratively to assess the particularized needs of each CCP and jurisdiction before requiring the adoption or implementation of any particular tool, and that the importance of a resolution authority's access to a toolbox does not outweigh the need for any available tools to be fit for purpose for the relevant CCP and jurisdiction. We further wish to emphasize that any future work by regulators and standard setting bodies in the area of CCP resolution should be based on publicly-disclosed data, and should reflect clear guidelines to ensure coordination between resolution authorities and supervisory authorities.

<u>About OCC</u>

Founded in 1973, OCC is the world's largest equity derivatives clearing organization. OCC operates under the jurisdiction of both the United States Securities Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"). As a registered clearing agency under the SEC's jurisdiction, OCC clears and settles transactions for exchange-listed options. As a registered derivatives clearing organization under the CFTC's jurisdiction, OCC clears and settles transactions in futures and options on futures. OCC also provides central counterparty clearing and settlement services for securities lending transactions. In addition, OCC has been designated by the Financial Stability Oversight Council 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, OCC is subject to prudential regulation by the Board of Governors of the Federal Reserve System. OCC is recognized by the European Securities and Markets Authority as a Tier 1 CCP established in third countries under Article 25 of the European Market Infrastructure Regulation ("EMIR"). OCC operates as a market utility and is owned by five exchanges.

Background and Prior Comments

The Report is a continuation of work undertaken by international standard setting bodies stretching back to before the issuance of the *Key Attributes* in 2014. Within the past three years, this work has included the 2020 Guidance, as well as the 2022 Joint Report. OCC and other CCPs have engaged with FSB and its members throughout this period, providing consistent and comprehensive feedback reflecting frontline views from CCPs based on their hands-on experience balancing their mandates with the views and concerns of various stakeholders and regulators.

Throughout, CCPs have consistently emphasized the proven resilience of centrally cleared markets and the careful planning reflected in CCPs' rulebooks, risk management frameworks, default management procedures, and recovery and orderly wind-down plans which together make resolution – while critical to consider and plan for - a remote possibility. OCC's comments in 2020 reflected this theme. Below, we summarize them at a high level, as we wish to emphasize their continued salience in the global dialogue on CCP resolution:

- **Scenarios:** Standard setting and rulemaking on resolution-specific resources should be based on extreme but plausible scenarios, and should take into account existing, legally-grounded recovery and incentive frameworks.
- **NDLs:** CCPs are not and should not be required to act as guarantors of the performance of custodian and settlement banks, who are subject to their own comprehensive oversight and resolution regimes. As such, resolution guidance should not assume that CCPs can or should act in such a capacity by being wholly responsible for the default of such a third-party provider.
- **Early Intervention:** Early intervention (i.e. prior to the exhaustion of recovery tools) by a resolution authority should be limited to circumstances in which the CCP poses a risk to financial stability. Continuing to rely on a CCP's pre-defined tools and procedures to the greatest extent possible provides more certainty to market participants, increases the likelihood of a successful recovery and is in the best interests of CCPs, clearing members and the market as a whole.
- **Relevance of CCP Structure:** CCP ownership and governance structures are highly relevant to resolution planning, as different models – such as OCC's market utility model – create unique processes and alignments of interest that underpin CCP resilience. Therefore, resolution planning should take into account each CCP's individual structure and mix of products cleared.
- **Role of CCP Equity:** CCP equity levels are set at levels intended to align incentives between CCP and clearing member interests for effective risk management encouraging the active participation clearing members in default management and recovery. This is particularly true for the equity of CCPs that operate as market utilities, where the CCP's goal is to maintain sufficient resources to support the CCP's operations, cover certain business and operational risks and NDLs, and support its recovery and wind-down plan. For such CCPs, a tranche of prefunded "skin-in-the-game" is

> positioned in the default waterfall prior to loss mutualization in order to incentivize risk management by the CCP and its management,[4] but the risk of significant losses is mutualized between and among clearing members. Moving CCP equity to a first loss position in resolution would undermine this structure. Resolution guidance on equity contributions should therefore be consistent with the PFMIs, established in conjunction with supervisory authorities, and set forth in the CCP's rulebook or bylaws.

