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By Email

June 5, 2017

Honorable Jay Clayton
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Honorable J. Christopher Giancarlo
Acting Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street NW.
Washington, DC 20429

Honorable Steven Mnuchin
United States Treasury Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

RE: Central Counterparty Standards for Derivatives

Dear Sirs:

The American Council of Life Insurers, Investment Company Institute, Managed Funds Association, and Securities Industry and Financial Markets Association's Asset Management Group (collectively, the "**Associations**")[1] write to provide their recommendations on central counterparty ("**CCP**") standards for derivatives—namely, futures, swaps and options—that we believe regulators should impose domestically and endorse through international bodies to support financial stability in derivatives markets. Regulators, including the U.S. Department of the Treasury, Commodity Futures Trading Commission, Federal Deposit Insurance Corporation, and U.S. Securities and Exchange Commission, in reviewing derivatives regulations for potential reform, should strengthen CCP standards to foster robust derivatives markets while keeping systemic risk in check.

The success of the G20's over-the-counter derivatives market reforms hinges on whether CCPs can withstand the next financial crisis with a system that increasingly depends upon central clearing. Pension funds, life insurers, retail investor funds (*e.g.*, U.S. mutual funds and UCITS), private funds and other investors for whom asset managers serve as fiduciaries (each a customer of CCP clearing members) have increased their centrally cleared derivatives positions after the financial crisis due to regulatory directives and heightened awareness of bilateral counterparty risks. Post-crisis

[1] For a description of each Association, see the Annex to this letter.

regulations have advanced this migration directly through mandating the clearing of additional derivatives and indirectly through higher margin requirements and bank capital charges for uncleared transactions.

The value of this shift to clearing will be measured in large part on whether these customers—investors who are ultimate stakeholders of cleared positions with no control of the CCP and no stake in the CCP's profits—are protected from potential CCP failures by robust resilience, recovery and resolution standards. To this end, the Associations make the following recommendations:

1. **To foster resilient CCPs and reduce the likelihood of CCP failure, regulators should strengthen minimum funding requirements and risk management processes.**

   (a.) **Regulators should require risk-aligned capital contributions from the CCP (*i.e.*, CCP skin-in-the-game) and contributions from clearing members, both of which should be prefunded**. While much of the discussion on the topic of clearing member and CCP contributions has focused on "Cover 2," "Cover 3" and percentages of the guarantee fund, the Associations believe that regulators should formulate a sophisticated, risk-based model to calculate the amount of resources needed to cover a CCP's potential future risks and provide transparency of the formulas to all market participants, including clearing members' customers. Regulators have performed this function for bank capital and liquidity requirements and should use similar tools for CCPs with similar transparency.

   The Associations believe that the quantum of resources identified should be pre-funded and include clear and knowable limits for clearing member contributions to avoid potential unlimited losses impacting clearing members' ability to continue doing business. The increasing concentration of clearing member business—particularly for swaps—exacerbates market challenges, including those of asset managers handling client transactions. Further, excessive capital requirements, which do not acknowledge the exposure-reducing effects of margin posted to CCPs, exacerbates this problem. We believe that, by providing advance certainty of clearing member contributions combined with reasonable capital requirements, both clearing members and regulators will be able to calculate their exposure and costs, and hopefully, reverse the trend of firms exiting the clearing business.

   The Associations further believe that CCP skin-in-the-game should reflect a meaningful percentage of risk that CCPs manage under both default and non-default loss scenarios. Current requirements do not meet this standard.

