

**Financial Stability Board  
Bank for International Settlements  
Centralbahnplatz 2  
Basel  
CH-4002  
Switzerland**

Via email: [fsb@fbs.org](mailto:fsb@fbs.org)

17 October 2016

Dear Sir/Madam,

**Response to FSB Discussion Note: *Essential Aspects of CCP Resolution Planning***

The Alternative Investment Association Limited<sup>1</sup> (**AIMA**) welcomes the opportunity to submit its comments on the Financial Stability Board's (**FSB**) consultative Discussion Note on *Essential Aspects of CCP Resolution Planning (the Discussion Note)*. Our members are substantial users of central counterparty (**CCP**) clearing services for both exchange-traded and cleared over-the-counter (**OTC**) derivative contracts, and their demand for such services will increase over the coming years, as the respective G20 jurisdictions mandatory clearing initiatives take effect. As significant users of CCPs, our members are exposed to the risk of losing their positions and posted collateral if a CCP fails, even though our members are indirect CCP participants, who access a CCP as a client of a clearing member.<sup>2</sup>

Overall, we support the development of further guidance on robust measures and a consistent underlying framework, seeking to avoid the failure of any systemically important financial market infrastructure (**SIFMI**) in the first instance and, should failure nonetheless occur, to enable the orderly, fair and transparent resolution of such SIFMI without recourse to taxpayer funding through the implementation of a proportionate resolution plan.

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<sup>1</sup> AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,700 corporate members in over 50 countries. AIMA works closely with its members to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes, and sound practice guides. Providing an extensive global network for its members, AIMA's primary membership is drawn from the alternative investment industry whose managers pursue a wide range of sophisticated asset management strategies. AIMA's manager members collectively manage more than \$1.5 trillion in assets.

<sup>2</sup> In this letter, we use the term 'clients' to mean the buy-side participants that undertake a contractual relationship with a clearing member that enables the relevant buy-side participant to clear derivative contracts indirectly with the relevant CCP.

Fundamentally, the most effective regulatory framework to address the prospect of CCP failure is one that focuses on preventing CCP failure *ex ante*. Existing financial resource requirements,<sup>3</sup> risk management rules and default rules and procedures for CCPs<sup>4</sup> are designed to achieve a viable financial structure and a confidence buffer so that participants know that the CCPs they use will honour their contracts and repay their collateral. However, as no set of rules ensures the absolute safety and soundness of CCPs, there remains a residual risk, however remote, that a CCP failure will occur and that the results could be extremely damaging.

We, nonetheless, stress that any resolution regime stepping in at the point at which a CCP's internal resources are exhausted must allocate losses in a fair and predictable manner in order to prevent disproportionate burdens from being placed on certain categories of clearing participants, particularly indirect participants. As clients of clearing members, AIMA members require robust protection of their assets. We are, thus, extremely concerned about the possibility of a resolution authority using client initial margin (**IM**) as a potential loss allocation tool during a CCP resolution to cure a direct participant's default. Use of non-defaulting clients' IM assets should not form part of any resolution regime.

Overall, we agree that there needs to be a level of flexibility built into the regime to manage the recovery and resolution of CCPs, to accommodate the specificities of individual CCPs and the different circumstances which may trigger recovery and/or resolution. However, we believe there should be a strong underlying framework to ensure there remains a level of consistency and predictability for direct and indirect participants, coupled with close supervision by supervisory authorities during recovery, and active oversight by resolution authorities throughout a resolution process.