Comments on Analytic Framework

The Report assesses potential resolution-specific tools along four broad parameters[5] and, corresponding to the various parameters, six analytical dimensions.[6] We believe the parameters and dimensions accurately and comprehensively incorporate the critical criteria for assessing potential resolution tools, and do not believe any additional criteria should be added to the analysis. However, we disagree with FSB's determination that "none of the parameters and their underlying analytical dimensions could be prioritised over others."[7] The goal of both CCP risk mutualization and the contribution of CCP equity to the default waterfall is to align incentives across participants to ensure sound risk management in BAU and continuity of service in both default loss ("DL") and non-default loss ("NDL") scenarios, thereby promoting market stability. This alignment is further reinforced by the requirement that CCP governance arrangements "promote the safety and efficiency of the [CCP], and support the stability of the broader financial system. . . ."[8] Pursuant to that requirement and existing regulations in the United States, OCC has adopted default management and recovery and wind-down plans that are designed to ensure that members are incentivized to participate in recovery efforts (i.e. likely to achieve better outcomes when participating than if not participating), in light of

[4] Under OCC's Capital Management Policy, OCC provides two tranches of skin-in-the-game. The first is the amount of liquid net assets funded by equity ("LNAFBE") above 110% of its target capital requirement, which must be utilized to offset the loss after utilizing the margin and default fund contributions of the defaulting clearing member. In addition, OCC will contribute the unvested funds held under its Executive Deferred Compensation Plan ("EDCP"), on a pro rata basis *pari passu* with nondefaulting clearing members' default fund contributions. We believe the inclusion of the EDCP unvested funds is unique among CCPs and that it is the most effective and direct way to strengthen the alignment of interests between management and clearing members. *See generally* Order Approving Proposed Rule Change, as modified by Partial Amendment No. 1, Concerning a Proposed Capital Management Policy That Would Support The Options Clearing Corporation's Function as a Systemically Important Financial Market Utility, Exchange Act Release No. 88029 (Jan. 24, 2020), 85 FR 5500 (Jan. 30, 2020) (File No. SR-OCC-2019-007).
[5] The parameters described in the Report are: A) provide sufficient loss absorption, CCP recapitalisation options, and liquidity to give resolution authorities a reasonable opportunity to achieve a successful resolution in default loss (DL) and non-default loss (NDL) scenarios; (B) be reliable and readily available to achieve one or more of the above purposes in resolution; (C) mitigate potential adverse effects on financial stability; and (D) align incentives across recovery and resolution and achieve outcomes in resolution consistent with the Key Attributes, including by ensuring CCP equity remains in a first-loss position and by preserving incentives for market participants to participate in recovery and central clearing. Report at 9.
[6] The dimensions described in the Report are: (i) purpose and usability; (ii) timeliness and performance risk; (iii) legal and operational considerations; (iv) impact on financial stability; (v) costs - magnitude and allocation; and (vi) impact on CCPs' business models and clearing participant incentives. *Id.*
[7] Report at 17.
[8] Principle 2, 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 ("PFMIs") (Apr. 2012).

the costs and systemic disruption that would be caused by the CCP's failure. We therefore believe it would be appropriate, in assessing potential resolution tools, to prioritize the mitigation of adverse effects on financial stability (i.e. Parameter C) and the alignment and preservation of relevant incentives (i.e. Parameter D). We do not believe either of those goals can be satisfied by any tool that does not provide sufficient resources to make successful resolution possible, or that is not reliable and available. As such, we believe Parameters A and B are necessarily subordinate to the critical objectives of Parameters C and D.

As an additional point, while we believe the Report identifies the appropriate set of analytic criteria for assessing resolution tools and resources, we believe FSB should make clear that any given tool or resource should be judged against those criteria as of the end of the recovery process. That is, the consideration of potential resolution tools or resources should proceed upon the assumption that recovery efforts are fully played out prior to the use of any resolution-specific tool or resource. A resolution tool or resource that is only effective (or is only considered useful) if used before the completion of the recovery process has the potential to create incentives to cut short the recovery process, which would run counter to international standards and the carefully designed default management and recovery plans of CCPs.