   (b.) **Regulators should require CCPs to exclude non-defaulting customer assets from default waterfall resource calculations.** CCPs should never presume that they will be able to use non-defaulting customer collateral to backstop poor CCP risk management practices. Dynamic margin calculations, risk-based CCP skin-in-the-game, clearing member assessments, standby credit, and any other resources of the CCP (*e.g.*, retained earnings and other resources) should comprise the available pre-resolution, dedicated resources determined by the credit and liquidity needs measured by stress tests. Regulators should prohibit CCPs from adopting risk management procedures that permit the CCP to use the margin of non-defaulting customers to cover credit or liquidity shortfalls. Although the Associations understand and agree with the regulatory imperative of avoiding a future tax payer bailout of a CCP, we believe that the most appropriate way to do so is to incentivize

CCPs, which charge for the service of clearing trades, to manage risk appropriately and put their own assets at stake. We do not think it appropriate for CCPs instead to jeopardize the assets of pension funds, life insurers, U.S. mutual funds, UCITS and other investors who have no control over how CCPs calculate margin, accept new products for clearing, and manage risk.

(c.) **Regulators should require CCPs to have margin requirements that are appropriately sized and foreseeable.** Regulators should permit CCPs to adjust margin for risk in the system in addition to potential future exposure and volatility adjustments. Regulators should also require CCPs to provide a simulation tool to allow clearing members and their customers to calculate margin payments under varying scenarios, providing both transparency and predictability when CCPs change margin levels. The Associations recognize that increases to margin will mean that market participants may need to tie up more collateral to support positions; however, we believe this outcome is preferable to a system that relies on using customer property as a backstop.

(d.) **Regulators should require CCP risk and default management committees to consider feedback provided by clearing members' customers.** CCP risk and default management committees have important decision-making responsibilities at CCPs. These committees typically approve new products (*i.e.*, determine what products a CCP will clear), risk models, initial margin methodologies and frameworks, and the size of the guarantee fund. Customers of clearing members, as crucial stakeholders and participants in the cleared derivatives markets, should have their views considered by these committees. As such, each CCP should build into its decision-making process a means by which it will consult with clearing members' customers, including an opportunity for non-members to offer input in a non-voting, advisory capacity.

2. **Regulators should require CCPs to provide expanded public disclosure that is reliable, readily available, and comparable.**

(a.) **Regulators should, for the purpose of public disclosure, require CCPs to run new "benchmarking" stress tests**. Disclosure of uniform stress tests results for each CCP would aid investors in making informed decisions about which CCP will serve their best interests. Investors and their fiduciaries need to know how different CCPs are expected to perform when significant stress events occur. Although CCPs would not need to use these benchmarking stress tests to inform directly the CCP's risk management, a CCP should use this additional analysis to judge whether it would be prudent to make any adjustments in its risk management. The Associations recommend that regulators review and refresh the construction of these publicly-disclosed, uniform stress tests with input from the CCPs, clearing members, and clearing members' customers.

(b.) **Regulators should require CCPs to make their Public Quantitative Disclosures available on a central website, and should require those disclosures to be accurate, with quality controls supported by penalties for material misstatements.** Regulators should strengthen Public Quantitative Disclosure standards so that customers, and fiduciaries that act on their behalf, can effectively assess a CCP's resiliency before a crisis occurs. Customers and fiduciaries should have the means to assess the CCP prior to a crisis, when the consequences of poor risk management may come to light. In so doing, regulators harness the analytical abilities of the marketplace to scrutinize CCP risk controls and incentivize CCPs to pass the public test in addition to the various non-public evaluations undertaken by the CCP and regulators. Accurate and accessible disclosure is key to this objective.

(c.) **Regulators should require CCP rulebooks to disclose clearly the impact of recovery and resolution tools on clearing members' customers**. Current rulebooks do not set forth the impact of recovery and resolution tools on customers.

(d.) **Regulators should require CCPs to disclose publicly lessons learned from default drills and include investors and asset managers in CCP default drills.** Public disclosure of high-level observations from these drills will aid a broader group of market participants to be better prepared. Similarly, we believe that the inclusion of customers in drills, including in auctions and porting exercises, will allow the markets and buy-side participants to be better prepared for market stress.

3. **When a CCP is in recovery (rather than resolution), regulators should require CCP recovery standards to provide full protection of customer interests.**

(a.) **Regulators should strictly prohibit CCPs from taking non-defaulting customer assets to cover CCP shortfalls**. For a troubled CCP that is not yet in a resolution proceeding, returning the CCP to a matched book is a key imperative. Nonetheless, regulators should prohibit a troubled CCP from overriding customer protections with extraordinary measures, including, among other things, mutualization of losses to non-defaulting customers.

