



Secretary

U.S. Securities and Exchange Commission

100 F Street NE

Washington DC 20549

SUBMITTED Electronically and by Email

August 30, 2023

Re: File No. S7-10-23 - COVERED CLEARING AGENCY RESILIENCE AND RECOVERY AND WIND-DOWN PLANS

The issue raised in the U.S. Securities and Exchange Commission’s (“SEC” or the “Commission”) proposed “Covered Clearing Agency Resilience and Recovery and Wind-Down Plans (in whole or in part, the “Proposal”) has been the focus of several public comments from the Systemic Risk Council (“SRC” or the “Council”) during its decade of service and oversight.¹ In each of these communications, the Council has commended policymakers for their achievements in simplifying on a global scale the network of exposures among intermediaries and for mandating, where possible, the expansion of central clearing of many derivatives transactions by covered clearing agencies (“CCAs”)² with mandated resiliency requirements. At the same time, we have felt the need to recommend further modifications to this resiliency system in order to create a system of stable, better prepared, and more durable CCAs that are adequately capitalized, structured, and governed.

In this letter, the SRC responds to the Proposals to improve CCAs’ ability to manage stressed markets through monitoring and margining practices. The Proposals seek to enhance the recovery and wind-down plans CCAs must prepare due to their interconnectedness and size, as well as the critical role they play in the modern financial market system.

¹ SRC Letter to SEC, *SRC Letter to SEC re CCPs*, 28 May 2014; SRC Public Statement, *To the Finance Ministers, Governors, Chief Financial Regulators, and Legislative Committee Leaders of the G20 Countries*, 27 February 2017 (“2017 Statement”); FSB Discussion Paper, 15 November 2018, *Financial resources to support CCP resolution and the treatment of CCP equity in resolution*; (“2019 FSB Letter”); FSB Consultation, 31 July 2020, *SRC Response to FSB CCP Consultation*; (“2020 CCP Consultation”); SRC Letter to Congress, *SRC Public Letter to Congress on GameStop Episode*, 3 March 2021.

² 17 CFR § 240.17Ad-22(a)(5), adopted in April 2020, defines a CCA as “a registered clearing agency that provides the services of a central counterparty or central securities depository.” While we use CCA for such entities here, we use central counterparty or CCP when quoting prior letters.

The Proposals

The Council strongly supports the Proposals as far as they go. We believe they contain incentives that should encourage CCAs to take steps that will prevent their becoming “systemic-risk transmitters and amplifiers.”³

These include:

- **Intraday Margin Monitoring:** require CCAs to implement policies and procedures that allow for ongoing monitoring of member and non-member participants’ intraday exposures, together with giving CCAs the authority and operational capacity to collect intraday margin from participants as circumstances warrant;
- **Pricing Accuracy and System Redundancies:** require CCAs to include other substantive inputs into existing procedures to ensure they are using sources of reliable price data, and to implement new procedures to handle situations when primary inputs are unavailable or unreliable; and
- **More Detailed Resolution Planning:** create a new rule requiring CCAs to include nine specific elements in their recovery and wind-down plans (“RWP”).

At the same time, we believe the Proposals can be enhanced by considering a number of essential elements that would significantly augment resiliency against a CCA’s failure, preventing almost certain systemic shockwaves that could undermine the stability of the financial system.

Discussion of the Proposals

The first of these proposed changes would allow CCAs to monitor markets in real time, with the ability to mark exposures to current market value and, where needed, collect variation margin on an ongoing basis from participants. Via these actions, the CCAs would have the tools to lessen the potential accumulation of significant loss positions by and among individual or multiple participants that might trigger greater systemic instability.

The second proposed change would ensure CCAs are monitoring accurate information or will have access to supplemental data sources should the accuracy of their primary data sources become suspect.

