INVESTMENT COMPANY INSTITUTE

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April 16, 2015

Mr. Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street N.W.
Washington, DC 20581

Re: CFTC Public Roundtable on Recovery of Derivatives Clearing Organizations

Dear Mr. Kirkpatrick:

The Investment Company Institute ("ICI")[1] appreciates the Commodity Futures Trading Commission ("CFTC" or "Commission") holding a public roundtable to discuss issues related to the recovery and orderly wind-down of derivatives clearing organizations ("DCOs") on March 19, 2015. The goal of this roundtable was to gather views from a variety of stakeholders, including DCOs, their clearing members, and the customers of their clearing members (including asset managers, end-users, and others). As significant portions of the swaps markets are being cleared through DCOs, it is critical to consider the systemic risks posed by DCOs and to plan for a recovery or an orderly wind-down in the event of a severe stress to a DCO's financial well-being. We agree with Chairman Massad's statement at the roundtable that there must be an effective overall framework for DCOs and encourage the Commission to consider whether other resources should be available to a DCO in the event of a substantial clearing member default.

At the roundtable, the first topic discussed was variation margin gains haircutting ("VMGH") as a tool for recovery of a failing DCO. VMGH is a tool through which unpaid variation margin payment obligations are reduced on a pro rata basis in the event of a DCO failure. We are writing to express our opposition to the use of VMGH by DCOs as a recovery tool because margin of non-defaulting customers of clearing members could be used to support the recovery of a DCO. We believe

[1] The Investment Company Institute (ICI) is a leading, global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's U.S. fund members manage total assets of $18.1 trillion and serve more than 90 million U.S. shareholders.

VMGH would impose unfairly the costs of recovery of DCOs on entities that did not contribute to the losses or the default and do not have the ability to manage the risks of the DCO.

We have previously expressed these concerns to the Committee on Payment and Settlement Systems ("CPSS") and the International Organization of Securities Commissions ("IOSCO") in a letter responding to their consultative report on the recovery of financial market infrastructures, including central counterparties ("CCPs").[2] A copy of that letter is attached. The letter articulates our concerns with some of the recovery tools suggested by the CPSS and IOSCO that were discussed at the Commission's roundtable and explains our reasons for opposing the use of VMGH and initial margin haircutting by CCPs. We urge the Commission to consider our concerns and rationale for opposing VMGH when it determines its next steps in this area.

If you have any questions regarding our concerns, please feel free to contact Sarah Bessin at (202) 326-5835, Jennifer Choi at (202) 326-5876, or me at (202) 326-5815.

Sincerely,

/s/ David W. Blass

David W. Blass
General Counsel

cc: The Honorable Timothy G. Massad
The Honorable Mark Wetjen
The Honorable Sharon Bowen
The Honorable J. Christopher Giancarlo

Attachment

[2] Consultative report, Recovery of financial market infrastructures, Committee on Payment and Settlement Systems and Board of the International Organization of Securities Commissions (August 2013), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD418.pdf.

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October 10, 2013

Via Electronic Mail (cpss@bis.org and fmirecovery@iosco.org)

Klaus M. Löber
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Bank for International Settlements
Centralbahnplatz2
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David Wright
Secretary General
International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid
Spain

Re: *Consultative Report on Recovery of Financial Market Infrastructures*

Dear Mr. Löber and Mr. Wright:

The Investment Company Institute ("ICI")[1] and ICI Global[2] appreciate the opportunity to provide comments on the consultative report issued by the Committee on Payment and Settlement Systems ("CPSS") and the International Organization of Securities Commissions ("IOSCO") on the

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $15.2 trillion and serve over 90 million shareholders.

[2] ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets in excess of US $1 trillion.

"recovery" of financial market infrastructures ("FMIs"), including central counterparties ("CCPs").[3] The purpose of the Consultative Report is to provide guidance on the development of recovery plans for FMIs to enable them to recover from threats to their viability and financial strength that might prevent them from continuing to provide critical services. The Consultative Report discusses the recovery planning process and tools that FMIs should consider in their recovery plans.

We have significant concerns with some of the recovery tools suggested by the CPSS and IOSCO. In particular, we oppose the use of variation margin and initial margin haircutting by CCPs as recovery tools because margin of non-defaulting indirect participants (*i.e.,* customers of clearing members) of CCPs could be used to support the recovery of a CCP. We believe these tools would impose unfairly the costs of recovery of CCPs on entities that did not contribute to the losses or the default and do not have the ability to manage the risks of the CCPs. We discuss our concerns in greater detail below.

