BlackRock®

April 27, 2015

Mr. Robert Wasserman
Chief Counsel, Division of Clearing and Risk
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Roundtable on Recovery of Derivatives Clearing Organizations

Dear Bob:

BlackRock, Inc.[1] (together with its affiliates, "BlackRock") very much appreciated having the opportunity to share our views at the March 19th Roundtable on Recovery of Derivatives Clearing Organizations. We welcome the focus by the CFTC and other regulators on the risks and issues arising from a potential CCP failure, and we are pleased to provide this comment letter to memorialize some of our comments and thoughts on this important topic. We believe it is critical for voices other than central clearing counterparties (CCPs) and clearing members (CMs) to be heard in this debate.

BlackRock has been very supportive of the concept of central clearing for OTC derivatives, which we believe brings many benefits, including increasing transparency for regulators and market participants and eliminating many of the counterparty risks inherent in bilateral OTC transactions. However, along with generating these benefits, central clearing results in certain risks being concentrated into a handful of CCPs. We offer the following suggestions and observations to improve and strengthen central clearing of OTC derivatives:

1. **CCP Loss Absorbing Resources Are Insufficient** — The default waterfall should be strengthened by increasing the CCP's risk-based contribution to the guaranty fund and by requiring clearing member assessments to be pre-funded. Market participants need to be certain that loss absorbing resources will be available both in "peacetime" and "wartime".
2. **Increased Transparency and Consistency** — Market participants need increased transparency into the risk management practices of CCPs. As a fiduciary, BlackRock assesses the creditworthiness of the counterparties our clients face, including CCPs. We do not believe the CCPs currently provide sufficient information regarding matters such as the results of stress tests or the totality of resources available for loss absorbency in the event of a CM default. CCPs should be subject to rigorous stress testing under independently determined standards. This stress testing should be overseen by regulators with the results publicly disclosed.

[1] BlackRock is one of the world's leading asset management firms, managing approximately $ 4.78 trillion (as of March. 31, 2015) on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

3. **Broader Auction Participation** — Where an auction is necessary to neutralize a CCP's market risk position following a CM default, market participants other than CMs should be allowed to take part in the auction. Including non-CMs under well-crafted predefined rules and requirements can only improve auction results for the CCP by bringing in participation from entities with different risk appetites and capacities than the CMs.
4. **Margin of Non-Defaulting Parties is Not an Appropriate CCP Liquidity Source** — Discussions regarding use of Initial Margin as a liquidity or capital source for a failing CCP should cease as it is both prohibited under LSOC and utterly inappropriate for both swaps and futures. Further, Variation Margin payments should never be reduced to cover a shortfall in a CCP's default waterfall and so called "haircutting" should only occur in connection with the resolution of a failed or failing CCP.
5. **Recovery v. Resolution** — Recovery of a CCP at all costs should not be the only option on the table. CCPs should be allowed to fail and should have resolution plans that include public ex ante liquidation procedures to provide reasonable certainty to participants as to risk exposures. Regulators should step in to oversee the CCP's resolution process as soon as the auction has failed or is highly likely to fail.

CCP Loss Absorbing Resources Are Insufficient

The best way to ensure that a failed or failing CCP does not have a systemic impact on the financial system is to strengthen its defenses so that events, such as the default of one or more CMs, can be buffered by sufficient resources. This requires strengthening the totality of loss-absorbing resources available to a CCP – the "default waterfall" – as well as specifying the relative contributions of CCP stakeholders (the CCP and its CMs) and the order in which these resources would be expended. We understand that increasing the amount of funded loss absorbing resources brings with it additional costs for CCPs and CMs, which ultimately will likely be shared (at least in part) with all CCP participants through higher fees. However, any such incremental costs must be weighed against the benefits that greater certainty and less risk of a CCP failure would bring.

CCP Contribution to Loss Absorption

Originally CCPs were member-owned "utilities" designed to mutualize the risk of clearing by relying on the resources of their clearing participants, in particular those firms that are CMs. These resources include both the risk management capabilities of CMs, as well as financial resources in the form of contributions to the CCP guaranty fund.

