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March 13, 2017

Via Electronic Mail

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

Re: *Guidance on Central Counterparty Resolution and Resolution Planning—
Consultative Document*

Dear Sir or Madam:

ICI Global¹ appreciates the opportunity to comment on the Financial Stability Board's (FSB) consultative document on resolution and resolution planning for central counterparties (CCPs).² We support the FSB's objectives of issuing guidance to maintain market confidence and promote a consistent international process for CCP resolution. The uncertainty potentially associated with resolving a CCP could disrupt markets if not managed effectively. Accordingly, we strongly support the FSB's efforts to foster the development of plans for the orderly resolution of a CCP.

In providing guidance, we urge the FSB to enhance market confidence by recommending that CCP resolution plans strike an appropriate balance between providing a level of certainty regarding the resolution process and allowing resolution authorities sufficient flexibility to respond to unanticipated circumstances. We believe the proper balance would: (1) provide all market participants with guidance concerning the steps that a CCP or resolution authority likely would take during CCP resolution; and (2) give CCPs and resolution authorities flexibility to deviate

¹ 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\$20.5 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.

² See Financial Stability Board, *Guidance on Central Counterparty Resolution and Resolution Planning, Consultative Document*, February 1, 2017, available at <http://www.fsb.org/wp-content/uploads/Guidance-on-Central-Counterparty-Resolution-and-Resolution-Planning.pdf> (Consultation).

from a resolution plan if doing so would improve substantially the outcome of the resolution proceeding. Market participants that understand a clear plan exists to resolve a failing CCP and have confidence the plan will be followed likely will not panic upon activation of the plan. Their responses should instead be measured and proportionate to the risks that the plan presents to their business. If, however, market participants question whether authorities have a plan to resolve a financially distressed CCP, lack adequate information concerning the risks that a resolution plan presents to their business, or believe authorities will abandon the plan, they would have every incentive to exit the market at the first sign of CCP distress, possibly exacerbating stress at the CCP.

Section I of our letter explains the importance of regulatory supervision of CCPs and reducing the likelihood of the need to trigger resolution. Section II discusses how the nearly limitless discretion the Consultation proposes to afford CCPs and resolution authorities risks undermining market confidence. In Section III, we caution against adopting the elements of the proposed guidance that promote resolution strategies that would enable a distressed CCP or its resolution authority to seize the assets of non-defaulting customers of clearing members 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 on entities that did not contribute to the CCP's failure and do not have the ability to manage the risks of the CCP. Adopting our suggestions would improve market confidence during a stressful time by demonstrating an international commitment to a transparent and orderly CCP resolution process.

I. ICI Global Supports Central Clearing of Derivatives but Urges Regulators to Supervise CCPs Properly to Encourage Clearing

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”)³—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, and 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.

³ 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.

In particular, we have supported the G-20 commitments to reform the derivatives markets, including clearing standardized derivatives contracts.⁴ As regulators globally implement G-20 clearing mandates 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 an appropriate regulatory framework exists to govern CCPs, consistent with mutually agreed international standards.⁵ Although CCPs provide an important risk mitigation service, they are for-profit enterprises, not non-profit market utilities. Given the fundamentally commercial nature of the clearing business, we urge regulators to focus first and foremost on proper regulatory oversight, which is critical to reducing the likelihood of a CCP failure.

II. Disclosure of Key Information about CCP Resolution Plans Will Enhance Market Confidence

We strongly urge the FSB to encourage national regulators and resolution authorities to communicate to clearing participants the tools and strategies they will use to resolve a CCP. At a minimum, authorities should define more clearly when a CCP resolution begins, describe the likely steps that resolution authorities would take to resolve the CCP, and identify with specificity resources they intend to use to finance each step. Communicating these important details to clearing participants should reduce uncertainty, build trust, and promote fair treatment for all stakeholders should a resolution plan ever be activated. Issuing vague statements about potential resolution indicators—like the Consultation—will increase uncertainty, impair market confidence, and could contribute to panic should a CCP require resolution.