The third set of changes are the most additive and consequential to systemic protection. They would require CCAs to include the nine specific elements summarized below in their RWPs. The goal of including these elements is to enable resolution authorities to quickly comprehend the structure of the CCA and take actions to stem the tide of market instability. These elements include:

- 1) Identification and description of each CCA’s critical payment, clearing, and settlement services and how a resolution authority and successor might operate these

³ *Supra* 2019 FSB Letter.

- services during recovery or a troubled CCA's wind-down process;
- 2) Identification and description of service providers CCAs use to perform their critical services and the various contractual obligations between the CCAs and these service providers, in the event a CCA's RWP is implemented;
 - 3) Identification and description of market and operational scenarios in which CCAs may not be able to execute their critical services;
 - 4) Identification of circumstances that might trigger implementation of each CCA's RWP;
 - 5) Description of the rules, policies, procedures, and tools each CCA would rely upon when operating under its RWP;
 - 6) Procedures to ensure timely implementation of each CCA's RWP;
 - 7) Procedures for CCAs to use to notify the SEC when they are considering implementation of their RWPs;
 - 8) Procedures for annually stress testing each CCA's ability to implement its RWP and reporting the results to the CCA's Board of Directors; procedures for amending the RWP to address any weak points or gaps identified; and
 - 9) Review of CCAs' RWPs by each CCA's Board, at least annually.

The SRC's Views

The SRC believes that individually and collectively, these Proposals cover many of the procedures needed to ensure CCAs create and implement "credible and robust resolution plans." These improvements would add to the preparedness not just of the CCAs themselves, but also for the regulators providing ongoing oversight of these entities and the resolution authorities that might be called upon to handle the insolvency of a CCA.

While we congratulate the Commission for its continued progress on a set of rules and approaches that help meet the growing risks to financial stability posed by CCAs, we also believe further refinements are needed for the Proposals to achieve that objective. We describe these suggested changes in the paragraphs that follow.

Operational Risks

One such refinement to the Proposals would be to address an important omission from number 8 of the above-summarized mandatory RWP elements. While this part of the Proposal covers the potential for loss of liquidity sources and for severe operational disfunction, it fails to require consideration for such factors as loss from the investment of margin collateral or "the hazard of a clearing member's default affecting a number of CCPs at the same time" given the overlapping clearing memberships such entities may have.⁴

⁴ *Supra*, 2017 Statement.

A CCA's aggressive strategy for investment of margin collateral could generate losses that not only create additional liabilities for a troubled CCA, but also would reduce the funds available to mitigate potential losses incurred by member firms and their customers. In stressed markets, these funds will be needed to buffer against insolvency and a pro-cyclical distribution of financial risk. Consequently, we recommend the SEC include a mandate for policies and procedures for the prudent investment of margin funds to support individual CCAs and financial markets as a whole.

We further recommend that these policies and procedures for the prudent investment of margin collateral require CCAs to maintain a highly diversified investment portfolio with limits on the exposures to any given issuer. While we believe these limits should cover all issuers, we also recognize the current status of U.S. Treasury securities as a safe haven in stressed markets, and therefore recommend higher holding thresholds for Treasury holdings. At the same time, we believe a highly diversified portfolio is needed for CCAs to avoid large concentrations in securities of any one issuer.

We also believe it is imperative that CCAs and their regulators consider and prepare for the potential distribution of financial risk across markets, firms, and CCAs. Such preparedness should include policies and procedures to ensure stress-tests estimate the effects broad-based defaults may have on individual CCAs and their member firms. They also should test for how the default of multiple CCAs will affect their ability to function. It is only through preparation, we believe, that all relevant parties can at least mitigate, if not prevent such broad-based calamities.

A second operational concern is the potential overlap between the Proposal's mandated stress-testing procedures and the testing already required under Rule 17Ad-22(e)(13). As noted in the Proposal, the similarities between the two tests would include an attempt to "simulate how the RWP would perform in crisis situations and would include the participation of senior management and the CCA's board of directors."