Today, CCPs are often commercially-owned, for-profit independent institutions – yet they largely maintain their historical risk allocation. A CCP's mutualized guaranty fund is typically the primary line of defense against losses incurred in a CM default in excess of the defaulting member's margin and guaranty fund contribution. While some CCPs do contribute capital to their guaranty fund, CCP exposure is generally minimal and limited to the funded or dedicated amount.[2]

Given the evolution in the structure of a CCP, we believe the CCP should be required to contribute more than a minimal amount, and that the amount should be risk-based and measured by the lower of either a fixed percentage of the fund or the largest single CM contribution. We estimate that the contribution by the CCP would likely be in the range of 8% to 12% of the fund. Having more skin in the game will incentivize the CCPs to at all times have robust risk management and would align incentives between the CCP, clearing members and market participants.[3] As for-profit institutions, the CCP can issue equity, debt or a combination thereof to fund its cash/cash equivalent contribution to the guaranty fund.

It is important that the CCP contribution to loss absorbency be risk-based. The guaranty fund contribution of the CMs are risk based and aligning the CCPs contribution would better align incentives and interests. A risk-based contribution will also indirectly benefit the CCPs ability to maintain a broader and diverse clearing member group and manage concentrated exposure to a single clearing member.

Clearing Member Contribution

Currently, in addition to their guaranty fund contributions, CMs may also be called upon to contribute additional monies in the event funds are needed by a financially distressed CCP. The assessment funds typically would be called upon when all resources in the default fund are exhausted. However, the right to claim funds from a CM is not the same as holding the funds, particularly in times of severe market distress. Even in relative "peacetime" conditions, payments may not arrive as quickly as anticipated – as evidenced by what occurred with the Korean Exchange (KRX) when it took an additional 2 months beyond the initial deadline for assessment payments to be made in full. We think market participants should be concerned that in times of substantial market turmoil – "wartime" – the CCP may have significant difficulty in collecting these unfunded liabilities.

We recommend that CM assessments be pre-funded and held in escrow accounts or a special purpose trust vehicle so as to be readily available if needed as part of loss absorbency resources.

We recognize that CMs for one CCP may also be CMs for other or multiple CCPs. Guaranty fund contributions are funded by CMs, but are a charge that is borne by all CCP participants indirectly through fees charged by the CMs. Pre-funding of assessments may incrementally increase funding costs to CMs and indirectly to other participants, although prudent risk management should require that CMs already have available capital set aside to cover this potential liability. Thus, a balance must be struck between the relative size of the guaranty fund and pre-funded assessment amounts as needed to protect the CCP, and the cost of clearing. To the extent the CCP itself contributes more to the guaranty fund (which is indirectly paid for by CCP investors), the funding pressures on CMs can be

2 See, The Clearing House Report, "Central Counterparties: Recommendations to Promote Financial Stability and Resilience" (December 2012).

3 While CCPs themselves are market risk neutral, they must effectively manage credit/concentration risk of their CMs as well as operational risks of their enterprise.

mitigated, and increases in the costs of clearing contained. Given that the CCPs receive a benefit from the clearing mandate, requiring more CCP resources in order to maintain a robust clearing system and retain as many CMs as possible is a trade-off worth further discussion.

Increased Transparency and Consistency

BlackRock also believes increased transparency by CCPs – as to margin setting decisions of their risk committee, the results of stress tests, and the totality of resources available for loss absorbency in the event of default – is necessary to provide market participants sufficient information to permit independent analysis as to the risk of clearing with a particular CCP. Stress testing should be subject to independently determined standards, consistently applied across CCPs and subject to regulatory oversight, with the results publicly disclosed. As a fiduciary, we believe it is incumbent on us to regularly conduct diligence on the creditworthiness of our clients' trading counterparties. We have the ability to request information from bilateral counterparties and can refuse to trade where we are unable to secure the necessary information. However, while we are exposed to risk in a CCP default, we do not have a direct relationship with the CCP or access to the same degree of information as we do with bilateral counterparties. Absent a regulatory mandate, our experience tells us that CCPs are not going to voluntarily provide the depth and breadth of transparency into these issues that we believe market participants should receive. Increased transparency for the swaps market was a central tenant of Title VII of the Dodd–Frank Wall Street Reform and Consumer Protection Act – it would be incongruent for transparency to be mandated in so many other areas of the swaps market while leaving market participants in the dark with respect to these critical issues.

We also believe risk management practices should be harmonized across all CCPs. This will bring additional market discipline to CCPs. However, for such harmonization to be meaningful, it would require that clearing for a particular class of swaps only be mandated when at least two CCPs provide this service.

In addition we recommend that regulators establish harmonized risk capital standards across CCPs. CCP resolution plans should include ex ante liquidation procedures to minimize losses and provide reasonable certainty to participants as to their risk exposure. Resolution plans should also be periodically reviewed and updated to assure that the plan takes into account changes (if any) in relevant insolvency regimes and current market practices to minimize operational risk in resolution implementation.