Comments on Toolbox Approach

The Report recommends a "toolbox approach" to resolution, whereby "resolution authorities would have ready access to a combination of resources and tools from the toolbox as options to use in resolution."[9] The Report further states that the toolbox approach would enable relevant authorities "to select which resources and tools to implement in their jurisdiction, as needed, to complement the resources and tools already available."[10] We applaud the Report's recognition that resolution resources and tools should be tailored to the needs of individual CCPs, within the context of the existing recovery and orderly wind-down framework of the relevant jurisdiction, and believe the Report's qualitative analysis of the included tools will be useful to local authorities in making those decisions. However, we are concerned that the Report could be interpreted to suggest that every jurisdiction should seek to adopt or implement multiple tools from the toolbox. As noted above, we believe the "toolbox" of available resources and tools should instead be viewed as a reference that should be carefully reviewed by CCPs and relevant authorities, without being considered binding as to any particular application.[11] Moreover, we urge FSB to recognize that certain recovery tools contemplated by CCPs' rules (e.g. VMGH) may also serve as resolution tools, and therefore should be considered when evaluating a CCP's resolution preparedness.

As a dually registered securities clearing agency and DCO, OCC is subject to a detailed regulations from both the SEC and CFTC, drawn from corresponding international standards in the PFMIs, that govern OCC's risk and capital management frameworks and recovery and orderly wind-down planning.[12] These regulations, and

[9] Report at 2.
[10] *Id.*
[11] We note that the statement in the Report that "Regimes with access to a combination of resources and tools would benefit from optionality that would diversify the risk that stems from reliance on any one resource or tool" (Report at 22) could be read to suggest that a regime may be viewed more favorably if it adopts numerous tools from the Report's toolbox, irrespective of the merit of those particular tools and resources as applied to the CCPs subject to that regime.
[12] See generally See 17 CFR 17Ad-22(e)(4), 17 CFR 17Ad-22(e)(7), and 17 CFR 17Ad-22(e)(15); PFMI Principles 4, 7, and 15; and Standards for Covered Clearing Agencies, Exchange Act Release No. 3478961, 81 Fed. Reg. 70786 (Oct. 13, 2016). The SEC and CFTC have both recently proposed new and amended rules relating to the contents of CCP

OCC's rules implementing its default management waterfall and recovery tools, are collectively reasonably designed to provide for sufficient loss absorption, recapitalization options and liquidity to recover and continue operations in a wide range of extreme but plausible loss scenarios, or, in the unlikely event recovery is not possible, to achieve an orderly wind-down, including in resolution. As the Report recognizes, and is discussed further below, the identified tools all have drawbacks that may render them inappropriate to use or inconsistent with the overriding goal of maintaining incentives for effective default management and recovery and therefore financial stability.[13] Moreover, certain tools that CCPs and relevant authorities may consider as part of a recovery/wind-down/resolution continuum are not discussed in the Report (also discussed below) yet should be accounted for in resolution planning.

<u>Comments on Specific Tools</u>

As noted by OCC[14] and other CCPs[15] in response to the 2020 Guidance, CCPs' existing recovery frameworks have been developed pursuant to their governing law, in conjunction with regulators and stakeholders, to maximize, in light of their unique governance and ownership characteristics and the markets they serve, the likelihood of the CCP continuing to provide its services even in extreme circumstances. Any requirements for resolution-specific tools and resources should be considered in the context of the careful alignment of interests reflected in those existing frameworks, and the overriding necessity of preserving financial stability through the maintenance of effective, transparent, and predictable recovery processes.

OCC operates like a market utility, owned by five options exchanges and governed by a Board of Directors that includes clearing member, exchange, and public directors. Over 95 percent of OCC's revenue is

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recovery and wind-down plans, with the aim of further harmonizing their rules with evolving international standards. *See* Derivatives Clearing Organizations Recovery and Orderly Wind-Down Plans; Information for Resolution Planning (Jun. 7, 2023), 88 FR 48968 (Jul. 28, 2023) [CFTC] *and* Covered Clearing Agency Resilience and Recovery and Wind-down Plans (May 17, 2023), 88 FR 34708, 34717 (May 30, 2023) [SEC].

[13] Report at 4 ("some of these resources and tools may have knock-on effects and potentially material adverse impacts on financial stability," and therefore, even if available, "the use of these resources and tools might be destabilizing or inappropriate in certain circumstances.")

