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October 17, 2016

Via email

Financial Stability Board
Bank for International Settlements
CH-4002 Basel, Switzerland
fsb@fsb.org

Re: FSB Discussion Note: Essential Aspects of CCP Resolution Planning

Ladies and Gentlemen:

The Depository Trust & Clearing Corporation (“**DTCC**”) appreciates the opportunity to respond to the recent discussion note prepared by the Financial Stability Board (“**FSB**”), *Essential Aspects of CCP Resolution Planning* (the “**Discussion Note**”). We also appreciate the active engagement of the FSB in the ongoing discussions among regulators, CCPs and industry groups on this topic, and hope that our views will be taken into consideration in preparing the next stage of proposed resolution guidance for CCPs. The Discussion Note poses a series of questions grouped around specific themes and issues. Our response addresses these issues thematically.

Introduction

DTCC is the operator of the U.S. cash market securities CCPs—National Securities Clearing Corporation (“**NSCC**”) and Fixed Income Clearing Corporation (“**FICC**”), both of which have been designated as systemically important financial market utilities (“**SIFMUs**”) under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“**Dodd-Frank**”). NSCC and FICC provide critical clearing and settlement services for multiple asset classes, including US equities, corporate and municipal bonds, and government and mortgage-backed securities. DTCC is the parent company of NSCC and FICC. NSCC and FICC are registered under the Securities Exchange Act of 1934, as amended, and supervised by the US Securities and Exchange Commission (the “**SEC**”) as clearing agencies.¹

DTCC is owned and governed by the users of its SIFMU subsidiaries, all of whom commit capital as owners, pay fees for services and ultimately benefit from the safeguards, efficiencies and risk mitigation that DTCC provides. This ownership model effectively aligns interests among our users, our Board of Directors and management, while fostering capital efficiency and delivering cost-effective operating and processing solutions.

¹ DTCC is also the parent company of The Depository Trust Company (“**DTC**”), the US central securities depository. Like NSCC and FICC, DTC is also designated as a SIFMU and is a registered clearing agency supervised by the SEC.

General

The Discussion Note follows on from the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the "**Key Attributes**") published in October 2014, and the additional guidance on financial market infrastructure ("**FMI**") resolution provided in the appendix to the Key Attributes.² When considering CCP resolution planning, regulators and resolution authorities, in particular, need to understand the types of events that are likely to push CCPs to the point of resolution. Given the emphasis on CCP resiliency, and the requirement that CCPs plan for, and size their financial resources based upon extreme, but plausible, stress scenarios in order to credibly recover from such events, resolution is only likely to result from extreme events that are not, by definition, plausible. The most likely situation where this might occur would involve the simultaneous default of multiple SIFI participants.

Given the systemic importance of CCPs, DTCC agrees that the key objective of CCP recovery and resolution planning must be the continuity of payment, clearance and settlement services and other essential CCP functions for the participants and markets served by the CCP. This goal implies a number of important considerations, including:

- Ensuring that steps taken for recovery and resolution do not interrupt the continued availability of liquidity;
- Relying, wherever possible, on the FMI's pre-existing loss allocation and risk management practices;
- Those CCPs should retain primary responsibility to design and apply the rules for their individual recovery and, in consultation with their primary regulators and resolution authority, to identify the most appropriate triggers for resolution, based on an analysis of potential stress scenarios. Allocating this task principally to the CCPs to develop and apply these individualized rules is particularly important, and appropriate, (i) given the diversity that exists among CCPs in their ownership, governance, loss allocation processes, and exposure to credit and other risks, and (ii) where the resolution authority is separate and independent from the CCP's supervisory and/or prudential authority, and thus does not have day-to-day experience or insight into the functioning and operations of the CCP.
- Given this diversity, and the fact that participants' own credit and risk management planning is premised on the CCP's loss allocation and other rules, continuity of CCP operations can most effectively be maintained through continued application of those rules. Application of the CCP's rules, where practicable, thus will facilitate continued operations because it conforms to participant and market expectations, and promotes sustained utilization of the CCP.
- Finally, it is important to distinguish between normal application of a CCP's loss allocation and recovery processes, and a need for intervention by governmental resolution or regulatory authorities.

² See Key Attributes, Appendix II (Sector-specific Guidance) Annex 1: Resolution of Financial Market Infrastructures (FMIs) and FMI Participants.