It is unclear whether these new tests would differ noticeably from those required by 22(e)(13). As such, to avoid duplicative efforts that can become costly and perfunctory, we encourage combining the elements of both the existing 22(e)(13) rules with these Proposals into a single stress test process that would reduce duplication and better insure timely RWP execution.

Financial Risks

Beyond these operational modifications, the Council remains concerned about several financial risks.

Residual exposures. Potential resiliency challenges resulting from the concentration of residual exposures at CCAs as outlined by Title VIII of the Dodd-Frank Act of 2010 remains a concern. Such concentration could potentially jeopardize the priorities for efficient clearing, settlement, and payment functions that CCAs must ensure.

Over reliance on RWPs. The mandated upgrades and focus on RWP design and testing has the potential to create unrealistic expectations and over-reliance that could actually worsen a downward market spiral. Care is needed to ensure that confidence in such plans is well grounded and that the efficient implementation of RWPs is properly stressed, accounts for rapidly evolving market risk, and the ever-increasing speed of market-moving data.

Loss Absorbing Capacity. To help offset possible financial risks of all manner, the SRC reiterates several of its previous recommendations for strengthening CCAs' loss-absorbing capacity. As described in the [2020 CCP Consultation](#), CCAs have three sources of primary loss-absorbing capacity: 1) initial margin (in the case of a member default); 2) the CCA's default fund; and 3) the equity of the CCA's owners. As the SRC noted, "if a CCP exhausts its primary loss-absorbing capacity, the excess losses have to go somewhere if a bankruptcy proceeding is to be avoided."

After members have fulfilled their *refunding* obligations for the default fund and those funds have been depleted, a CCA could be forced into renegeing on obligations to extinguish its losses by tearing up contracts, haircutting variation-margin obligations, or haircutting initial-margin obligations. As members and other participants get wind of such distress, they will have strong incentives to move fast, close out contracts and sell related assets to reduce their exposure to the distressed CCA.

These actions would further undermine asset prices and liquidity in already stressed markets. The likelihood of contagion to other market participants and CCAs would leave authorities with the much-maligned prospect of bailout, choosing between permitting markets to continue to falter or stepping in to stabilize the CCA, perhaps with taxpayers' support.

To avoid facing such severe choices, the Council reiterates two principles it believes should guide regulatory policy. Both principles are dependent upon the availability of loss-absorbing capacity:

- 1) Incentivize owners to act as systemic risk monitors and managers by requiring elimination of owners' equity upon a CCA's entry into resolution (or bankruptcy), and forbidding CCA owners from retaining any CCA's profits; and
- 2) In order to mitigate pro-cyclicality, CCAs' resolution regimes and plans should distinguish between "operational" and purely "financial" liabilities, with changes made if necessary to clearing houses' rules.

In regard to the first principle, the SRC believes the incentives of CCA owners are of significant consequence to resiliency and recoverability because they, through their senior management, set margin and other requirements that determine market leverage. It is important that CCA owners and management have substantial economic exposure to the CCA's failure, and to ensure they will not benefit from subsidies drawn from other market

participants or ultimately, from taxpayers. To create these incentives, the SRC reiterates its call for regulatory authorities to review the level of tangible equity each CCA is required to hold, together with “the exposure of owners’ equity in the loss-waterfall.”⁵

Concerning the second principle, operational obligations of a CCA participant such as funding and maintaining margin accounts are related to a CCA’s services. Consequently, participants can alter their obligations by changing their use of these services. By comparison, the financial obligations of CCA owners/management are of the type that cannot be avoided by terminating business or closing-out contracts.

Operational Losses Caused by Member Defaults. Previously the SRC recommended requiring CCAs to issue “bailinable” bonds which would absorb losses that exceed a CCA’s primary loss-absorbing capacity. These bonds would serve as financial obligations that CCAs’ owners could not move elsewhere to avoid loss. CCA owners would have a right of first refusal to purchase the bonds, but clearing members of the CCA would be obligated to purchase whatever face amount of the bonds remains after the equity owners’ subscriptions are filled. Holders of the bonds could not sell the instruments or trade them, making it easier to track ownership. When circumstances trigger implementation of an RWP, the bailinable bonds would be available to cover losses beyond the primary loss-absorbing capacity of the CCA.