<u>Background</u>

Our members – U.S. funds that are regulated under the Investment Company Act of 1940 ("ICA") and non-U.S. regulated funds publicly offered to investors (collectively, "Regulated Funds") – use swaps and other 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 swaps and other derivatives include, for example, hedging positions, equitizing cash that a Regulated Fund cannot immediately invest in direct equity holdings, managing a Regulated Fund's cash positions more generally, adjusting the duration of a Regulated Fund's portfolio, or managing a Regulated Fund's portfolio in accordance with the investment objectives stated in a Regulated Fund's prospectus. Accordingly, we have a strong interest in the safety and soundness of the derivatives markets, including protection of customer collateral and funds held by CCPs and their members when derivatives transactions are required to be cleared or are voluntarily cleared.

<u>Recovery Tools for FMIs</u>

The Consultative Report states that an FMI is required under international standards for FMIs published in 2012,[4] to have recovery tools that allow it to allocate fully any uncovered losses and liquidity shortfalls caused by a participant default. Two of the tools discussed by the CPSS and IOSCO

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[3] Consultative report, Recovery of financial market infrastructures, Committee on Payment and Settlement Systems and Board of the International Organization of Securities Commissions (August 2013), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD418.pdf ("Consultative Report").

[4] 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 ("PFMI").

are variation margin haircutting and initial margin haircutting by CCPs, which could be used when the financial resources of the default waterfall of the FMI are exhausted.[5]

Variation margin haircutting by CCPs contemplates the CCP 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-the money (net) positions.[6] Losses, therefore, are allocated to participants who have experienced a gain and have not contributed to a participant default. Initial margin haircutting by CCPs would require the CCP to write down initial margin provided by non-defaulting participants who then would be required to replenish the initial margin.[7]

ICI and ICI Global strongly disagree with the CPSS and IOSCO that variation margin haircutting and initial margin haircutting are appropriate tools for CCP recovery plans. We consistently have advocated for ensuring the protection of customer collateral provided by Regulated Funds and held at CCPs and their clearing members and have supported ways to improve customer protection.[8] Specifically, we have supported efforts to eliminate fellow customer risk[9] and to reduce

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[5] The CPSS and IOSCO also recommend that, to maximize the chances of a successful voluntary or auction-based approach to re-establishing a matched book of obligations, the CCP should make use of tools such as variation margin haircutting so that it has significant additional resources over and above its pre-funded default resources before it is forced to employ mandatory tools such as tear-up of contracts or forced allocation. *See Consultative Report*, *supra* note 3, Paragraph 3.9.24.

[6] The Consultative Report states that where a "CCP does not have a direct contractual relationship with indirect participants (ie clients or direct participants), the impact on such indirect participants will depend upon their contractual arrangements with their respective direct participants." *See Consultative Report*, *supra* note 3, at Paragraph 3.5.14.

[7] The CPSS and IOSCO acknowledge that in many jurisdictions the legal or regulatory frameworks protect initial margin from being used to cover obligations other than those of the particular participants.

[8] *See* Letter from Karen Barr, General Counsel, Investment Adviser Association, Karrie McMillan, General Counsel, Investment Company Institute, Timothy W. Cameron, Managing Director, and Matthew J. Nevins, Managing Director and Associate General Counsel, Asset Management Group, Securities Industry and Financial Markets Association, to Ananda Radhakrishnan, Director, Division of Clearing and Risk, Commodity Futures Trading Commission, dated June 4, 2013, *available at* http://www.ici.org/pdf/27276.pdf; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 4, 2013, *available at* http://www.ici.org/pdf/26967.pdf; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Sauntia S. Warfield, Assistant Secretary, Commodity Futures Trading Commission, dated January 14, 2013, *available at* http://www.ici.org/pdf/26872.pdf; 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; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated January 18, 2011, *available at* http://www.ici.org/pdf/24882.pdf.

[9] "Fellow customer risk" refers to the risk that the collateral of one customer will be used to compensate a CCP for market losses resulting from another customer.

opportunities for fraud and operational risk at the clearing member level and advocated for the ability of Regulated Funds to maintain excess collateral at the CCP to provide greater protection of customer collateral. After supporting all of these initiatives to enhance protection of customer funds, we are greatly dismayed at the possibility that CCPs could appropriate customer collateral they hold to cover losses unrelated to those customers. We oppose efforts to "recover" a CCP at all costs and at the expense of innocent customers that did not contribute to the losses or to a default of a clearing member. We do not believe it is appropriate to focus exclusively on the survival of a CCP and destroy the protection of collateral of indirect participants of the CCPs (such as Regulated Funds).