The highly unlikely nature of a resolution event also mandates that regulators apply a careful risk reward analysis when deciding appropriate funding and replenishment approaches for CCP resolution frameworks. That is, the benefits of prefunding must be realistically assessed against the limited likelihood of its use and the burden of requiring participants to prefund such amounts. This is not the best use of participant capital and may make CCP services too expensive for smaller participants. This may result in further concentration of CCP membership, which increases the potential for systemic risk.

Timing and Factors for Entry into Resolution

For the reasons outlined above, CCP recovery must be permitted, and encouraged, to run its course, so long as recovery remains viable. Resolution authorities should not pre-emptively intervene and trigger a resolution.

- This argues for a general trigger being the point of non-viability.

DTCC believes that qualitative indicators are most appropriate for determining when to resolve CCPs. As we note, the diversity of CCPs and the variety of risk management techniques they use given the assets they clear and markets they serve, make it difficult to identify a useful and generally applicable quantitative indicator of non-viability. On the other hand, we recognize the value of setting a clear legal standard for predictable and reasonable application by resolution authorities. Qualitative indicators of non-viability similar to those utilized in other statutory resolution regimes to provide for entry into resolution, such as the inability to meet current obligations or transact current business, or the inability to return to a matched (flat) book, may be most appropriate. The key consideration remains the likelihood of whether the CCP can successfully effectuate its recovery plan and continue to fulfill its normal functioning for participants.

Decisions surrounding the timing of entry into resolution should take into account the market structure of the relevant jurisdiction. Furthermore, where the resolution authority is not the CCP's supervisory authority, the resolution authority must consult with the supervisory authority before taking any resolution action. As noted above, CCPs, working closely with their supervisory authority and the resolution authority, should help identify the appropriate triggers.

- Given that preference, resolution authorities and resolution regimes should not be overly prescriptive as to the timing of entry into resolution.

There needs to be practical recognition that resolution authorities, like CCPs themselves, need some flexibility so as to be able to effectively deal with situations which, by definition, go beyond extreme but plausible circumstances. They need to be able to act to contain systemic events and prevent contagion. The timing of entry into resolution will also be dependent on the nature of the stress scenario, and the message that entry into resolution sends to the marketplace: How, for example, would resolution impact the functioning of the relevant market and affect the ability of critical functions to reliably continue? How would this impact the availability of liquidity, a key driver of the CCP's ability to continue to function?

The resolution authority should also have the ability to take participant behavior into account when deciding the point in time when to invoke its resolution powers. That is, resolution plans or triggers should not inadvertently create incentives for participants to undermine the CCP's

efforts to effectively recover from a stress event. Providing the resolution authority with flexibility to account for behaviors would have the effect of incentivizing member participation in recovery measures such as auctions and/or the timely payment of participant assessments.

- So, while CCP participants desire maximum certainty and transparency, the FSB guidance, for the above reasons, needs to balance that desire with a proper alignment of incentives and a reasonable need for flexibility.
- Concomitantly, while this argues for a measure of discretion, we believe that resolution authorities should be able--and required--to clearly articulate the reasons for the actions they take, once they decide upon a course of action.

Tools Available to the Resolution Authorities

DTCC believes that resolution authorities should have available at their disposal a broad tool box of general resolution powers designed to preserve clearing and settlement functions while avoiding taxpayer losses, along with flexibility to exercise one or more of such resolution powers according to the demands of the particular situation and what the CCP's ex ante rules provide. DTCC believes that no tools should be prohibited, but their usage should be used subject to appropriate safeguards or conditions.

- DTCC believes it is important for any FSB guidance to avoid implicitly or explicitly endorsing any one loss allocation rule as the "gold standard" or adopting a de facto one-size-fits-all approach to loss allocation rules. Similarly, we do not believe that any specific tool should be prohibited.

As DTCC has noted elsewhere,³ where the use of variation margin gains haircutting ("VMGH") is discussed as the "preferred" recovery/resolution tool when default fund resources are exhausted, this is not appropriate for those CCPs that do not pass through variation margin to their participants, or otherwise for those CCPs that are not closed systems and where a "participant might have an equal (or larger) opposite position outside the CCP that it is hedging," such that "variation margin haircutting does not necessarily allocate losses to those who are best able to cope with them."⁴ In this case, we believe that cash assessments or calls may, in certain circumstances, be an appropriate recovery tool that should be available to CCPs and also available to resolution authorities.

- Any determination as to whether one or more loss allocation tools is inappropriate for a CCP in the context of resolution should be made by the resolution authority, in consultation with the CCP and its supervisory authority, and should take into account the unique market and regulatory environment in which the CCP operates. As previously noted, the resolution authority should, to the extent practicable, continue to apply the tools provided in the CCP's own loss allocation rules.

