



MANAGED FUNDS  
ASSOCIATION



asset management group

October 28, 2019

**Via Electronic Mail**

Clark Hutchison  
Director  
Division of Clearing and Risk  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street NW  
Washington, DC 20581

**Re: CME Amendments to CME Chapter 8G (“Interest Rate Derivative Clearing”) and Chapter iii. (“CME Definitions”) Regarding End of Waterfall Rules for Interest Rate Swaps**

Dear Mr. Hutchinson:

Managed Funds Association (“MFA”)<sup>1</sup> and The Securities Industry and Financial Markets Association’s Asset Management Group (“SIFMA AMG” and, together with MFA, the “Associations”) are aware that the Commodity Futures Trading Commission (the “Commission”) is in the process of reviewing CME’s proposed amendments to its “End of Waterfall Rules for Interest Rate Swaps” (the “CME Rule Amendments”).<sup>2</sup> Our members are a vital part of the cleared derivatives markets, and clear a large number of interest rate swaps (“IRS”) through CME. Since the CME Rule Amendments directly impact the default waterfall and the potential use of customer assets during a default event, our members could be adversely affected by CME’s contemplated “portfolio gains haircutting.”

The Associations are concerned that CME is adding portfolio gains haircutting as a recovery tool for IRS because, as discussed further below, portfolio gains haircutting primarily affects market participants that have directional portfolios. As a result, this type of loss allocation mechanism may disproportionately affect customer portfolios as compared to clearing member proprietary portfolios, because clearing member portfolios may be less likely to be significantly directional in nature.

Due to the potential disparate impact of the CME Rule Amendments, and for other reasons explained below, we believe that further careful consideration of the CME Rule Amendments, and potential alternatives, is warranted. Therefore, the Associations respectfully request that the

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<sup>1</sup> See Annex A for descriptions of MFA and SIFMA AMG.

<sup>2</sup> Available at: <https://sirt.cftc.gov/sirt/sirt.aspx?Topic=ClearingOrganizationRulesAD&Key=42285> (the “CME Rule Filing”).

Commission extend its review under CFTC Rule 40.10(f) (“**Rule 40.10(f)**”) and request further analysis from CME.

**I. The CME Rule Amendments Lack Sufficient Analysis and May Be Inconsistent with the CEA**

**(a) CME Did Not Obtain Sufficient Market Participant Feedback**

Although the CME Rule Amendments will directly impact buy-side market participants, CME notes that its discussions of the CME Rule Filing were limited to “members of the CME IRS Risk Committee” and “all founding and active IRS clearing members.”<sup>3</sup> The Associations strongly believe that it is necessary for CME to solicit feedback from all market participants that could be affected by the CME Rule Amendments, not just its clearing members. As mentioned, buy-side market participants are important stakeholders in the cleared derivatives and IRS markets as well as at CME. In addition, buy-side market participants often have different and unique perspectives from clearing members, which are critical for CME to take into account. Therefore, CME’s oversight in seeking buy-side input during its process is a problematic omission. To that end, the Associations urge the Commission to extend the review under Rule 40.10(f) in order to provide an opportunity for the Associations and other buy-side trade associations and market participants to provide feedback on the CME Rule Filing, including potential alternatives that merit consideration.

The Associations also note that the insufficient feedback obtained from market participants by CME underscores the importance of amending Commission rules to require customer participation on all derivatives clearing organization (“**DCO**”) advisory committees and to ensure that all market participants have a meaningful opportunity to provide feedback to the DCO regarding a proposed rule change, as discussed further in Section II below.<sup>4</sup>

**(b) CME Did Not Provide Sufficient Quantitative Analysis of the CME Rule Filing’s Expected Impact**

In the CME Rule Filing, CME acknowledges that portfolio gains haircutting can negatively impact both clearing members and customers.<sup>5</sup> However, CME did not provide any quantitative analysis of the impact of the CME Rule Amendments. For example, CME should have provided analysis showing, among other things, whether this loss allocation mechanism could be expected to affect disproportionately customer portfolios compared to clearing member proprietary portfolios. Core Principle G (*Default Rule and Procedures*) of the Commodity Exchange Act

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<sup>3</sup> *Id.* at 3.

<sup>4</sup> See e.g., Separate MFA and SIFMA AMG letters to the Commission on its notice of proposed rulemaking on “Derivatives Clearing Organization General Provisions and Core Principles”, each dated Sept. 13, 2019. MFA letter available at: <https://www.managedfunds.org/wp-content/uploads/2019/09/CFTC-Amended-DCO-Core-Principles-Final-MFA-Letter-9-13-19.pdf>; SIFMA AMG letter available at: <https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=62185&SearchText=>.

<sup>5</sup> See CME Rule Filing at 4-7.

(“CEA”)<sup>6</sup> provides that all DCO rules and procedures must allow for the **fair** management of default events.<sup>7</sup> Consistent with the Core Principles, the Commission should require CME to provide robust quantitative analysis of the expected impact of the CME Rule Amendments and of introducing portfolio gains haircutting, including whether losses would be more likely to be allocated to customer portfolios than clearing member portfolios.