Broader Auction Participation

CCP failures will most likely arise where a CCP is unable to secure sufficient interest to cover the positions guaranteed or owned by a defaulting CM or where the cost of covering those positions would result in losses that exceed the resources available to the CCP. One way to help mitigate that risk would be to allow creditworthy market participants who are not CMs to participate in the auction process. In situations where a CM has defaulted, other CMs may be hesitant to take on additional risk and may not bid aggressively or at all. Furthermore, the Volcker rule, BASEL rules and other regulations have impacted CM balance sheets and their willingness and ability to take on such positions. Other market participants, however, may have more capacity and risk appetite and be willing to take on positions at better levels than CMs.

Some have argued that including non-CM participants in an auction process would bias the results as non-CM participants would not have the same incentives to stabilize the CCP. We don't understand this concern, as CMs would still be able to bid at whatever levels they wished. Non-CM participants would either provide improved bids and a better result for the CCP, or would provide bids at less attractive levels leaving the CMs and the CCP in the same position they would have been in without non-CM participation. If the CMs have an incentive to bid at relatively higher levels in order to stabilize the CCP, all that would mean is that non-CM participant bids would be less likely to win.

Another potential concern could be that informing persons other than CMs of the specific positons being auctioned could result in pre-auction market activities that adversely influence the auction prices. In situations where the CCP or a regulator believed such a risk exists, CM and non-CM participants could be required to accept confidentiality and trading restrictions as a condition to participation that would effectively require them to temporarily "wall off" persons with knowledge of the positions being auctioned from others in the relevant firm.

In summary, we don't see any meaningful downside to increasing participation and firmly believe expanding the participants eligible to bid in the auction process is highly likely to improve auction results. The criteria for non-CM participation in the auction process should be established and published as part of the CCP's resolution and recovery plans, which would allow both the CCPs to identify potential non-CMs for participation and non-CMs to take preparatory actions in a measured fashion rather than during the midst of a crisis.

Margin of Non-Defaulting Parties is Not an Appropriate CCP Liquidity Source

Margin of a defaulting participant (and the participant's CM) are the primary assets a CCP uses to manage losses in the event of a participant's default. A defaulting participant's variation margin (VM) and initial margin (IM) are thus first in the waterfall, and adequate and efficient margining is critical to minimizing losses to others.

Regulators and market participants are currently debating whether and from what source loss allocations should be made if existing loss absorbency resources in the CCP guaranty fund waterfall prove insufficient. The use of customer margin – usually VM but sometimes also IM – has been suggested by some as a source for recovery.

Allowing a CCP to retain a portion of a non-defaulting participant's IM – the amount a participant is *required* to post in order to transact – would fundamentally alter the market's view of cleared products. IM of a non-defaulting participant should never be at risk of loss. In our view, allowing a CCP to cover its losses using IM held by or though non-defaulting CMs would be contrary to the spirit and the letter of LSOC. While use of IM is sometimes still suggested in connection with the recovery process for CCPs doing cleared swaps, we are heartened that most stakeholders seem be concluding that IM should never be part of the cleared swap default waterfall. We note, however, that these arguments and issues apply equally to futures and we believe it would be beneficial for the CFTC to adopt explicit prohibitions on the use of IM owned by non-defaulting participants as part of a recovery plan for a DCO clearing futures products.

But suggestions are still being made around allowing VM to be tapped as a liquidity source. One point that seems to be lost at times in this debate is that the VM primarily at risk of being "haircut" is the property of the CMs' customers.[4] It is not a pot of windfall gains that happens to be sitting at the CCP on any particular day. It is funds contractually owed by the CCP to participants under the terms of a cleared product. Allowing a CCP to use a VM "haircut" to recover after all other waterfall resources are depleted will likely discourage market participants from using risk mitigating financial instruments that are subject to mandatory clearing requirements. It could potentially cause cascading defaults as participants expecting such payments to cover hedging or other costs may not be able to fund the unexpected shortfall. Most fundamentally, it is simply unfair to impose what amounts to a random tax on some or all market participants – particularly where those participants have been required by law to use a CCP's services. We do not believe CCPs – for either futures or cleared swaps – should be allowed to unilaterally impose rules taking funds from some participants in order to maintain itself.

Furthermore, some have also suggested that if one day's VM is not sufficient to cover the shortfall, VM previously paid to a participant under an open contract be clawed back. It is difficult to see how that could work in practice, but in any event such an approach would likely cause end users (at least savvy end users) to periodically realize profits from in-the-money swaps in order to reduce VM exposure to the CCP, increasing transaction costs and also reducing the size of this potential funding source.