[14] OCC 2020 Letter at 2 ("In accordance with locally implemented laws, rules and regulations arising from these international standards, CCPs have strengthened their risk management frameworks, increased their resources and carefully designed rules and processes to incentivize clearing member risk management and participation in the CCP default and recovery processes. CCPs have, for example, implemented default waterfalls that include both CCP capital and mutualized clearing member resources to ensure that all interested parties are appropriately motivated to manage their risk. CCPs have also worked closely with regulators and international policy makers to develop structures that are reasonably designed to incentivize clearing member participation in the default management and recovery process. These incentive structures have worked well, including throughout the record high volumes and volatility experienced during the pandemic.")

[15] *See, e.g.,* Letter from Intercontinental Exchange, Inc. dated July 31, 2020 at 1-2 ("CCPs, together with their stakeholders and local regulators, have undertaken a substantial amount of work to enhance CCP resiliency, reducing systemic risk in the financial markets. Among other things, CCPs have established tools and recovery processes, including through their rulebooks, to provide for recovery under relevant law and in collaboration with their local authorities. CCPs existing recovery procedures have been: (1) developed in consultation with the CCPs' clearing members and end-users; (2) formally agreed upon, by the clearing members pursuant to CCP rulebooks and member agreements and, where applicable, by customers pursuant to their clearing agreements; (3) reviewed and approved by CCPs' regulators; and, (4) incorporated in the CCPs rulebooks for purposes of transparency and certainty. These recovery procedures are expected to manage most, if not all, difficulties faced by a CCP.")

generated from clearing fees. OCC's Board is comprised of at least 20 directors and includes nine clearing member directors that represent over forty percent of the aggregated clearing fund and margin risk across all participant segments. OCC's board-level Risk Committee includes clearing member representatives representing firms responsible for significant levels of clearing activity and margin risk at OCC, along with representation from exchange and public directors. With respect to default losses, this structure aligns the interests of OCC, its clearing member firms, exchanges, and other market participants in helping to ensure that our risk management framework is sufficiently robust so that defaults do not occur, and that in the exceedingly rare event that there is a clearing member default, the prefunded financial resources of the defaulting clearing member are sufficient to fully cover its obligations to OCC. In the unlikely event those resources are insufficient, OCC's default management waterfall provides for the sequential use of tools including OCC's skin-in-the-game, prefunded capital from non-defaulting clearing members' clearing fund contributions, cash calls, voluntary contributions and tear-ups, and OCC-directed partial tear-ups. With respect to NDLs, OCC has a similarly transparent and purpose-built set of tools, including insurance covering certain types of operational losses, the unvested EDCP amounts acting as a second tranche of skin-in-the-game, as well as the ability to assess an operational loss fee to clearing members to replenish capital utilized to address the NDL. This framework is transparent and described in detail in a publicly-available participant guide.[16] In accordance with its recovery and orderly wind-down plan, approved by its primary supervisory authority, if all of those resources do not return OCC to viability and a matched book, OCC's rules provide a number of orderly wind-down scenarios including a sale of OCC or merger with another entity, and failing that a close-out netting process outside of a resolution process.

Against that backdrop, and as a supplement to the comments provided by CCP Global and WFE, we offer the following comments on the tools in the Report's proposed toolkit, as well as additional comments on certain tools not discussed in the Report:

Bail-in Bonds: OCC is particularly concerned about the inclusion of bail-in bonds in the proposed toolkit, as such an instrument both inappropriately conflates CCPs with banks, potentially increases systemic risk, and also fails to the accommodate the unique ownership structures of some CCPs. Fundamentally, banks are "risk-takers" while CCPs are "risk managers."[17] CCPs "do not perform the central risk-taking function that distinguishes banking: asset/liability (or maturity) transformation through deposit taking and lending and related activities" and instead "[t]hey serve as a substituted counterparty to both sides of a transaction brought to them by their clearing members, becoming the sole principal to both buyer and seller after a transaction has been consummated and cleared. . . . In contrast to the mismatched books of banks, CCPs run matched books. They do not take risk other than counterparty risk in connection with their role as substituted counterparty, assuming risk when a member fails to perform its obligations until such time as the position risk is either liquidated or transferred to another member."[18] CCPs operate on a core risk-management principle of risk mutualization subject to predictable, pre-defined processes. That risk mutualization is, in turn, predicated on aligning the interests of users (i.e. clearing members and end-users), owners (i.e. the five equity holding exchanges), and management. Under its utility model, OCC maintains prefunded resources at a level