For example, the Consultation urges resolution authorities to “consider communicating publicly *some of the indicators* that would inform their determination” to activate a CCP’s resolution plan.⁶ This language evidences no genuine commitment to providing the transparency that is so critical to maintaining market confidence. If the FSB intends to maintain market

⁴ See e.g., Letter from Dan Waters, Managing Director, ICI Global, to Secretariat of the Financial Stability Board, dated October 17, 2016, available at https://www.iciglobal.org/pdf/16_icig_fsb_ccp_resolution_ltr.pdf (advocating for CCP resolution planning strategies that protect the assets of non-defaulting customers of clearing members-including margin and positions); 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 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).

⁵ 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>.

⁶ See Consultation at 8 (emphasis added).

confidence during a CCP resolution, we respectfully suggest that it go farther and recommend that resolution authorities make public the full text of CCP resolution plans or a summary of the material portions of each plan. Resolution authorities should disclose all the indicators that they would consider, along with the weights or the relative importance that they would assign to a particular indicator. At a minimum, however, resolution authorities should inform clearing participants of the indicators that are most critical to resolution because the activation of a resolution plan could have significant consequences for these entities.

Importantly, we believe a resolution proceeding should commence any time that a CCP has depleted its own resources and the resources of clearing members that are committed to the CCP's recovery (i.e., resources established under prudential requirements designed to ensure that a CCP can meet its obligations, including the CCP's own capital and clearing member guaranty fund deposits). At this stage, the CCP cannot continue to provide clearing services without external funding and the most likely sources for this bail out are the funds of clearing participants, CCP creditors, or taxpayers. From this point, the resolution authorities should determine whether to provide additional funding to the CCP under the auspices of a resolution plan.

III. Customer Assets Should Not Be a Tool for CCP Resolution

We strongly urge the FSB not to recommend the use of resolution strategies that appropriate customer assets. A resolution plan that permits a CCP or resolution authority to seize customer assets would discourage voluntary clearing of derivatives contracts and encourage CCPs to adopt questionable risk management practices. Instead, we urge the FSB to recommend other resolution strategies that rightfully allocate losses of the CCP to those with the ability to monitor the risks of the CCP.

A. The Consultation Encourages Resolution Strategies that Appropriate Customer Assets

According to the Consultation, an effective resolution plan must describe how to: (1) return a CCP to a matched book if necessary; (2) address any outstanding default losses and non-default 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.⁷ The Consultation contemplates that the funds required to finance each of these steps could originate from a variety of sources, including non-defaulting customers of clearing members.⁸ The Consultation suggests, for example, that a CCP or resolution authority could use partial tear-ups or margin haircuts (including customer initial margin) as a resolution tool.⁹

Contract tear-ups and margin haircuts pose a serious risk to CCP customers. To affect a tear-up, a CCP would cancel some or all of the exposure associated with a particular contract, reducing the CCP's exposure and helping it return to a matched book at the expense of the contract holder, which loses the rights that it had negotiated and paid for when the CCP accepted the

⁷ See *id.* 3-4.

⁸ *Id.* at 5-6.

⁹ *Id.* at 5-6.

contract for clearing.¹⁰ Similarly, margin haircutting—which can occur either with variation margin or initial margin—would allow a CCP to seize 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-money (net) positions. Initial margin haircutting occurs when a CCP writes down initial margin provided by non-defaulting clearing participants and requires those participants to replenish the initial margin. Contract tear-ups and margin haircuts amount to a seizure of customer assets to support CCP resolution, and we urge the FSB not to endorse their use.