We respond, below, to certain aspects of the Discussion Note. Our response is based on AIMA's established policy principles with regard to the development and implementation of rules to deal with failing and failed CCPs, as follows:<sup>5</sup>

1. Clear and concise distinction between recovery and resolution - recovery using internal resources to return CCP to financial health, resolution to immediately wind-down and liquidate a failed CCP;
2. Client margin never haircut during recovery stage – losses in recovery to be allocated to stakeholders obtaining benefit from the CCP's financial success, not customers;
3. Losses allocated during resolution subject to the no-creditor-worse-off-than-in-ordinary-insolvency proceedings principle – any losses incurred by participants, including clients, upon the liquidation of the CCP should not be worse than ordinary insolvency. Client IM should be off-limits at all times;
4. Maximum transparency into the CCP's financial health for all participants – regular updates as to the financial health of a CCP implementing its recovery tools for both direct and indirect clients;

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<sup>3</sup> Such financial resources include, among others, margin, the CCP's own capital, guaranty fund deposits, and assessment powers. See e.g., Articles 16, 41, 42 and 43 of EMIR and Article 35 of Commission Delegated Regulation (EU) No 153/2013 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on requirements for central counterparties (Commission Delegated Regulation), available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0041:0074:EN:PDF>.

<sup>4</sup> See e.g., Chapter III of EMIR, and Chapter IV of CFTC Final Rule on Derivatives Clearing Organisation General Provisions and Core Principles, available: <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-27536a.pdf>.

<sup>5</sup> For further discussion, please see AIMA White Paper: CCP Recovery and Resolution (April 2015), available: [https://www.aima.org/objects\\_store/white\\_paper\\_on\\_ccp\\_recovery\\_and\\_resolution\\_-\\_april\\_2015.pdf](https://www.aima.org/objects_store/white_paper_on_ccp_recovery_and_resolution_-_april_2015.pdf).



5. Emergency governmental liquidity tool – states should have a last resort option to intervene to sustain the critical functions of a failed CCP in exchange for a 100% ownership stake.

If you have any questions or would like to discuss any aspect of this response in more detail, please contact Jiří Król ([jkrol@aima.org](mailto:jkrol@aima.org)) or Adele Rentsch ([arentsch@aima.org](mailto:arentsch@aima.org)).

Yours sincerely,

A handwritten signature in blue ink, appearing to read "J. Król", is positioned below the text "Yours sincerely,".

**Jiří Król**  
**Deputy Chief Executive Officer**  
**Global Head of Government Affairs**

## **ANNEX 1**

### **Objectives of CCP resolution**

Overall, we are concerned that the overwhelming focus of resolution initiatives remains on returning a CCP to financial health, even when the CCP is viewed by the relevant authorities as non-viable. We note the FSB guidance contained within section 1.1 suggests that 'An effective CCP resolution should have as its objectives the pursuit of financial stability and the continuity of critical functions... achieved either by restoring the ability of the CCP to continue to perform those functions as a going concern or ensuring continued performance of those functions by another entity or arrangement coupled with the orderly wind-down of the CCP in resolution.' We are of the view that, whenever the relevant supervisory and prudential authorities determine that the criteria for entering a CCP into resolution have been met, the relevant authorities should seek to liquidate the CCP in a swift and orderly manner that ensures that clients have immediate access to their collateral held by the failed CCP. A prompt and orderly liquidation may be preferable from the client perspective because it would allow them to close-out their open positions, access their funds, and enter new positions cleared with an alternative CCP. We, therefore, respectfully suggest that the FSB revise the position under section 1.1 to provide that resolution authorities, wherever achievable, focus on a prompt and efficient liquidation of the failed CCP, with the immediate return of clients' assets held at the CCP.

AIMA stresses the need to avoid a protracted resolution process that would attempt to artificially preserve the functioning of a CCP whilst placing costs of this preservation solely upon the CCP's participants. We consider that this would be ineffective and could in fact exacerbate contagion. Nonetheless, if the preservation of a failed CCP's functions is considered in the public interest – for example, upon the occurrence of truly exceptional tail-risk events – we consider that emergency financial support should be made available by the government to that failed CCP to preserve its critical functions. In return for which, AIMA proposes that the government should acquire 100% of that CCP's equity. The government would then be able to exert full control over the CCP and recoup its financial support through future profits of the CCP or the eventual divestiture of its stake.

