INVESTMENT COMPANY INSTITUTE

MEMO# 28858

March 26, 2015

CFTC Staff Holds Public Roundtable on Recovery and Resolution of Derivatives Clearing Organizations

[28858]

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 22-15 RE: CFTC STAFF HOLDS PUBLIC ROUNDTABLE ON RECOVERY AND RESOLUTION OF DERIVATIVES CLEARING ORGANIZATIONS

On March 19, 2015, the staff of the Commodity Futures Trading Commission ("CFTC") held an all-day public roundtable to discuss issues relating to the recovery and orderly wind-down of derivatives clearing organizations ("DCOs") in the event a DCO's financial resources are insufficient to cover losses or payment obligations following a clearing member default. [1] The roundtable was attended by members of the CFTC staff from the Division of Clearing and Risk, including Phyllis Dietz, Acting Director; Bob Wasserman, Chief Counsel; and Kiersten Robbins, Associate Chief Counsel. Attendees from the industry included representatives of DCOs, futures commission merchants ("FCMs") that are clearing members of DCOs, and customers of FCMs whose trades are cleared through DCOs, including asset managers. The roundtable consisted of four sessions. Issues of particular interest to registered funds are summarized briefly below. [2] The roundtable did not discuss the resources that should be available to a DCO in the event of a clearing member default or the order in which those resources should be expended (i.e., the DCO "waterfall"), which the CFTC staff said will be discussed at a later date.

First Session: Variation Margin Gains Haircutting

Variation margin gains haircutting ("VMGH") is a tool through which unpaid variation margin payment obligations are reduced on a pro rata basis in the event of a DCO failure. Panelists discussed issues including the pros and cons of using VMGH, whether VMGH should be used more than once, and whether specific processes or governance mechanisms should be implemented to alleviate concerns that VMGH will be used too many times. A concern was raised that a DCO's use of VMGH as a recovery tool too many times creates a disincentive for participants to clear through that DCO in the future. Others noted that VMGH can be a useful limited purpose tool in extreme stress situations because of the certainty it provides, and because it encourages clearing participants to participate in the DCO's recovery. One roundtable participant noted the potential for VMGH to exacerbate market stress if it is not subject to strict controls.

An asset manager representative expressed the view that a DCO should not be permitted to look to any client margin other than margin from defaulting clearing members in a recovery situation. She thought the priority should be on fully funding the DCO waterfall, stress testing, and similar measures. She believed VMGH should only be used in rare resolution situations, for a short window where the DCO has exhausted the waterfall and is trying to liquidate positions. Another asset manager representative expressed the view that DCOs should be allowed to fail, rather than relying on non-defaulting customer margin.

To address the concern that assessments on DCO members may turn out to be inadequate at the time of a DCO's instability, a DCO representative raised the idea of requiring pre-funding by institutions considered more risky. While favoring VMGH as a recovery tool, he supported a limit of two cycles of VMGH, and asserted that VMGH should be the final step that takes place before full tear-up of trades. Roundtable participants also discussed whether, if VMGH is used as a tool, it should be considered part of a DCO's pre-funded resources, or outside the waterfall as a loss allocation tool.

Second Session: Re-establishing a Matched Book

The second session focused on how a DCO should go about re-establishing a matched book of trades. Methods that were discussed to re-establish a matched book included auctions, which were acknowledged as generally successful, forced allocations, partial tear-ups of trades, and complete tear-ups of trades. Roundtable participants first discussed whether auction participation can be broadened, and how DCOs can incentivize auction participation. DCO representatives, as well as others, supported broadening auction participation, but acknowledged challenges remain in determining how to best accomplish that goal. One of the concerns raised with broadening participation in the auction is that front-running could result when a potential auction participant knows the content of the portfolio that will be sold at auction. Possible solutions were discussed, including creating "skin in the game" for auction participants in order to incentivize them not to engage in front-running, but no clear resolution was reached on this issue. Another issue that was discussed and on which there seemed to be more consensus was the importance of regular default drills for DCO participants, including indirect users that would participate in auctions.

Forced allocation, and partial and complete tear-up of trades, were discussed as possible tools systemically important DCOs could include in their recovery plans in the event of a failed auction. There was some discussion of when a forced allocation would be appropriate, as compared to a tear-up.

Third Session: Wind-down

Roundtable participants discussed whether there is a minimum amount of time following a participant default, or some other point (e.g., the exhaustion of available resources or the failure of an auction) that should be required before the determination to wind-down a DCO is made. A DCO representative suggested there should be a "time out" period of one to two days in which clearing is suspended to discuss possible recapitalization before complete tear up of trades, and a final decision to wind down a DCO, are undertaken. Another DCO representative disagreed with the idea of a time out period, however, raising concerns about the accumulation of risks that could result.

An asset manager representative thought wind-down should occur after specified events or steps have taken place, and stressed that clarity in the process is important to maintain participant confidence, as is a robust governance process. Another asset manager representative agreed that wind-down should not occur until after specified events or steps have taken place, and believed that there should be a maximum time period in which these events or steps must occur. She stressed DCO resolution in this situation over recovery.

An FCM representative stated that it is important, in the event of an expected wind-down, for participants to have the opportunity to seek other options before their trades are torn up. Another FCM representative emphasized the importance of maintaining transparency and market confidence in a stressed market, and advocated for ongoing clearing without suspension, and the possibility of VMGH for a limited number of cycles.

Roundtable participants discussed the implications of the likelihood that, in a "worst case scenario," such as where there is a broad market failure, multiple DCOs would be in distress. In that situation, many DCO participants could be left with open positions, which, in the view of some roundtable participants, makes ex ante planning all the more critical.

Fourth Session: Liquidity Risk Management

Roundtable participants discussed how DCOs could best manage liquidity shortfalls or losses. Discussion focused in large part on how DCOs and clearing members can balance the regulatory requirements to which they are subject, with their need for liquidity in the event of shortfalls and losses. Issues discussed included DCO facilitation of collateral transformation for DCO participants that post less liquid collateral to the DCO that then must be converted to cash or Treasuries.

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endnotes

[1] Related issues will be discussed at an upcoming public meeting of the CFTC's Market Risk Advisory Committee on Thursday, April 2. An agenda for that meeting, which will also include discussion of the market's response to the introduction of swap execution facilities, is available at: http://www.cftc.gov/PressRoom/PressReleases/pr7142-15 (details regarding listening to the meeting by telephone are available at: http://www.cftc.gov/PressRoom/PressReleases/pr7135-15).

[2] A transcript of the roundtable was not yet available at the time of this memorandum, but will be made available at: http://www.cftc.gov/PressRoom/Events/opaevent_cftcstaff031915.