B. Seizing Customer Assets Would Discourage Voluntary Clearing and Encourage Questionable Risk Management Practices

The FSB should insist that CCP resolution plans advance the G-20's commitment to encourage central clearing of derivatives contracts. The Consultation falls short of this standard. Resolution plans that authorize margin haircuts or position tear-ups will discourage regulated funds and other customers from voluntarily clearing their derivatives trades by introducing risks that do not exist in uncleared derivatives products and that they cannot monitor or control.¹¹ Both of these tools would allocate losses to parties that have not contributed to a CCP's distress but happen to have their assets available to the CCP when its risk management function fails and it needs additional funds to continue operations. Regulated funds and other customers of clearing members play no meaningful role in the risk management process of a CCP and do not share in the profits of the CCP's business. The only way that they can mitigate the risk of a CCP seizing their assets is to reduce their use of the CCP by curtailing the practice of voluntarily clearing derivatives not subject to a clearing obligation or increasing their use of derivatives not mandated for clearing.

Moreover, the Consultation does not provide clear guidance on the role of a CCP's owners and managers during and after resolution. If the possibility exists for the same team that led a CCP into ruin to continue to control the enterprise following resolution or for the equity owners to remain unaffected, the provision of customer funds as a resolution tool could create perverse motivations for a CCP's owners and managers. In this circumstance, a resolution strategy that permits a CCP or resolution authority to seize customer assets—particularly variation margin and initial margin—could provide an incentive for 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. These strategies therefore inject moral hazard into CCP operations by providing inappropriate incentives to clearing members and owners of CCPs. The misalignment of incentives that results from moral hazard is somewhat similar to bailouts using public funds, which policymakers want to avoid.

¹⁰ 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 Consultation 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.

¹¹ A regulated fund can, for example, use a third-party custodian to remove the ability of a bilateral counterparty to seize its initial or variation margin in the absence of a default by the fund.

Ultimately position tear-ups and margin haircuts would weaken the central clearing system rather than making it more robust to market shocks by reducing the willingness of customers to use cleared products and introducing moral hazard into CCP risk management decisions. Although the FSB likely does not intend to cause these consequences, they flow logically from the Consultation's endorsement of tools that use customer assets to fund CCP resolution. We acknowledge that appropriating customer assets looks easy—a CCP, after all, already holds these assets—but permitting margin haircuts and position tear-ups is a policy choice that could have negative ramifications for the financial system.

C. Resolution Plans Should Encourage the Use of Other Resolution Tools To Strengthen the Financial System

If the FSB intends the Consultation to help strengthen the financial system, it should insist that CCPs, their members, and shareholders bear the costs of CCP resolution. The FSB should recommend that 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 that have the ability to monitor or manage the CCP's risk-taking and management activities. The Consultation identifies a variety of strategies that would not involve seizing customer assets, including imposing losses on CCP owners, enhancing CCP contributions to recovery efforts, selling new equity in the CCP and using the proceeds to replenish its financial resources, and setting aside additional pre-funded resources for use in resolution beyond those already stipulated in the regulatory requirements for CCPs.¹² Although we recognize that each of these tools presents certain issues to address, 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.

If the FSB is unwilling to rule out the use of customer assets, it should constrain their use to a tool of last resort that can be used only after other tools have been exhausted and only if a resolution authority authorizes and supervises its use. The methodology and process for appropriating customer assets should be fair, transparent, and subject to pre-determined caps, and customers must be compensated for their loss.

As previously noted, we are concerned about the use of customer assets as a resolution tool, particularly if the managers and owners are left intact after a resolution is triggered. We recommend that the FSB further limit any use of customer assets to scenarios involving default losses (i.e., losses caused by the default of a clearing member). A CCP and its shareholders should bear all responsibility for non-default losses because these losses result directly from business decisions of the CCP's management and the CCP's management is the only group able to control and mitigate the CCP's exposure to these losses. When a CCP and its shareholders exclusively bear the risk of non-default losses, they will be incentivized to make arrangements in advance to address non-default losses.

¹² See Consultation at 10, 13-14.

We urge the FSB to recommend that CCP resolution plans articulate how non-default losses will be addressed to allow customers and other clearing participants to assess fully their exposure to a CCP.

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We appreciate the opportunity to provide input on the Consultation. 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

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