



**THE FOUNDATION
FOR SECURE
MARKETS**

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VIA ELECTRONIC SUBMISSION

Secretariat to the Financial Stability Board

Bank for International Settlements

Centralbahnplatz 2

CH-4002 Basel

fsb@fsb.org

Re: *Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution* – Consultative Document

Dear Sirs/Madams:

The Options Clearing Corporation ("OCC") is pleased to provide comments on the Financial Stability Board's ("FSB's") consultative document titled [*Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution*](#) dated May 4, 2020 (the "Guidance"). OCC appreciates the FSB's focus on central counterparties ("CCPs") and believes the FSB's continued dialogue with regulators, CCPs and the industry on CCP resiliency and resolution is valuable. As a member of CCP12 and the World Federation of Exchanges ("WFE"), OCC's responses to the Guidance can be found in the letters submitted to the FSB by those organizations. In this letter, OCC offers supplemental comments and observations on some of the key issues presented by the Guidance.

About OCC

OCC, founded in 1973, is the world's largest equity derivatives clearing organization. OCC operates under the jurisdiction of both the U.S. Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"). As a registered clearing agency under SEC jurisdiction, OCC clears transactions for exchange-listed options, security futures and OTC options. As a registered derivatives clearing organization ("DCO") under CFTC jurisdiction,

OCC clears 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 (the “Dodd-Frank Act”). As a SIFMU, OCC is also subject to oversight by the Board of Governors of the Federal Reserve System. OCC operates as a market utility, owned by five exchanges, governed by a Board that includes clearing member, exchange and public directors.

Introduction

CCPs performed exceptionally well during the global financial crisis of 2008, and, in the years following the financial crisis, international policy makers expanded the prevalence of and reliance on the CCP model as a part of their efforts to support the stability of the financial system. Since 2008, international policy makers, including the FSB, the Committee on Payments and Market Infrastructures (“CPMI”) and the International Organization of Securities Commissions (“IOSCO”), have also implemented a framework of international standards for CCP resiliency, recovery, and resolution that has further strengthened CCPs and the central clearing model. This framework includes the [Principles for Financial Market Infrastructures](#) (“PFMIs”), which was published by CPMI-IOSCO in April 2012, [Key Attributes of Effective Resolution Regimes for Financial Institutions](#), which was published by the FSB on October 14, 2014, and [Guidance on Central Counterparty Resolution and Resolution Planning](#), which was published by the FSB on July 5, 2017. Many jurisdictions have incorporated these international standards into laws, rules and regulations that are tailored to the specific characteristics of their local market, legal framework and the CCPs subject to their authority. In the United States, for example, the international standards for CCPs were implemented as part of the Dodd-Frank Act and have been incorporated into the SEC’s Standards for Covered Clearing Agencies and the CFTC’s Core Principles for DCOs.

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.

As described more fully below, OCC is concerned that the Guidance is focused on a number of extreme scenarios and may not adequately reflect the importance of maintaining the incentive structure that has enabled the CCP model to achieve success. As an example, the Guidance calls for CCP equity to absorb losses first and to be fully loss absorbing. If implemented, this guidance would drastically undermine the carefully calibrated and long-standing incentive structure based on a mutualized risk model that has been a major factor in the continued success of the CCP model by encouraging market participants to manage risk and support CCP recovery.

Assessing the Adequacy of Financial Resources to Support CCP Resolution

Scenarios

The Guidance sets forth a prescriptive list of default and non-default loss (“NDL”) scenarios that the resolution authority (“RA”) should consider as a part of its resolution planning. Given that the local RA is the primary authority with respect to the design and implementation of resolution plans, we believe that the local RA, in coordination with local oversight authorities where they are different, should evaluate the framework and governance that support a CCP’s scenario program in the context of its ability to deliver its critical services. The local authorities are generally more familiar with the local market characteristics, legal framework and regulatory structure. The RA (in collaboration with the local oversight regulator, when appropriate) are, therefore, better positioned to determine the best approach to resolution planning for a particular CCP. Instead of following a one-size-fits-all approach or focusing on a prescriptive list of scenarios, the RA should review the framework that a particular CCP uses to identify loss scenarios and evaluate that process and the CCP’s overall governance related to delivering the CCPs critical services.