AIMA would also stress our belief that traditional tools used for bank resolution would not work in the context of CCP recovery. The highly concentrated and specialised nature of CCP activities means, for example, that a third party transferee is unlikely to be found for a failed CCP sufficiently quickly to make a sale of business tool an effective short term solution. Similarly, it is unlikely that public control applied through a bridge institution would add any value to the resolution of a CCP unless emergency government liquidity were to be provided for the service lines of the CCP managed by the bridge institution. Furthermore, in our view, in the case of non-default failings, it would be necessary to consider the root cause of the failings to avoid them being repeated if critical functions are to be maintained or transferred. However, the time that such reviews and functions transfers would take is only likely to exacerbate instability when, from the perspective of clients, they would be in no different financial position and would obtain legal certainty benefits from the immediate winding-up and liquidation of the CCP with the return of any residual margin.

### **Incentive effects of resolution strategies**

In our view, it is important to be mindful of the impacts of resolution strategies on incentives, not only to support recovery, but to continue voluntary participation by clients with a CCP under financial stress. We consider transparency is a key factor in maximising voluntary participation by clients for as long as possible during a period of financial distress and encouraging a swift return of those clients that ceased

participating upon signs of the CCP's recovery. In this regard, AIMA suggests that CCP participants must be provided with information sufficient that they can be confident that: (i) the CCP will continue to operate normally so that delays or other inconveniences are not experienced; and (ii) their variation margin (**VM**) gains will not be at risk of an arbitrary haircut. We, therefore, strongly recommend that regular detailed and reliable information is given to CCP participants as to the financial health of the CCP to which they are exposed in order for the recovery initiatives to be given the greatest chance of proving successful.

In assessing incentive effects, we would also note that there are different ownership structures across CCPs and that this will need to be factored into any exercise of assessing non-default loss allocation and the corresponding alignment of incentives across key stakeholders, including owners and managers. Resolution strategies designed to incentivise shareholders may need to be assessed differently for a publicly listed CCP as compared with a private manager/owner-run CCP.

### **Timing of entry into resolution**

Once a CCP has exhausted its internal resources, such that external resources would be required for the CCP to continue to function - such as government capital or client VM - AIMA members would view that CCP as non-viable. In such situations, we would propose that the CCP should be wound down and liquidated as per a clear resolution plan. As mentioned previously in this response, we would recommend against resolution taking the form of a protracted artificial process that attempts to preserve the functioning of a CCP and/or return it to viability whilst placing any resulting costs solely upon the CCP's participants. We consider that this would be ineffective and could in fact prove counterproductive by causing greater disruption and uncertainty than simply winding the CCP down.

AIMA supports the proposition raised by the FSB that resolution authorities have the power and practical arrangements to intervene during the recovery phase to place a CCP into resolution. However, we would stress that the introduction of an 'early intervention' framework should not unnecessarily blur the distinction between recovery and resolution, and should only take the form of fast-tracking entry into resolution due to clear shortcomings in the recovery process of a CCP which means that entry into resolution is the only likely outcome of the period of financial stress.

### **Adequacy of financial resources in resolution**

AIMA notes that it is impossible and economically unrealistic for a CCP to maintain sufficient pre-funded resources to enable it to withstand every tail-risk eventuality. A balance must be reached between the: (i) the likelihood of extreme tail-risk events that could threaten the viability of a CCP notwithstanding compliance with EMIR prudential rules; (ii) the systemic costs associated with the disorderly failure of a CCP bearing in mind the level of uncovered losses that would likely result; and (iii) the additional costs of clearing associated with such extra buffers to prevent the disorderly failure of the CCP.

As a general concept, we agree it is important that the CCP itself is exposed to the loss of its own funds as part of the default waterfall so that its interests are harmonised to the greatest degree with the interests of its participants to avoid default. It is also important that CCPs accept a high level of responsibility for non-default losses, reflecting that, as with any profit-making business, losses should be focused on those owners and other stakeholders that obtain the benefits of the CCP's financial success i.e., its shareholders and CMS.

As a separate measure for consideration, AIMA also broadly supports the principle of obliging CCPs to issue a minimum quantum of bail-inable instruments as a 'recovery' tool to complement the EMIR default

waterfall with additional internal resources. In our view, such ‘skin-in-the-game’ has important benefits both by providing an additional layer of capital protection and ensuring that CCPs have a significant mutual interest with their participants of ensuring robust risk management.