³ See DTCC's June 2015 White Paper, *CCP Resiliency and Resources* (the "DTCC White Paper"), available at www.dtcc.com, and DTCC's letter to CPMI-IOSCO responding to the 2013 Consultative Report, *Recovery of financial market infrastructures* (October 2013), available at www.bis.org (the "DTCC Letter").

⁴ See the DTCC Letter, citing the 2013 Consultative Report at §3.5.18.

We also believe that no tools (whether VMGH, partial tear-ups, cash calls or otherwise) should be reserved solely for resolution authorities that could not also be used by CCPs themselves, if they are appropriately included ex ante in CCP rulebooks.⁵

Being overly prescriptive in the interests of predictability may unnecessarily restrict CCPs and Resolution Authorities in being able to nimbly address a situation which by its nature is unprecedented.

Allocation of Losses in Resolution

Given the view that a CCP's waterfall tools should be exhausted before entry into resolution, where the resolution authority has determined it necessary from a systemic risk perspective to step in prior to that point, it should have the power to, and should to the extent practicable, follow and enforce the CCP's ex ante loss allocation waterfall.

- Subject to appropriate safeguards, resolution authorities should have broad power to allocate losses, including but not limited to, the ability to:
 - enforce participant obligations to meet cash calls or default fund top ups;
 - haircut gains to by the CCP to participants (for example, by VMGH);
 - write down or bail-in equity or unsecured debt in a manner that respects the insolvency claims hierarchy (but does not disincentivize or interfere with the provision of credit or liquidity to the CCP);
 - do contract tear-ups; and
 - where permitted within the legal and regulatory framework and rules of the CCP, write down initial margin of participants where IM is not held in a bankruptcy-remote manner.

Effectively, this provides the resolution authority with maximum optionality, subject to appropriate conditions and safeguards, a view we support.

These same principles should apply to both default and non-default scenarios. That is, resolution authorities should follow, to the extent practicable, the CCP's ex ante rules, and should also be able to take into account factors such as the CCP's ownership structure and applicable marketplace standards relevant to the type of loss at issue, when selecting or applying tools to allocate such losses.

- Resolution authorities should be transparent in articulating reasons for the choices they make. And, as noted above, their decisions should be made in consultation with the CCP's national supervisors.

⁵ In this context, it is important to distinguish between statutory resolution *powers* typically provided to resolution authorities to facilitate orderly resolution, such as the ability to impose a short-term stay, implement a bridge-bank transfer, step in as conservator, etc, from the specific *tools* that may be applied to allocate losses among a CCP's participants and other creditors. We agree that resolution authorities should have sufficient flexible powers to effectuate a resolution in the most efficient, timely, and least systemic, means practicable. As to the selection of loss allocation tools, however, we believe resolution authorities should take their cue from the CCP and its national supervisor, who will be most familiar with the design and operations of the relevant CCP.

Should additional prefunded resolution resources be required?

Among the questions asked by the FSB is whether CCPs should 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. We understand this to mean whether prefunded resources to cover extreme tail events (by definition implausible scenarios) should be required.

DTCC does not support full pre-funding of cash assessment rights or resolution resources. Unlike banks, CCPs are more monoline businesses and have predefined and predictable loss mutualization. Requiring them to hold substantial prefunded cash resources risks making CCP's de-facto investment companies which, in and of itself, would introduce a whole new set of risks. Moreover, we do not believe this is the best use of industry resources, and could serve to further concentrate CCP membership (and also have implications for the amount of capital that participants themselves must hold).

DTCC believes that any benefits that could result from prefunding a CCP's capital and loss absorption resources must be realistically assessed against the limited chances such resources would ever be needed and the burden that this type of prefunding would place on CCPs' diverse memberships. For example, NSCC's and FICC's memberships include many small broker-dealers who have already contributed significantly to the CCPs' loss absorption resources in form of capital (at the DTCC level) and default (Clearing Fund) resources. These firms offer valuable services for their clients, and this diversity of firm membership reduces concentration risk for NSCC and FICC.

Although we do not support prefunding loss absorption resources, we believe that a balanced approach to recapitalization, combining a combination of committed or prefunded operating capital with default fund contributions from continuing clearing members at the time would, in a resolution event, effectively support a prompt resumption of critical clearing services. Committed capital could be in the form of shareholder commitments to replenish depleted capital resources, appropriately designed insurance funding, or other types of reasonably reliable committed resources. DTCC believes that such an approach would be most appropriate for our CCPs in light of our utility ownership model and the markets and diverse memberships that NSCC and FICC serve.