Financial Losses Not Caused by Member Defaults. The types of losses that member defaults do not create typically arise as a consequence of CCAs’ exposures to financial and market risks caused by their investment of margin and default funds. The transition from mutual to for-profit CCAs in recent decades brought with it a worrying insufficiency of shareowners’ equity to absorb losses produced by the investment of these funds, losses of which cannot be passed along to CCAs’ members.⁶ To avoid such problems, the SRC reiterates our recommendation that the Commission impose very restrictive investment and credit policies for those margin and default funds. We further reiterate our recommendation that CCAs be required to obtain insurance against losses that come as a consequence of poor business decisions or strategy, from unaffiliated, unconflicted, and third-party insurers.

Conclusions

⁵ As noted in footnote 2 of the Council’s 2020 FSB CCP Consultation response: “Addressing the hazard of margin requirements being affected by races to the bottom among competing clearing houses goes beyond resolution policy, but a credible resolution policy regime and plans could affect the incentives of clearing-house risk managers, their bosses, and owners.”

⁶ A CCP can put such losses to clearing members only where that is expressly codified in its contractual rule book. Practice varies across CCPs in this respect. The CPMI/IOSCO PFMI call for clearing houses to ensure that their “own funds” are sufficient: see Principle 4 (on credit risk), Principle 15 (general business risk), and Principle 16 (custody and investment risks). But the PFMI do not establish a minimum standard. The amount of equity carried by CCPs is typically thin, although that varies somewhat between user owned mutualised CCCs and externally (e.g., exchange) owned for-profit CCPs: see Figures 6 and 7 of Wenqian Huang, “Central Counterparty Capitalization and Misaligned Incentives”, BIS Working Papers No. 767, Bank for International Settlements, February 2019. At present, there is not an international minimum standard for CCP common equity.

The SRC is fully supportive of the SEC's recent Proposals as a further enhancement and sound extension of existing rules relating to RWPs. We think even more can be done to strengthen CCA resolution. In doing so, we encourage adherence to the two guiding principles described herein, namely – to impose losses on pure financial obligations before applying losses to operational liabilities and, to extinguish owners' equity when a CCA experiences losses that trigger implementation of its RWP.

In that regard, our CCA Resiliency and Resolution *to-do* list includes:

- Any in-life haircutting of margin funds or part tearing up of the underlying contracts should be completely mechanical recovery actions that do not involve CCA management making discretionary judgments and, in the judgment of the authorities, do not threaten or exacerbate financial instability.
- Once a CCA has entered resolution, the order in which losses are absorbed should be equity, subordinated bonds converted into equity, any incomplete recovery actions, partial haircutting and conversion into equity of margin obligations, partial tearing up of underlying contracts.
- CCA owners should have right of first refusal to buy *bailinable* bonds, together with mandates for clearing members to subscribe any remaining bonds.
- CCAs should take out third-party insurance from unconnected insurers against losses that do not arise from the default of their members.
- Policymakers should explore the possibility of establishing an internationally mutualized disaster fund subscribed to by internationally systemic CCPs.

The SRC recognizes that changes to current CCA rules, to the G20 authorities' international accord for financial market infrastructure (the CPMI/IOSCO PFMIIs), and even new legislation may be needed to advance these ideas. However, given the potential risk to financial stability posed by CCAs, leadership, collaboration and time are of the essence.

For more information or questions regarding this comment letter please contact Kurt Schacht, Executive Director, CFA Institute Systemic Risk Council at kurt.schacht@fainstitute.org

On behalf of the Systemic Risk Council
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Sincerely,

Erkki Liikanen, Co-Chair

Simon Johnson, Co-Chair

The views expressed herein represent the collective views of the SRC and not all members agree with all aspects of this comment letter.

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