With regard to potential reliance on other external resources, AIMA would accept that it should remain the prerogative of a State - in the same way as is envisaged under the EU BRRD – to provide emergency financial support to a CCP so as to preserve its functioning and/or return it to viability if the latter is likely to be effective and in the public interest. Exceptional situations could exist, for example, where truly extreme and unforeseeable events have exhausted the CCP’s internal capital and only a small top-up is needed to tide the CCP over. In many cases the cost of this extra capital could well be less than the likely economic cost of the CCP’s failure.

We recognise that the moral hazard arguments we raise against artificial preservation using external resources in recovery and resolution also apply to an emergency public funding tool and so believe that the outcome for the existing owners and managers upon the application of the tool should reflect the fact that the CCP has failed as business. In return for public funding of a CCP in resolution, whatever the amount, AIMA proposes that the relevant government acquires a 100% ownership stake in that CCP such that it becomes a state owned enterprise. We suggest that the government could then seek to recover its financial support through the future revenues of the CCP and its eventual divestment to alternative private sector buyers.

With regard to additional funding structures from other entities, we would encourage regulators to ensure that the impact does not disproportionately fall on clients or indirectly raise the costs of clearing such that it may become economically unviable. In particular, while we accept that resolution authorities must allocate losses more broadly once available CCP resources are exceeded, in our view, haircutting net gains of participants on a particular day is both unfair and unpredictable. Specifically, net VM haircutting allocates losses disproportionately to participants with directional positions, which are more likely to be buy-side participants (as opposed to market makers, dealers and other sell-side participants). Dealers and market makers generally maintain a risk-neutral book at the CCP. Many buy-side participants, however, are more likely to have a directional portfolio at the CCP, either because they are taking an outright view on the direction of certain products or markets, and or are using their positions at the CCP to hedge other positions not cleared with that CCP. Other participants may not be subject to directional exposure voluntarily either. For example, a physical producer of commodities may make one directional trade at a CCP to hedge its future commodity production. We are therefore of the view that VM haircutting should be avoided other than as a last resort in resolution.

### **Allocation of losses in resolution and non-default losses**

We strongly object to IM haircutting in any CCP resolution. Many jurisdictions’ legislative and regulatory frameworks prohibit the use of a client’s posted IM to cover obligations other than those resulting from that client’s own default. In the U.S., for example, such use of a non-defaulting client’s IM is contrary to U.S. bankruptcy law,<sup>6</sup> Dodd-Frank<sup>7</sup> and related rules of the U.S. Commodity Futures Trading Commission

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<sup>6</sup> See U.S. Bankruptcy Code, 7 U.S.C. §741-753 and §761-766.

<sup>7</sup> See Sections 724 and 763 of Dodd-Frank.

(CFTC),<sup>8</sup> and we expect the rules of the U.S. Securities and Exchange Commission (SEC)<sup>9</sup> to prohibit it as well. In short, we do not believe IM haircutting presents a legally viable option as a CCP resolution tool.<sup>10</sup> Clearing participants have also made it clear that, in practice, IM haircutting is not suitable as it will result in procyclicality and contagion as participants will be required to replenish it during periods of financial stress.

Again, we stress that any resolution regime must allocate losses in a fair and predictable manner in order to prevent disproportionate burdens from being placed on certain categories of clearing participants, particularly indirect participants. As clients of clearing members, our members require robust protection of their assets. We are, thus, extremely concerned about the possibility of a resolution authority using client assets as a potential loss allocation tool during a CCP resolution in the form of VM haircutting to cure a direct participant's default. Use of non-defaulting client assets should not form part of any resolution regime. If such use is permitted, it must only be as a last resort.