The Associations believe that the mutualization of loss through taking non-defaulting customer property is an extraordinary measure that regulators should only potentially permit a CCP to deploy during its resolution as a last resort after equity holders have been incentivized to recapitalize and the resolution authority has taken over control from the failing CCP's management. To do otherwise would undermine the dynamics that have effectively incentivized corporate workouts for decades and treat clearing members' customers worse than equity holders who, unlike customers, benefited or stood to benefit from the profitable performance of the CCP.

"Loss mutualization" essentially amounts to the taking of a portion of a non-defaulting customers' margin. This reality is often lost in the "VMGH" acronym ("variation margin gains haircutting," a term used for one of the measures to have customers cover CCP losses) or the misplaced use of the term "haircut." The Associations would like to draw attention to what loss mutualization is—namely, the appropriation of non-defaulting customer property without regard to customer protections. Any such practice is entirely misplaced prior to resolution proceedings. Rather, regulators should expressly prohibit CCPs' use of these extraordinary measures until resolution. Only after full write-down of the CCP holders' equity, which may incentivize equity holders or other parties to recapitalize, and after change of control to the resolution authority should regulators permit CCPs to deploy such measures. Even then, CCPs should only be able to use the measures if no other means are available to return to a matched book or to wind up the CCP, and in such case, regulators should require CCPs to provide clear limits on the use of such measures, and to compensate customers (in the case of a CCP that returns to a matched book) or provide customers with a high priority of repayment (in the case of a liquidated CCP).

(b.) **Regulators should require open auctions and mechanisms to continue the payment of variation margin to and from the customers of a defunct clearing member.** The Associations believe that a successful auction is the best mechanism to return a distressed CCP to a matched book. Regulators should ensure that CCPs permit non-clearing members to participate in the auctions without having to provide risk capital or meet other artificial barriers. In addition, a mechanism to bypass the defunct clearing member is essential to keep collateral in the system, pay collateral due back to non-defaulting customers, and allow those customers to maintain their positions until they can be ported.

(c.) **Regulators should exercise discretion to suspend temporarily swap clearing mandates during a CCP recovery**. To allow markets to continue to function without further stressing the system, regulators should have discretion to suspend swap clearing mandates when they believe that the unavailability of the distressed CCP will impact the swap negatively; such discretion should continue to be exercised until the negative impact has dissipated.

(d.) **A pre-designated regulatory authority should initiate resolution proceedings when deemed necessary.** In considering whether to put the CCP into resolution, a designated authority should move decisively to resolution when it believes that the CCP has reached a point where recovery tools can no longer return the CCP to a matched book with recovery tools. For example, if the designated regulatory authority believes that the only means of returning the CCP to a matched book is use of extraordinary measures, including loss mutualization, we believe that the CCP should be put into a resolution proceeding.

4. **Regulators should require CCPs to have clear protocols for the porting of customers' positions, LSOC treatment for all customer collateral, and rationalized capital requirements that recognize the exposure-reducing effects of posted initial margin.**

CCP rulebooks should set forth a protocol agreed to by all CCP key stakeholders (including the CCP's Board, committees, clearing members, and customers) for porting during times of market distress including: contact information for post-insolvency points of contact, requirements to address requests to port within a set amount of time and industry protocols to handle operational steps required. For FCMs onboarding the ported customers, regulators need to address Know Your Customer ("**KYC**") obligations by either suspending the requirements or creating a centralized utility to handle KYC requirements. Regulators should also consider providing limited and temporary capital relief to FCMs that are accepting ported positions in order to facilitate and incentivize a smooth transition. In addition, CCPs should apply the Legally Segregated with Operational Commingling ("**LSOC**") standard across all cleared customer derivatives so that fully paid clients can be ported. Further, capital requirements such as the Leverage Ratio should recognize the true exposure of cleared transactions that FCMs handle as an agent for customers by netting the margin amounts posted.

