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September 25, 2023

Mr. Christopher Kirkpatrick

Secretary of the Commission

CFTC

Three Lafayette Center

1155 21st Street NW

Washington, DC 20581

Re: Part 39 NPRM, “Derivatives Clearing Organizations Recovery and Orderly Wind-down Plans; Information for Resolution Planning

Dear Sirs:

I submit this Comment Letter respecting the above-captioned NPRM in my individual capacity as a longtime observer and participant in the derivatives industry. In particular, prior to becoming a consultant to major financial firms that employ derivatives as a hedging device, I practiced law in the derivatives space for over 40 years (most recently at Prudential Financial), taught derivatives law and regulation for 12 years (Columbia Law School), published and edited the leading law journal devoted to derivatives regulation for 41 years (*Futures and Derivatives Law Report*), served on the Staff of the Presidential Task Force on Market Mechanisms (“Brady Commission”) and was appointed to the CFTC’s Market Risk Advisory Committee for two terms.

One of the most informative experiences of my career in derivatives was my participation in the Brady Commission’s study and analysis of how the clearing houses functioned (or nearly did not function) during the 1987 market break. The central importance of clearing became, for me, a lodestar for any understanding of how futures and cleared derivatives markets should perform normally and in a crisis. The clearing infrastructure epitomized in the U.S. by the CME is systemically important and must be as “bullet proof” as possible against member defaults and even more critical, a failure of the clearing house itself.

To that end, as the Commission recognizes, it is imperative that systemically important derivatives clearing organizations (SIDCOs), like the CME, have recovery plans that describe how the SIDCO will deal with losses arising from clearing member defaults and/or non-default losses. Presumably, and particularly in the case of member defaults, such a recovery plan will describe in reasonable detail the so-called waterfall wherein the SIDCO should specify the order in which its members and its customers will bear losses in order to save the SIDCO from failure and a resulting wind-down. (My remarks are principally concerned with recovery rather than wind-down because it is my belief that SIDCOs must remain viable and that wind-downs are nearly unthinkable.)

My comments on the NPRM revolve around two subjects: transparency and certainty. These comments are offered from the point of view of market end-users like the life insurers that I had the privilege to advise during my career.

Life insurers occupy a nearly unique position vis-a-vis the derivatives markets and DCOs. Under the Dodd-Frank Act life insurers are designated financial entities that are compelled to clear their risk-mitigating interest rate, equity and other swaps. (Life insurers are prohibited by state law from speculating with derivatives.) In effect, life insurers are hostages of SIDCOs. (I do not mean to argue that compulsory clearing is inappropriate but rather to submit that its hostages should be well-treated.)

The NPRM notes, “A recovery plan enables the DCO, its clearing member, *their clients*, and other relevant stakeholders, to *prepare* for such extreme circumstances, increases the *probability* that the most effective tools to deal with a specific stress will be used and reduces the risk that the effectiveness of recovery actions will be hindered by *uncertainty* about which tools will be used.” (Emphasis added)

**Recovery Plans Should Be Reasonably Transparent to End-Users**

The NPRM implicitly states that end-users (i.e., the clients of clearing members) should be able to “prepare” for the steps necessitated by a SIDCOs recovery plan. While the NPRM does not detail what steps might be included in such a plan, we know that SIDCO waterfalls include such measures as application of members default funds and member assessments, application of DCO skin-in-the-game (SITG), variation margin gains haircutting (VGMH) and position tear-ups. Obviously, tear-ups and VGMH are of great importance to market end-users.

Accordingly, elements of a SIDCO’s recovery plan such as the circumstances that could result in tear-ups or VGMH should be disclosed to the public. I do not advocate that all elements of the recovery plan should be made public but I do submit that those elements that the market “needs to know” should be. When, how and why an end-user will suffer monetary losses to facilitate a SIDCO’s recovery are matters that end-users need to know beforehand. Like the SIDCOs, they too, should be able to plan how to deal with potential losses arising from the application of the SIDCO’s recovery tools.

If I am not mistaken, there is no current or proposed regulation that requires SIDCOs to disclose their recovery plans in any respect. Currently, there is information available in varying forms and formats on SIDCO websites but these disclosures are discretionary and could be taken down or allowed to become obsolete if the SIDCO so chooses. *The Commission should require such disclosure as a matter of regulation rather than leave it to the discretion and business judgment of the SIDCO.* Such a rule would, indeed, permit end-users to prepare (as best they can) for the extreme event a recovery entails. Or to press the hostage analogy, it is unfair and unwise to leave a SIDCO’s hostages blindfolded in the center of the storm.[[1]](#footnote-1)

**Recovery Plans Should Be Made Certain**

As a matter of law, SIDCOs have broad discretion to adopt emergency actions to protect their business franchises. Market end-users can suffer the adverse consequences of these actions and have no recourse.

There is nothing we know of that bars a SIDCO from adopting an emergency action that materially alters its recovery plan at the eleventh hour. Particularly in the case of publicly owned SIDCOs, their governance is subject to myriad crosscurrents and potential conflicts of interest among its clearing members and governing boards, whose first and fiduciary duty is to protect their public shareholders. Facing collapse, what measures might the SIDCO take? Notwithstanding its existing recovery plan, for example, could the SIDCO decide at the eleventh hour to diminish its SITG? Or forego VGMH and go directly to tear-ups? Are there any guardrails on what emergency measures might trump the recovery plan.

Perhaps the Commission is cognizant of this ambiguity in so far as it notes that having a recovery plan will increase the “*probability*” that effective recovery tools will be used. We submit that the application of a recovery plan should not be left to chance and eleventh-hour discretionary decision-making to the detriment of end-users.

*The Commission should adopt a regulation that places guardrails around a SIDCO’s ability to exercise its discretion to amend its recovery plan to the detriment of existing end-users affected by its recovery plan.* The Commission should recognize that end-users – particularly hostage end-users -- occupy a different position than other potential loss bearers such as the SIDCO’s clearing members and shareholders. Their connection to the SIDCO is tied to their business models and investment judgments from which they expect to profit. An unexpected outcome at the eleventh hour is a business risk they should be prepared for. End-users like insurers required to use a SIDCO just to clear their hedges view the SIDCO as a mere utility and not as a vehicle for profit. Accordingly, the Commission should, in my opinion, distinguish between the potential treatment of these different classes of SIDCO-participants and provide more protection for end-users.

**Conclusion**

I support the Commission’s effort to ensure the safety and soundness of our clearing eco-system. I believe that, in general, the proposed Part 39 rules are a good step in that direction. But I also respectfully submit that some modest modifications as discussed above will further protect end-users and the system at large from the dangers of SIDCO failure.

Respectfully submitted,

Richard A. Miller

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1. While the amount of potential loss from VMGH or tear-up cannot be known ahead of time, the likelihood of *any* such loss can be. [↑](#footnote-ref-1)