[16] *Available at* https://www.theocc.com/getmedia/a2fdfeaa-9526-4f16-a4c3-c81b3c905f6a/OCC_PartGuide_Sept_2020.pdf.
[17] See Federal Reserve Bank of Chicago, "A CCP is a CCP is a CCP", by Robert T. Cox and Robert S. Steigerwald (April 2017), *available at* https://www.chicagofed.org/publications/policy-discussion-papers/2017/pdp-1.
[18] *Id.*

determined pursuant to rulemaking by its supervisory authority, consistent with the PFMIs, as well as consultation with impacted stakeholders. Those financial resources are calibrated to weigh the need for mutualized loss absorption capacity against the costs that would be imposed on clearing members and end-users by adding more resources through increased clearing fees. Higher fees resulting from a requirement to fund bail-in bonds could in turn lead to increased systemic risk (through concentration of membership and an increase in uncleared activity).[19]

As an additional drawback to bail-in bonds, to the extent the buyers of such bonds were the participating exchanges who are the existing stockholders of OCC, their issuance would not bring in capital from outside the OCC clearing ecosystem, and the costs of funding the bonds during BAU would ultimately be borne by clearing members and end-users through higher fees necessary to pay the yield on any such bonds. Moreover, as described above and in our response to the 2020 Guidance,[20] OCC's current rules and waterfall structure for risk mutualization are designed around the alignment of interests under our current, non-public ownership structure. A requirement to issue convertible instruments to additional potential holders, who may have competing incentives, would not only present certain administrative hurdles, potentially adding friction to the resolution process, but could disrupt the fundamental balancing of interests reflected in OCC's current recovery and wind-down framework. The conversion of the debt into equity may also serve as a disincentive to clearing members to participate in recovery, as they would receive equity in the CCP in resolution. Any requirement to issue bail-in bonds to a more diverse set of holders would also risk creating an incentive for those holders to avoid participating in or funding recovery efforts in favor of receiving equity of the recapitalized CCP, thereby undermining the goal of the recovery and risk mutualization framework.

Resolution Funds: Whether conceived as a local or supra-national mechanism, we believe any resolution fund would be extraordinarily difficult to structure, govern, and administer.[21] Contrary to the assumption in the Report that "[a] resolution fund would be available in a timely manner, in an amount that is certain, and have low performance risk. . . once established,"[22] we believe governance and administrative hurdles would be unavoidable not just during the establishment of the fund but also in connection with any attempt to use the fund. This stems in part from the likelihood that any circumstance that leads to a CCP entering resolution is likely to be the result of systemic issues, such that multiple CCPs, potentially across jurisdictions, will be impacted. In such a situation, both the timing and extent of any payment would raise concerns about procyclicality and prioritization as between CCPs, impacted stakeholders, and potentially jurisdictions. Even assuming functionality, a resolution fund, like other pre-funded resolution-specific resources, has the potential

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[19] We disagree with the statement in the Report that "Increased fees may reduce incentives to centrally clear products for which clearing is voluntary, but would not be expected to impact market participant's [*sic*] willingness to centrally clear products for which clearing is mandatory. Report at 13. To the extent similar risks can be hedged through different products, market participants may choose to hedge through bilateral markets if centrally cleared markets become sufficiently expensive.
[20] *See* OCC 2020 Comment Letter at 4-5.
[21] By way of one of many possible examples, would a resolution fund be permitted to impose membership standards on participating CCPs? If so, how would those standards be accorded with international standards and local laws and regulations? How would such membership standards be enforced and by whom? Even for a single-jurisdiction resolution fund, in jurisdictions like the U.S. where the supervisory authority and the resolution authority are different entities, which would be responsible for administering the fund? If the resolution authority, how would you ensure that the rules of the fund do not undermine the efforts of the supervisory authority?
[22] Report at 13.

to undermine incentives for members to participate in recovery efforts by bringing in third-party resources to pay for resolution, while also imposing additional costs during BAU that may discourage the use of central clearing.