5. **CCP resolution should proceed based on clear protocols that balance market and systemic interests with customer protections.**

Regulators should strictly constrain the use non-defaulting customer assets, and allow it only as a last resort and after further review to ensure fair treatment and compensation of customers.

Further review and comment is required to assess how loss mutualization can be used in resolution such that all open contracts bear a proportionate share of losses; none of the tools discussed to date achieve this result. For example, some market participants have suggested VMGH as a tool for CCPs to use on a net (a/k/a portfolio level) basis. However, to apply VMGH on a net basis and not on a gross basis or upon the full net equity means that the loss allocation will arbitrarily impact participants' positions that happen to be positive on the days applied and will not impact participants with a flat position at the CCP. Likewise, VMGH on a gross (a/k/a position level) basis effectively de-links linked transactions. For example, a curve trade whereby a market participant is exposed to the difference between two or more maturity dates for the same instrument (*e.g.,* a calendar spread between the front month and next month of a futures contract), would become decoupled if VMGH applied on a gross basis. Rather than paying or receiving the variation margin reflecting the relationship between these related positions, the market participant would have to pay the full amount due on the out-of-the-money position and receive a discounted payment of the in-the-money amount due. In addition, any form of margin haircutting on cleared positions turn perfect or near-perfect hedges of positions held away from the CCP into speculative ones. We do not believe that a regulator overseeing the CCP resolution should arbitrarily distribute loss or disturb fundamental reasons why customers enter into cleared positions.

Assuming regulators identify a tool for ratable distribution of losses, any customer whose assets are taken to cover the CCP's loss should, like clearing member contributions, have clear pre-identified limits. In addition, customers should be compensated if the CCP returns to a matched book or, in the case of a liquidation, provided with a high priority claim against the CCP.

6. **Regulators should make clear that a CCP and its parent company have the sole responsibility for non-default losses by the CCP.**

Regulators should not permit CCPs to use default waterfall resources beyond the CCP's own skin in the game or to use extraordinary measures to cover non-default losses, such as operational failures of the CCP. The CCP is solely responsible for managing operational risks, and the CCP's potential losses must be aligned with that responsibility. Customer assets should not be appropriated to cover a CCP's failure to do so. Nor should regulators allow CCPs to use bail-in tools to write down the CCP's liabilities. As stated above, calculations of CCP skin-in-the-game should take into account this responsibility of the CCP.

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The Associations hope that these recommendations will be reflected in U.S. standards and those set by international standard-setting bodies to continue strengthening CCP resilience, recovery and resolution standards and protect the customers of clearing members.

Should you have any questions or would like to discuss, please do not hesitate to contact, Carl Wilkerson (CarlWilkerson@acli.com / (202) 624-2118), Jennifer Choi (jennifer.choi@ici.org / 202-326-5876), Carlotta D. King (cking@managedfunds.org / 202-730-2600) or Stuart J. Kaswell (skaswell@managedfunds.org / 202-730-2600), or Laura Martin (lmartin@sifma.org / 212-313-1176).

Respectfully submitted,

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cc: Honorable Sharon Y. Bowen
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Honorable Thomas M. Hoenig
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ANNEX

Descriptions of the Associations

The American Council of Life Insurers (**ACLI**) is a national trade association with 280 member companies that represent 95 percent of industry assets, 92 percent of life insurance premiums, and 97 percent of annuity considerations in the United States. Our members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance that 75 million American families rely on for financial and retirement security.

The Investment Company Institute (**ICI**) is the leading association representing regulated funds globally, 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 members manage total assets of US$19.6 trillion in the United States, serving more than 95 million US shareholders, and US$5.6 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

Managed Funds Association ("**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 policymakers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

The Securities Industry and Financial Markets Association's Asset Management Group ("**SIFMA AMG**") brings the asset management community together to provide views on policy matters and to create industry best practices. SIFMA AMG's members represent U.S. and multinational asset management firms whose combined global assets under management exceed $39 trillion. The clients 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.