On a related point, the fact that clients will be impacted by CCP failure, may bear losses through loss allocation, including being subject to VM gains haircuts as a loss allocation tool, underscores the need for buy-side participants to have affirmative and meaningful representation on CCP governing bodies (in particular, CCP Boards, Risk Committees and Default Management Committees). Clients represent a substantial portion of the trading volume of each class of OTC derivatives. Clients are important stakeholders and should have their views reflected in the critical decisions of these bodies, including in developing and implementing recovery and resolution plans. Measures that require client representation will foster transparency and confidence in CCPs and greater parity in their governance structure. Such parity in CCP governance is essential for the fair and predictable deployment of CCP recovery tools to address uncovered losses, and will lead to higher levels of trust and confidence between CCPs and clients.

With regard to losses arising from non-CM default events, such as operational failings or investment losses, recourse of the CCP to resolution assets should be limited to the CCP's own resources, and not to the margin posted by CMs or the default fund. This also aligns with prudential rules for capital, CM margining and default funds under Chapter III of EMIR, which are designed to mitigate risks posed by CMs to the CCP.

Overall, we believe the approach to loss allocation tools should be established as a general framework in the legislation, to ensure a level of consistency and certainty for participants, and protection of key safeguards including the no-creditor-worse-off-than-insolvency principle. We accept that there will need to be a degree of flexibility both in terms of how loss allocation tools are implemented through a CCP's resolution plans, and how the tools are applied in an actual recovery or resolution scenario – to account for the size and breadth of services of the CCP; the specifics of the scenario triggering financial stress; and the overall financial stability of the market at the time.

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<sup>8</sup> See CFTC final rules on Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. 6336, (February 7, 2012), available at: <http://www.gpo.gov/fdsys/pkg/FR-2012-02-07/pdf/2012-1033.pdf>.

<sup>9</sup> See SEC proposed rules on Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. 70214 (November 23, 2012), available at: <http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf>.

<sup>10</sup> We also understand that broad responses to regulators that have consulted on the application of bail-in to client IM have led to the adoption of a clear policy position excluding client IM from such loss allocation.

### **Tools to return to a matched book**

In our view, tools applied for the purposes of returning a CCP to a matched book are relevant during the recovery process, but in resolution, the focus should change to the immediate winding down and liquidation of the CCP. In any event, it is AIMA's view that clients should be able to participate in auctions to the same extent as dealers and other sell-side market participants, particularly in light of the importance of clients to the continued functioning of the market in a CCP resolution scenario. This would maximise participation in CCP auctions of the unmatched positions of defaulted CMs and the likelihood that these unmatched positions obtain new counterparties. Moreover, increasing the number of buyers in an auction by permitting clients to participate would increase competition and likely result in higher auction bids and sales. We suggest that CCP's could include pre-determined criteria for participation in auctions in their recovery and resolution plans to ensure clients take any necessary steps in advance to ensure they are eligible to participate as and when it becomes necessary to auction unmatched positions.

### **Cooperation between resolution authorities**

In our view, the cooperation between the supervisory and resolution authorities of each CCP and their CMs is of paramount priority for the effective functioning of any EU harmonised measure on CCP recovery and resolution. AIMA would recommend that relevant supervisors must reach a consensus on the resolution procedure for particular CCPs to enable their fast and efficient liquidation as part of resolution. It is also highly important for cooperation should the home Member State of a CCP wish to provide extraordinary public liquidity support to maintain its operation in the public interest.

### **Suspension of clearing mandates**

AIMA considers that, upon the entry into resolution of a CCP which clears a contract that is subject to the clearing obligation in that jurisdiction, and no alternative CCP is readily available to clear that mandatorily clearable contract, it is important that the clearing obligation for that contract is suspended by the relevant authority. In such situations we believe that market participants should be permitted to return to bilateral trading so as to avoid exposures to counterparty credit and contagion risks.

We believe that it would be counterproductive to the G20 regulatory initiatives described above to impose a clearing obligation upon market participants when no viable CCP exists to clear them and would render the contract untradeable, exacerbating market distortions. Of course, once an alternative CCP has been found or the emergency public support tool is used to maintain the functions of a CCP in resolution, we appreciate that the clearing obligation should be reintroduced as soon as possible.