We are also concerned that the Guidance attempts to establish the plausibility of scenarios, which through experience we have determined to be unique to the markets and jurisdictions applicable to a given CCP. For example, the Guidance presumes that the resources and tools in the CCP’s recovery plan are not available at the time of recovery and suggests that the RA should consider losses arising from the investment of initial margin or default fund assets. In jurisdictions, like the United States, where recovery plans must have a well-founded and enforceable legal basis and CCPs are required to maintain conservative investment portfolios, the residual risks presented by these scenarios may not of the same magnitude as it is in jurisdictions that has less rigor.

The Guidance also suggests that the RA should consider a scenario in which a CCP’s shareholders do not support the recovery actions. In our utility model, OCC’s shareholders are options exchanges that rely on OCC as the sole clearing agency for listed equity options in the United States. Our options exchange shareholders benefit from the delivery of OCC’s critical services and their enterprise value is inextricably linked to OCC’s continued viability. Consequently, we believe OCC’s shareholders and the industry would support recovery in every conceivable scenario.

Finally, the Guidance implies that CCPs should have resolution resources in place for these scenarios, which is inconsistent with the current international standards set forth in the PFMLs calling for CCPs to maintain prefunded resources to address only “extreme but plausible market conditions”. We respectfully submit that working with CCPs to establish a principles-based approach to identifying and evaluating extreme but plausible market conditions would be a better approach for the Guidance than attempting to define a prescriptive inventory of presumed plausible scenarios across all jurisdictions.

Non-Default Losses

Section 1.2 of the Guidance seems to ascribe financial responsibility for all NDLs, including losses due to the failure of a custodian or settlement bank, to the CCP. The suggestion that CCPs should be responsible for guaranteeing the performance of custodian and settlement banks is an unworkable departure from the existing practice in financial markets. CCPs, like clearing members and many other market participants in the financial services industry, typically, if not uniformly, disclaim liability for the default of unrelated third parties. While CCPs are responsible

for guaranteeing the products they clear, CCPs are not a financial backstop for custodian and settlement banks, which are already subject to their own comprehensive regulatory oversight and resolution regimes. We respectfully submit that the Guidance should be revised to remove any suggestion that CCPs are responsible for the default of a third-party provider. Instead the Guidance should encourage RAs to evaluate the risks of NDLs based on a CCP's practices, rules and agreements.

Early Intervention

While OCC believes that the RA should have some flexibility in determining when to implement a CCP's resolution plan, we are concerned that certain scenarios set forth in the Guidance imply that an RA may intervene before the tools set forth in the CCP's rulebook are exhausted. In contrast, existing FSB guidance provides that a CCP should enter resolution after recovery measures have been exhausted and the CCP is unable to achieve viability and comply with applicable legal and regulatory requirements, or when financial stability is likely to be compromised.¹ The Guidance should be revised to specify that the RA should only intervene if: (i) the tools and resources defined in CCP's rulebook and recovery plan have been fully exhausted and the CCP has failed to recover; or (ii) the RA determines that 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.

CCP Structure

OCC believes that the Guidance on assessing the adequacy of CCP financial resources should be modified to allow RAs to consider a CCP's unique ownership structure and mix of products cleared in the resolution planning process. OCC is the sole clearing agency for listed equity options in the United States. As described above, OCC is organized as a market utility, owned by five exchanges and governed by a Board that includes clearing member, exchange and public directors. Over 95 percent of OCC's revenue is generated from clearing fees, and OCC manages its resources under a capital management policy that allows for certain tools to be utilized to lower fees for clearing members. For example, capital exceeding target capital requirement and needed investments may be returned to clearing members in the form of rebates or reduced fees.