**(c) CME Did Not Fully Consider Potential Inconsistencies with the CEA**

CEA Core Principle D(iii)(II) requires DCOs to ensure that “nondefaulting members or participants would not be exposed to losses that nondefaulting members or participants cannot anticipate or control.”<sup>8</sup> However, exposure to losses that non-defaulting participants cannot control is precisely the risk that CME would introduce by employing portfolio gains haircutting. In a default scenario, CME would apply haircuts based on the randomness of which market participants’ positions happen to be net “in-the-money” on a given day. However, as indirect clearing participants, customers (as compared to DCOs and direct clearing members) are least able to know or control the risks posed by other clearing participants and to protect themselves against another clearing participant’s default.

In addition, “portfolio gains haircutting” appears inconsistent with other CEA provisions mandating the protection of customer assets<sup>9</sup> and the fair management of default events by DCOs.<sup>10</sup> Central clearing is fundamentally designed to *protect* customer assets and customers, which have substantially less capital than DCOs and direct clearing members, making them less able to absorb losses related to another participant’s default. A loss allocation mechanism that disproportionately affects customers, in particular, would appear contrary to these statutory provisions.

**(d) CME Did Not Fully Consider Potential Alternatives**

In the Associations’ view, at a minimum, the Commission should require DCOs to use loss allocation mechanisms that are proportional to each market participant’s use of the DCO. Because, as discussed, portfolio gains haircutting could have a disproportionate effect on buy-side market participants, the Commission should require CME to consider and analyze quantitatively potential alternative approaches.

One alternative is for CME to allocate the applicable variation margin haircut on a *pro rata* basis consistent with the share of total initial margin posted by each market participant to the CCP. A second alternative is for CME to apply haircuts on a gross basis to each individual position, rather than on a net basis as proposed. Each of these approaches would allocate losses on a more equitable basis consistent with the share of total open positions that each market participant holds

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<sup>6</sup> 7 U.S.C. 1, available at: <https://www.law.cornell.edu/uscode/text/7/chapter-1> .

<sup>7</sup> See CEA Section 5b(c)(2)(G)(i).

<sup>8</sup> *Id.*, section 5b(c)(2)(D)(iii)(II).

<sup>9</sup> See *id.*, section 4d.

<sup>10</sup> See *id.*, section 5b(c)(2)(G)(i).

at the DCO, which may reduce the disproportionate impact on customers. CME does not appear to have considered either of these alternatives, and the Associations believe that the Commission should consider and analyze these alternatives and any other viable options.

**(e) Conclusion**

In light of the concerns above, and the potential inconsistencies with the CEA, the Associations recommend that the Commission extend the review under Rule 40.10(f) and request further analysis from CME.

**II. Customer Participation in DCO Governance and Default Auction Participation is Necessary**

The Associations note that, the issues raised above with respect to the CME Rule Amendments and portfolio gains haircutting emphasize why it is even more critical to ensure that customers are appropriately represented in all DCO governance committees, including risk and default management committees. Such customer representation is necessary to protect customer interests in the event losses must be allocated pursuant to the DCO's default waterfall. In addition, customers have invaluable insights to contribute to DCOs, and their representation in DCO governance is critical to mitigating conflicts of interest and to ensuring that diverse perspectives are brought into DCO decision-making processes.<sup>11</sup>

The Associations also strongly believe that the Commission should require DCO rules to provide explicitly for customer participation in default management auctions, without additional obligations that are designed to impede client participation, such as a separate default fund contribution.<sup>12</sup> In the CME Rule Filing, CME states that the use of portfolio gains haircutting is an incentive to “motivate IRS Clearing Members and their customers with positions in the affected contracts to participate in the default auctions in order to protect their gains from IRS Gains Haircuts”.<sup>13</sup> While market participants may want to participate in the default management auction to avoid the possibility of portfolio gains haircutting, the Associations emphasize that no such incentive is necessary to encourage customer participation in default auctions. We agree with CME that customer participation in DCO default management auctions is critical to the success of such auctions, and because our members desire such participation, the Associations have advocated for mandated customer participation with both U.S. and EU regulators.<sup>14</sup>

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<sup>11</sup> See *supra* note 4 for additional views on customer representation in DCO governance.

<sup>12</sup> See CME Rule Filing at 7.

<sup>13</sup> *Id.* at 5.

<sup>14</sup> See SIFMA AMG and MFA joint letter to the Committee on Payments and Market Infrastructure (“CPMI”) and the International Organization of Securities Commissions (“IOSCO”) on the CPMI-IOSCO joint discussion paper regarding CCP default management auctions, dated August 9, 2019, available at: <https://www.managedfunds.org/wp-content/uploads/2019/08/SIFMA-AMG-MFA-Letter-on-IOSCO-CCP-Default-Management-Auctions-Final-8-9-19.pdf>.

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The Associations appreciate your consideration of our comments as part of the Commission's review of the CME Rule Amendments. We welcome the opportunity to discuss our views with you in greater detail. Please do not hesitate to contact Mark Epley or Carlotta D. King of MFA or Timothy W. Cameron or Jason Silverstein of SIFMA AMG with any questions regarding this letter.

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cc: The Hon. Heath P. Tarbert, Chairman  
The Hon. Brian D. Quintenz, Commissioner  
The Hon. Rostin Behnam, Commissioner  
The Hon. Dawn DeBerry Stump, Commissioner  
The Hon. Dan M. Berkovitz, Commissioner

Eileen Donovan, Deputy Director, Clearing Policy, Division of Clearing and Risk

## Annex A

### **Descriptions of the Associations**

**MFA** represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

**SIFMA AMG** brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed \$45 trillion. The customers of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.