Resolution-specific insurance: While OCC maintains insurance for some forms of operational loss, we do not believe insurance would be effective or appropriate as a resolution-specific tool. In addition to not being a liquidity tool, insurance would present significant timeliness and reliability issues, not just relating to whether a payment will be made, but also to the size of such a payment in light of what will likely be highly complex contractual terms. In addition, use of insurance as part of a toolbox creates additional complications. To the extent the toolbox in a CCP's jurisdiction involves other tools such as a resolution fund, the sizing of a given CCP's insurance needs will be highly dynamic, while the CCP's ability to adjust that coverage in a timely fashion will be limited, raising the risk of CCPs being underinsured (and therefore without necessary resources for resolution) or over-insured (thereby unnecessarily raising costs of clearing and reducing systemic liquidity).

Resolution-specific third-party contractual support: As an initial matter, OCC operates as a standalone entity, with no affiliates, and not as part of a group structure. Therefore, in addition to the problems identified above in connection with insurance, any third-party contractual support would need to be with unrelated counterparties, increasing the risk that the use of such support would act as a transmission mechanism of instability to the broader financial system by requiring large capital and liquidity outputs from financial-system participants at a time when a systemic event is likely underway. In addition, as would be true for bail-in bonds or insurance, for a utility-model CCP such as OCC, the costs of maintaining such third-party contractual support will be borne by clearing members (and ultimately end-users), thereby potentially increasing concentration risk and reducing incentives to clear.

Resolution cash calls: For purposes of recovery, OCC's rules already permit OCC to assess members up to 200% of each member's clearing fund contribution, subject to a rolling 20-day cooling-off period.[23] A resolution authority would likely have access to any unused portion of those assessment rights. An additional, resolution-specific cash call, if mandated, should be similarly transparent and predictable, sized in reference to a member's clearing fund contribution and, to the extent possible, predictably timed in relation to the determination to proceed with resolution. Before implementing such a tool, it would also be necessary to determine , as OCC does for its existing cash call authority, whether members would have the wherewithal to meet these cash calls or whether they would default on these payments and thereby exacerbate financial and liquidity[24] stress. In addition, it is important to decide whether members will be permitted to "opt out" prior to the triggering of a resolution-specific cash call. Absent such an ability, the addition of a resolution-specific cash call would, from the time of its *adoption*, significantly increase the committed financial obligation of each clearing member. This in turn could potentially lead to concentration of clearing through the largest members by causing smaller members to cease offering clearing services.

[23] *See* OCC Rule 1006(h)(B). OCC's Rules are available at https://www.theocc.com/getmedia/9d3854cd-b782-450f-bcf7-33169b0576ce/occ_rules.pdf.
[24] To the extent a resolution-specific cash call would not be subject to the cooling-off period from a prior recovery cash call, members would potentially be required to access significant amounts of liquidity within a short period.

Statutory or contractual variation margin gains haircutting ("VMGH"): VMGH can be an effective recovery tool because it incentivizes market participants to participate in the recovery process to avoid the necessity of implementing VMGH. In the resolution context, VMGH may be an effective loss allocation tool for marked-to-market products, though it would no longer perform the same incentivization function. Nevertheless, it is important to bear in mind that VMGH may result in the allocation of risk to participants whose position at the relevant CCP is in a "winning" position, but whose risk across the market may be flat or even in the opposite direction.[25] Moreover, the existence of VMGH in a resolution toolkit has the potential to lead to participants positioning their portfolios prior to the entry of a CCP into resolution such that those participants would not be subject to VMGH (i.e. by reducing the directionality of their portfolio at that CCP). To the extent VMGH is implemented as a potential resolution resource for a particular CCP (i.e. is adopted by a jurisdiction as part of a resolution toolbox), the CCP should have access to VMGH for recovery as well as resolution.

Equity: OCC strongly believes that the most effective use of CCP equity is as part of the default waterfall to align interests of the CCP with clearing members/end-users or as a loss absorption tool to cover certain non-default losses. It is not an effective resolution tool as it may disincentivize clearing members from participating in recovery. [26] The Report includes the write-down of CCP equity as a potential resolution tool, but does not distinguish between the use of equity in default loss and non-default loss scenarios. To the extent that a CCP's rulebook calls for the mutualization of losses in certain NDL scenarios (as OCC's does), the same considerations should apply when addressing similar losses in resolution. We are thus concerned that the Report fails to provide adequate guidance on factors that may impact the timing, scale, and sequencing of an equity use across various scenarios. In addition, it bears noting that there may be legal or regulatory requirements for the maintenance of minimum equity levels by a CCP that could conflict with or prevent the use of equity in a resolution scenario.[27]