Reflective of these economics, OCC has a multi-pronged approach to incorporating input from clearing members and other market participants into its governance and policy development processes. OCC's 20-person Board includes nine clearing member directors that represent a majority of the aggregated clearing fund and margin risk across all participant segments. OCC's Board-level Risk Committee includes clearing member representatives representing more than 50 percent of the aggregate margin risk along with representation from exchange and public directors. 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 unlikely 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. OCC has a unique structure and product mix and believes that the

¹ FSB, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (2014) available at https://www.fsb.org/wp-content/uploads/r_141015.pdf.

RA should take into account each CCPs individual structure and mix of products cleared in the resolution planning process.

Treatment of CCP Equity in Resolution

Role of CCP Equity

Part II of the Guidance calls for CCP equity to absorb losses first, be fully loss absorbing and to be written down by RAs. As noted above, OCC is concerned that this aspect of the Guidance may improperly alter and undermine incentives for clearing members to participate in the default management and recovery process. Clearing members play a vital role in the default management and recovery process by, *inter alia*, participating in auctions, accepting customer accounts from a defaulting clearing member and, when appropriate, providing additional resources to the CCP. The incentive structure to encourage the active participation of relevant stakeholders has been carefully designed by policy makers, regulators, CCPs and clearing members. This incentive structure has been refined and demonstrated its effectiveness, through a variety of market events and several clearing member defaults. OCC is concerned that the Guidance related to the treatment of CCP equity could alter this incentive structure, decrease the likelihood of a successful default management process, and increase the probability of a CCP entering resolution. The treatment of CCP equity may also potentially conflict with bankruptcy laws in certain jurisdiction impacting the rights of secured and unsecured creditors.

Additionally, 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 PFMI, 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.² Finally, the RA should pursue transfer to a bridge entity or liquidation only after exhausting all other options.

² OCC appreciates that the FSB continues to recognize the importance of the NCWOL safeguard and acknowledges that deviating from the requirements set forth in CCP rules could give rise to a NCWOL compensation claim for losses imposed on CCP equity. See Guidance at 17-18, n. 24. See also FSB, *Guidance on Central Counterparty Resolution and Resolution Planning* (2017) available at <https://www.fsb.org/2017/07/guidance-on-central-counterparty-resolution-and-resolution-planning-2/>.

Compensation

OCC supports compensation for market participants under the NCWOL safeguard and through the recoveries from the defaulter's estate. OCC Rules currently adhere to these principles. If a default-related loss is charged to clearing members and subsequently recovered, OCC Rules provide for the compensation of the clearing members that were charged for the loss through a reverse waterfall.

We are concerned, however, that compensating clearing members with equity or claims on future earnings has the potential to undermine the effectiveness of a CCP's recovery process. Compensating clearing members with equity or claims on future earnings disincentivises clearing members active participation in the default management process, provides a diminished incentive for clearing members to bid for the defaulted portfolio and discourages a private recapitalization of the CCP. For these reasons, OCC believes that a policy that encourages these types of compensation for clearing members would increase the likelihood of a CCP entering resolution.

Conclusion

OCC appreciates the FSB's continued efforts to maintain the stability of financial markets. We respectfully request that the FSB consider whether the Guidance is necessary given the substantial number of risk-reducing measures that have already been implemented by international policy makers, regulators and CCPs. If the FSB proceeds, it should implement a less prescriptive approach to assessing the adequacy of financial resources and eliminate any specific scenarios that are not plausible for all CCPs. Finally, it is essential that the FSB refrain from issuing any guidance related to the use of CCP equity in resolution that undermines the incentive structure that has been carefully designed to encourage clearing member participation in the default management and recovery process.

We thank the FSB for the opportunity to provide comment on the draft Guidance. We would be pleased to further discuss our comments. If you have any questions, comments, or need any further information, please do not hesitate to contact me at +1-312-322-6220, or jdavidson@theocc.com.

Sincerely,

A handwritten signature in black ink that reads "John P. Davidson III". The signature is written in a cursive, flowing style.

John P. Davidson
Chief Executive Officer
Options Clearing Corporation