Finally, we note that in the event VM is ever taken from non-defaulting participants by a CCP, we strongly believe such participants should receive a senior claim against the CCP and its successors for the full amount of the VM taken from them.

Recovery v. Resolution

As regulators have sought to implement the central clearing mandate globally, attention seems to be focused primarily on assuring that a CCP can be "recovered" – that continuity of its services is paramount. We do not believe that maintaining the continuity of services by any one CCP is critical to avoiding the next financial crisis. In fact, we are concerned that this approach will accelerate participants' actions to close positions if a CCP is at risk of failing. Subject to available liquidity, market participants will likely want to close out positions, have margin returned and move their business away from such a CCP rather than maintain open positions. But when a CCP is at the brink of failure, participants will likely find it difficult to exit out of positions, and in order to avoid this situation may begin unwinding positions at the early signs of CCP distress. Further, given that the CCP's business is risk management, its failure would be a failure of risk management of such

[4] If a CM engages in trading in its own name (e.g., as a hedge to a non-cleared position or as an outright position), it too could have VM at the CCP. However, as the business practice of most CMs is to try to be "flat" risk at the end of each trading day, while end-users are usually directional in their trades (e.g., hedgers are either long or short, depending on the positions being hedged), the VM held by a CCP at any particular time is predominantly that of end-users.

proportion that market participants, especially those that are fiduciaries, are unlikely to be willing to put new risk positions on through such a failed CCP attempting to recover – especially if their client's margin would be at risk.

All market participants, including CCPs, should be allowed to fail while ensuring protections are in place to avoid systemic risk and to protect end-investors. A resolution plan that focuses on a rapid and complete wind down of the failing CCP's positions, along with a timely and orderly repayment of margin monies is preferable from our point of view to a recovery plan that uses customer margin to extend the state of a failed or failing CCP. A rapid liquidation and return of margin would minimize end-user losses and would allow market participants to have optionality to re-establish positions at a viable CCP, use other instruments to hedge risk or in some cases remain unhedged if the credit exposure to CCPs is viewed as greater than the market exposure that is being hedged. In order to minimize the market impact of a failed CCP, we recommend that a product not be subject to mandatory clearing until at least two CCPs can offer clearing for that product.

By definition, the failure of a CCP reflects a flawed risk management process which in turn will impact customer confidence in the abilities of the CCP on a forward-looking basis. Some may argue that a CCP failure could be the result of unexpected adverse market-wide events, and in such a situation a CCP's failure may not be the result of a flawed risk management process. However, given the primary function of a CCP is to appropriately size initial margin, default funds and capital amounts in a manner so as to maintain sufficient recourses even in unexpectedly adverse environments, we believe such a failure, even in extreme market conditions, would likely have a significant negative impact on customer confidence in the CCP.

We would define the point of failure of a CCP as the point in time that an auction to replace the positions for which the defaulting CM was responsible has failed – which we would categorize as an auction where no bids for one or more such positions were received, or where the losses arising from accepting the best bids for the positions is likely to exceed the CCP's available loss absorbing resources. In such a situation, we think the CCP's resolution plan should be swiftly invoked by the CCP and overseen by the relevant authority.

In such a situation, BlackRock believes customers would prefer a rapid liquidation of positions to close-out the clearing business very quickly and to return margin provided by non-defaulting CMs and non-defaulting clients with minimum market loss. The resolution plan could be followed by a timely recapitalization of the CCP if authorities deem that service continuity is desirable.[5]

The view that recovery at all costs is necessary or desirable is based on three assumptions: (i) that participants would prefer to be "position good" even if it means the potential loss of margin as part of the recovery process, (ii) that the failure of a CCP would be severely damaging to the financial system and (iii) that it would be necessary to continue the services of any particular CCP.

[5] To be effective, a recapitalization would need to be "next business day" which likely requires a pre-funding of the capital needed to re-establish CCP operations and replenish the guaranty fund.

We believe that the majority of investors would prefer to be "money good" rather than "position good" in the context of a troubled CCP. This preference for being "money good" over "position good" is driven in part by the knowledge that positions held in a CCP which is using margin haircutting in an attempt to recover, would be completely unprotected against further defaults. A CCP which is using collateral haircutting will already have used the entire guaranty fund plus any reassessment powers it has to recapitalize the guaranty fund. Any further defaults then will result in the full loss incurred being absorbed by non-defaulting end users. It is possible that a CCP may recover to the point where CMs are willing to replenish the guaranty fund, but the return of confidence required for this step is unlikely in the short to medium term. In the meantime, end users would be trapped in a CCP which is 'running on empty' in volatile market conditions where the likelihood of further defaults is increased.