Moreover, these recovery tools do not provide the appropriate incentives described in the Consultative Report for owners of, and participants in, CCPs. In this regard, the recovery tools should provide incentives for (1) participants to control the amount of risk that they bring to or incur in the system; (2) participants and owners to monitor the FMI's risk-taking and management activities; and (3) surviving participants to assist the FMI in its default management process.[10] The tools of variation margin haircutting and initial margin haircutting are inconsistent with the first two incentives for Regulated Funds but, as discussed below, may provide a perverse incentive for <u>direct</u> participants.

First, Regulated Funds, which are customers of participants of a CCP (*i.e.,* indirect participants), will not be able to control the amount of risk that they bring to or incur in the system except if they decide not to clear their trades at a CCP that would use these tools.[11] As clearly recognized in the Consultative Report, "participants, in particular indirect participants, may be unable or unwilling to participate in a CCP if their initial margin is subject to loss for reasons other than their own default."[12] A system that sanctions seizure of assets of customers that did not contribute to any losses to cover losses of other customers or clearing members would run counter to the goals of G-20 commitments to promote central clearing of standardized derivatives.[13] Moreover, these tools would discourage voluntary clearing by customers such as Regulated Funds.

Second, Regulated Funds do not have the ability to monitor the CCP's risk-taking and management activities because they are indirect participants of the CCP. Indirect participants (as customers of direct participants) have no way of gauging or managing the risks of the CCP.[14]

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[10] *Id.* at Paragraph 3.3.2.

[11] *See id.* at Paragraph 3.3.13 ("certain tools may incentivise a participant's complete exit from use of the FMI if usage exposes it to risks that are considered unacceptable").

[12] *Id.* at Paragraph 3.5.24.

[13] *Id.* at Paragraph 3.3.14 ("Where participants reduce their use of an FMI, this may result in risks remaining in bilateral transactions. In the case of CCPs, this would contradict the regulatory agenda of the G20 calling for expanded use of central clearing").

[14] We recognize that some jurisdictions, for example the European Union, will require CCPs to include buy-side participants on their risk committees. We have a strong interest in ensuring adequate and diverse stakeholder

Finally, direct participants may be incentivized to support these recovery tools because these tools may result in reduced default waterfall contributions by direct participants. If CCPs are able to use variation margin haircutting and initial margin haircutting as recovery tools, the CCPs may require a smaller default waterfall amount from the direct participants.

To provide appropriate incentives, the recovery tools should allocate losses and provide for replenishment of financial resources by those who caused or contributed to the losses and those who can control the amount of risk they bring to or incur in the system (as clearing members and owners of CCPs) or have the ability to monitor or manage the CCP's risk taking and management activities. As noted by the CPSS and IOSCO, "there may be benefits to allocating losses to those who have chosen roles that are consistent with absorbing such losses."[15] In the Consultative Report, the indirect participants are being asked, however, to cover losses that they did not cause or against which they cannot mitigate. We do not see any rational reason for recommending these measures as recovery tools. The only reasons for suggesting that CCPs use the customer margin appear to be that these assets are readily available to a CCP and the non-defaulting customers have the resources to assist the CCP. For example, the CPSS and IOSCO state that, although variation margin haircutting "may concentrate the loss on a subset of participants, these participants may be in a better position to absorb the losses."[16]

We recognize that systemically important FMIs may need to plan for recovery, but we firmly disagree that recovery should come at any cost and losses should be covered by anyone who has the resources to do so. We believe these recovery tools misalign the risks among the various parties engaged with a CCP as well as the CCP. We strongly urge the CPSS and IOSCO to reconsider the appropriateness of these tools. We do not believe these tools should ever be part of a CCP's recovery plan.

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If you have any questions on our comment letter, please feel free to contact the undersigned or Sarah Bessin at 202-326-5835, Jennifer Choi at 202-326-5876, or Giles Swan at 011-44-203-009-3103.

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representation on risk committees as well as transparency as to the committee's decision-making processes to control conflicts of interest that may exist. We do not believe, however, participation on such committees would give individual indirect participants, such as Regulated Funds, the ability to monitor and manage the risks of a CCP to their satisfaction.

[15] *Id.* at Paragraph 3.3.6.

[16] *Id.* at Paragraph 3.5.17.

Sincerely,

/s/ Karrie McMillan

/s/ Dan Waters

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The Honorable Scott D. O' Malia
The Honorable Mark Wetjen

The Honorable Mary Jo White
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