Cross-border Cooperation and Transparency

With respect to the issue of cross-border cooperation and the establishment of crisis management groups, DTCC is supportive of detailed and thorough regulatory cooperation both among different domestic regulators, as well as among regulators in different countries for resolution planning and execution. However, we are mindful of the challenges of coordinating responses of multiple regulatory authorities, and are wary of any delegation of a CCP's resolution away from its local regulator. As a result, DTCC supports ensuring that principal resolution responsibility remains with the home country resolution authority, acting in close consultation with the CCP's home supervisory and prudential regulators, because this ensures that collectively, the regulators with the best information about that CCP retain this crucial responsibility and can act efficiently and timely.

With respect to transparency, and what CCPs and resolution authorities should provide either to the public, or in a more circumscribed manner to the CCP's participants, we believe it may be appropriate for CCPs to disclose their general approach or framework for resolution, including their ex-ante rules regarding recovery tools, and for resolution authorities to disclose generally the types of tools they would have at their disposal. However, as we have said throughout, both will need to encompass a measure of discretion and flexibility to deal with unprecedented scenarios. Accordingly, we do not see a benefit in a granular level of prescriptive disclosure that may, in the actual event, prove inapplicable or potentially destabilizing.

Pari Passu Treatment and No Creditor Worse Off

Among the questions the Discussion Note poses is to what extent a resolution authority should be permitted to deviate from the principle of pari passu treatment of creditors within the same class, notably different clearing members, in resolution, and what would the implications be of such deviation from the fixed order provided in the CCP's rules. In a separate question the Discussion Note also seeks information about what the appropriate "No Creditor Worse Off" counterfactual scenario is. These two questions are closely intertwined.

We presume the first question stems largely from the concern about the need for flexibility to fashion an approach where the use of the CCP's waterfall tools or allocation priority has not been sufficient to result in a successful recovery (or not without significant systemic or contagion impact), or that such flexibility may be needed to provide necessary incentives, where appropriate, for participants to fully and in good faith participate in the recovery process.

DTCC believes that, to operate efficiently, the market needs to understand in advance how losses will be allocated among clearing members in the event of the resolution of a CCP. As it the case during business as usual, in a CCP resolution, risks should be mutualized among participants in a predictable and pre-agreed manner. Accordingly, DTCC believes that, in connection with resolution of a CCP, resolution authorities should honor the ex ante provisions of CCP rules regarding how losses will be allocated to the maximum extent practicable. We recognize that CCPs themselves may include provisions in their rules designed to incentivize constructive participant behavior (for example, by seniorizing certain parts of the waterfall).

An ad hoc exercise of regulatory discretion to alter the priority rules could interfere with market expectations and inappropriately favor some market participants over others. Market participants would likely challenge such actions as being arbitrary and capricious, especially in the absence of clear legislative authority. On the other hand, if the resolution authority were to alter pari passu treatment in a manner inconsistent with the CCP's rules, such action would likely result in claims or treatment contrary to NCWO treatment. In the case of DTCC's CCPs, the proper NCWO counterfactual would be liquidation under the US Bankruptcy Code, with creditors sharing any recoveries under the Code's absolute priority rule. Nevertheless, we understand that there could be a circumstance where, for practical systemic reasons, such deviation may be warranted. In such case, however, the resolution authority should only take the proposed action upon agreement with the CCP's home supervisory and prudential regulators.

As regards the treatment of equity in CCP resolution scenarios, DTCC believes that the, to the extent not already addressed by ex-ante rules, this can be adequately dealt with through the normal rules and standards for corporate liability and insolvency. Here too, it is

important to consider how the insolvency rules would affect the operational continuity of CCPs with a variety of types of ownership and governance structures. For example, losses assessed against 'owners' may have a different effect on a CCP owned by its participants (such as the DTCC CCPs) compared to a CCP owned as a public stock company. In the former ownership structure, members will be absorbing losses in their roles as participants as well as in their roles as owners, and this may affect their willingness and ability to carry on as part of the CCP and, by extension, the resiliency of the CCP. For these reasons we do not suggest that the FSB include any mandatory provisions requiring the provision of equity to CCP participants.

* * *

We appreciate this opportunity to respond to the issues raised in the Discussion Note and your consideration of the views expressed in this letter. Many of these matters are complex, and we welcome the opportunity to discuss the Discussion Note and our comments. If you have any questions or need further information, please contact me at ltompson@dtcc.com.

Sincerely,

A handwritten signature in cursive script that reads "Larry E. Thompson".

Larry E. Thompson