As concerningly from OCC's perspective, the Report does not address the impact of CCP ownership and governance models when discussing the potential usefulness of equity write-down in resolution. To this end, OCC wishes to reiterate the comments it provided in response to the 2020 Guidance:

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[25] This possibility creates some doubt as to the statement in the Report that "VMGH allocates costs to clearing participants that experience-to mark-to-market gains on their positions, which avoids allocating costs to clearing participants with mark-to-market losses. . . " (Report at 16) as that is only necessarily true as to the participant's risk as expressed through the product cleared at that CCP.

[26] As explained in note [4], above, OCC's rules provide that tranches consisting of LNAFBE above 110% of its target capital requirement and (in part) unvested funds held under its EDCP will be used prior to the mutualization of losses to non-defaulting clearing members. This "skin in the game" appropriately incentivizes OCC to prevent and minimize losses.

[27] *See* CFTC Regulation 39.11(a)(2) (requiring a DCO to hold an amount of financial resources that, at a minimum, exceeds the total amount that would enable it to cover its operating costs for a period of at least one year, calculated on a rolling basis; CFTC Regulation 39.11(e)(2) (requiring that a DCO's held financial resources include unencumbered, liquid financial assets – i.e., cash and/or highly liquid securities – equal to at least six months' operating costs); and. SEC Rule 17Ad22(e)(15) (requiring a Covered Clearing Agency to hold sufficient liquid net assets funded by equity equal to cover potential general business losses, including by holding liquid net assets funded by equity equal to the greater of either (i) six months of the Covered Clearing Agency's current operating expenses or (ii) the amount determined by the Board to be sufficient to ensure a recovery or orderly wind-down of the Covered Clearing Agency's critical operations and services.)

> . . . the Guidance does not account for the role of equity in a CCP that operates as a market utility. In a market utility structure, a CCP helps manage the risk of the overall market and maintains sufficient resources to support the CCP's operations, cover certain business and operational risks and NDLs, and support its recovery and wind-down plan. CCPs typically position a tranche of pre-funded resources (skin-in-the-game) in the default waterfall before losses are mutualized across clearing members. This CCP contribution is intended to incentivize appropriate risk management by a CCP and its management team. The risk of significant losses in this structure is not to be borne by the CCP, but rather, it is to be mutualized between and among the CCP's clearing members. Increasing CCP pre-funded resources or making CCP equity the first loss absorbing measure in resolution misconstrues the purpose of the CCP contribution to default resources and undermines a fundamental tenet of the market utility model.
>
> OCC believes that the Guidance should be revised to acknowledge that CCPs' equity contributions to a default management process should be consistent with the PFMIs, established under the oversight of the CCP's regulatory authorities and set forth in the CCP's rules or bylaws. We believe that the RA should exhaust non-equity adjustment provisions (e.g., cash calls and tear-ups) before using CCP equity in a resolution. If using CCP equity is necessary, it should be adjusted in a manner that is consistent with the "no creditor worse off than liquidation" ("NCWOL") safeguard.[28]

<u>Comments on omitted tools</u>

While we believe the qualitative assessment of the various tools in the Report is reasonably complete with respect to the included tools (subject to our comments above), there is no discussion in the Report concerning certain tools that were part of earlier work (e.g. the 2020 Guidance) but not included in the proposed toolbox. Below, we offer brief comments on two of those omitted tools:

Partial tear-up: Partial tear-ups were discussed in the 2020 Guidance, as well as FSB's 2018 discussion paper on *Financial resources to support CCP resolution and the treatment of CCP equity in resolution*, but the tool is not discussed in the Report. OCC believes it would be appropriate to include partial tear-ups in any discussion of potential resolution tools. Like VMGH, the ability for the CCP to perform partial tear-ups serves as an incentive to members to participate in the default management process prior to any tear-ups being undertaken in recovery, while the actual tear-up authority provides the ability for the CCP to return to a matched book. OCC, like other CCPs, includes the ability to perform partial tear-ups as a recovery tool. At the very least, any qualitative assessment of resolution-specific resources should consider partial tear-ups and their place on the recovery and resolution continuum.