A failed CCP would inflict the most damage to the financial system where no other options exist to clear. We believe that in order for a product to become subject to mandatory clearing, at least two CCPs should offer clearing for that product. The best way to mitigate the systemic impact of a CCP's failure, and to ensure that no CCP is too big to fail, is to ensure that an alternative exists to transact in the products the failed CCP clears. Mandating clearing where there is only one viable option for trading generates and embeds systemic risk unnecessarily and imprudently. Where an alternative exists, however, recovery of a failed CCP becomes less critical, and resolution becomes a potentially viable option.

CCP Resolution

To be clear, when we are referring to "resolution" in this letter, we mean an orderly unwind process undertaken by the CCP and overseen by the relevant regulator. We are not using "resolution" to refer to special resolution powers exercised by a CCP's regulator, or even necessarily to require a bankruptcy or insolvency proceeding. To minimize the likelihood and impact of such an orderly unwind of a CCP, we offer a number of recommendations to mitigate the risks arising from a resolution.

First, we note that immediately after a CM default, the CCP should have a matched book with the exception of a finite number of defaulted positions. The sooner the CCP can conduct an auction to replace the positions of the defaulting CM, the sooner the CCP and the market will know if the CCP has sufficient resources to cover its losses. As soon as it becomes apparent that the auction has failed – no bids are received for positions or the cost of replacing the positions of the defaulting CM at the best auction levels is likely to exceed the CCP's available resources – a resolution process should be invoked by the CCP and the relevant authority. The "tear up" price must be established immediately as delay will increase volatility and participant losses.

The purpose of the rapid liquidation of positions would be to close-out the clearing business quickly and to return margin provided by non-defaulting clearing members and non-defaulting clients with minimum market loss. A rapid liquidation and return of margin would minimize end-user losses and would allow clearing members and their clients the option to establish replacement risk exposure positions in the most efficient manner which may include instruments other than mandated swaps. In this process, we recognize that either net VM or VM from the point of default may need to be used to facilitate an orderly resolution. However, in such a situation, VM haircutting should only be imposed (or needed) over very short periods of time – essentially one business day and participants who do not receive full VM payments should receive a senior claim against the CCP and its successors for the full amount of the VM taken from them. That said, initial margin of non-defaulting customers should be sacrosanct.

Auction participants should be expanded beyond clearing members to other market participants who are judged able to honor their bids. A larger number and diversity in auction participants and open participation would result in a more transparent process and result in a more fair and accurate market price. As mentioned above, it is important that liquidation be swift and orderly with ex ante defined procedures to minimize the size of loss and provide reasonable certainty to participants of their risk exposure.

CCPs should be required to maintain information systems and controls that can promptly produce, both in normal times and during resolution, the relevant data and information needed to evaluate the state of recovery (the rate at which the loss absorbency resources are being used) and to facilitate the implementation of resolution measures.

CCP resolution plans can contain a prefunded recapitalization fund if authorities believe it would be prudent to re-start the services of the CCP in a timely manner. Under a new management structure and fully recapitalized default fund, there is a higher probability that market participants will return to use the new CCP facility relative to one that has been recovered with participants experiencing loss of margin.

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We appreciate the opportunity to provide our comments on these important issues. We encourage the CFTC to continue to gather input from multiple sources, particularly from sources other than CCPs and CMs. In particular, end-users' views need to be heard and considered.

As a representative of some of those end-users, we believe that the best way to minimize the risk of a CCP failure is to strengthen the default waterfall to ensure CCPs have sufficient skin in the game and that loss absorbing resources are available in wartime as well as peacetime, and to increase transparency into CCP risk management and loss absorbing resources. Where a CM default occurs, we believe broadening auction participation will decrease the likelihood of a failed auction. And we very strongly believe that our client's margin should never be viewed or used as a liquidity source to allow a failed or failing CCP to continue its operations. We believe end users would much rather be money good than position good in the context of a failing CCP. Maintaining a CCP at all costs is not in the best interests of end-users, and when a CCP has failed, it should be required to quickly implement a resolution plan that focuses on a rapid and complete wind down of the failing CCP's positions, along with a timely and orderly repayment of margin monies.

We look forward to a continuing dialogue on this topic. If you have any questions or comments on BlackRock's views, please contact any of the undersigned.

BLACKROCK®

Sincerely,

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