Initial Margin Haircutting ("IMH"): While not discussed in the Report, we note that IMH was included in the 2022 Joint Report. We agree with the 2022 Joint Report's negative assessment of IMH,[29] and applaud FSB's determination that it is an inappropriate tool for resolution planning.

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[28] OCC 2020 Letter at 5.
[29] 2022 Joint Report at 19 ("The inclusion of the tool in the toolkit is likely to have a negative impact during business-as-usual, as the possibility of haircutting participant collateral would undercut trust in the CCP. Many clients would be

Comments on Future Work

We appreciate FSB's continued focus on bringing transparency and analytical rigor to establishing international standards for the design and implementation of CCP resolution regimes. While the qualitative analysis and proposed toolbox approach discussed in the Report are important contributions to this ongoing effort, additional work would be required before local jurisdictions would be in a position to consider implementing these tools in any resolution-specific rules. The 2022 Joint Report recognized the need for additional work to assess the systemic impact of recovery and resolution-related tools.[30] Absent detailed and transparent quantitative analysis of such impact, local jurisdictions will lack adequate foundations and guidance on which to base decisions that could fundamentally alter the to-date highly successful set of incentives underpinning the operation of CCPs. For similar reasons, we would further expect, to the extent that any local jurisdiction does seek to implement resolution-specific tools on the basis of the contents of the Report, that such rulemaking would be done subject to notice and comment, and provide impacted stakeholders to provide input based on the specifics of the proposal as applied to the relevant markets, products, and legal and regulatory regime.

In addition, for jurisdictions such as the United States, where the CCP resolution authority and supervisory authority (or authorities) are different entities, it is critical that any future work in this area include careful consideration of the role and powers of both the resolution authority and the supervisory authority. As reflected in the *Key Attributes*, resolution of a CCP is and should remain a last resort, only to be contemplated if and when recovery is unsuccessful or it is otherwise deemed necessary to achieve the objectives of financial stability and maintaining continuity of the CCP's critical functions in resolution.[31] While the transparency called for by the Report is critical, it is also imperative that the resolution authority and supervisory authority collaborate if they are different entities to ensure that the local regime takes a holistic view of the calibration of incentives and knock-on effects of the use of any tools on the recovery and resolution continuum. By way of example, the Report does not discuss the potential tension that may result if the resolution authority and supervisory authority disagree on whether resolution is appropriate, either because they have different views on whether additional recovery tools are available, or on the question of whether earlier intervention is appropriate to preserve financial stability. Any further work by international standard setting bodies should include careful consideration of the means by which to ensure that resolution authorities and supervisory authorities work together to achieve the objectives of continuity of service and minimizing systemic disruption. The framework for cooperation of resolution and supervisory authorities should provide *ex ante* transparency and predictability, to provide market participants confidence at each step

unwilling, and others would be legally unable, to continue to clear at a CCP where IMH was possible. The use of IMH would also contradict the contractual and statutory protections, where they exist, that provide that client collateral is bankruptcy remote. . . IMH requires participants to immediately replace the initial margin that had been haircut or liquidate their positions, likely exacerbating market stress, and adding to concerns on knock-on effects.")

[30] See, e.g., 2022 Joint Report at 21 ("the level of understanding of the impact of the use of recovery and resolution tools on non-bank clearing members, clients and the financial system as a whole remains limited. Therefore, it would be beneficial to enhance as much as possible the understanding of the potential complex systemwide effects of the use of recovery and resolution tools.")

[31] See Key Attributes of Effective Resolution Regimes for Financial Institutions, II-Annex 1: Resolution of Financial Market Infrastructures (FMIs) and FMI Participants ("FMI Annex") at §§ 3.1, 4.1(v), 4.4, 4.9(i).

in the process, and should ensure that resolution measures do not undermine existing recovery and orderly wind-down planning.

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We thank the FSB for the opportunity to provide comments on the Report. If you have any questions, please do not hesitate to contact Andrew Feller, Associate General Counsel, at 202.971.7238, or afeller@theocc.com. We look forward to continued engagement on these critical issues and stand ready to provide FSB with any additional information or analyses that would be helpful to its ongoing work.

Sincerely,

Megan Malone Cohen

Megan Malone Cohen
General Counsel and Corporate Secretary