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Division of Clearing and Risk

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Division of Clearing and Risk

MEMORANDUM

TO:	All Registered Derivatives Clearing Organizations
FROM:	Jeffrey M. Bandman, Acting Director, Division of Clearing and Risk (DCR)
SUBJECT:	Recovery Plans and Wind-down Plans Maintained by Derivatives Clearing Organizations and Tools for the Recovery and Orderly Wind-down of Derivatives Clearing Organizations

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Background

Regulation 39.39(b) requires each systemically important derivatives clearing organization ("SIDCO")[1] and Subpart C derivatives clearing organization ("Subpart C DCO")[2] (referred to collectively hereafter as "DCOs") to maintain viable plans for: (1) recovery[3] or orderly wind-down[4] necessitated by uncovered credit losses or liquidity shortfalls; and, separately, (2) recovery or orderly wind-down necessitated by general business risk, operational

[1] A "systemically important derivatives clearing organization" is defined in Regulation 39.2 to mean a financial market utility that is a derivatives clearing organization ("DCO") registered under section 5b of the Commodity Exchange Act ("CEA"), which is currently designated by the Financial Stability Oversight Council to be systemically important and for which the Commission acts as the Supervisory Authority pursuant to 12 U.S.C. § 5462(8). 17 C.F.R. § 39.2.

[2] A "subpart C derivatives clearing organization" is defined in Regulation 39.2 to mean any derivatives clearing organization, as defined in section 1a(15) of the CEA and Regulation 1.3(d) which: (1) is registered as a DCO under section 5b of the CEA; (2) is not a SIDCO; and (3) has elected to become subject to the provisions of Subpart C of Part 39 of the Commission's regulations pursuant to Regulation 39.31. 17 C.F.R. § 39.2.

[3] Pursuant to Regulation 39.39(a)(3), "*Recovery* means the actions of a systemically important derivatives clearing organization or subpart C derivatives clearing organization, consistent with its rules, procedures, and other *ex-ante* contractual arrangements, to address any uncovered credit loss, liquidity shortfall, capital inadequacy, or business, operational or other structural weakness, including the replenishment of any depleted prefunded financial resources and liquidity arrangements, as necessary to maintain the systemically important derivatives clearing organization's or subpart C derivatives clearing organization's viability as a going concern." 17 C.F.R. § 39.39(a)(3).

[4] Pursuant to Regulation 39.39(a)(2), "*Wind-down* means the actions of a systemically important derivatives clearing organization or subpart C derivatives clearing organization to effect the permanent cessation or sale or transfer of one or more services." 17 C.F.R. § 39.39(a)(2).

risk, or any other risk that threatens the DCO as a going concern (each, as applicable, a "Recovery Plan" or "Wind-down Plan").[5] The preparation of these Recovery Plans and Wind-down Plans requires DCOs to "identify scenarios that may potentially prevent [the DCO] from being able to meet its obligations, provide its critical operations and services as a going concern and assess the effectiveness of a full range of options for Recovery or orderly Wind-down."[6] Regulation 39.39 became effective on December 31, 2013; the Commission was able to, upon request, grant a DCO up to December 31, 2014 to comply with the requirements of 39.39.[7]

The development of a Recovery Plan and the development of a Wind-down Plan are critical elements of risk management and contingency planning to address the extreme circumstances that could threaten a DCO's viability and financial strength. The analysis set forth in the Recovery Plan can contribute to a better *ex ante* understanding by the DCO of the scenarios that would lead to uncovered credit losses or liquidity shortfalls and the management of challenges the DCO would face. In addition, such analysis promotes the ability of the DCO to more effectively and efficiently meet its obligations promptly, thereby reducing the possibility of market disruptions and financial losses to clearing members and their customers and avoiding harm and market disruption from a DCO default. Further, this analysis can provide a DCO with a better understanding of clearing members' obligations and the extent to which the DCO would perform its obligations to its clearing members in times of market stress. These analyses are particularly critical for SIDCOs, in light of their systemically important nature.

A Wind-down Plan sets forth a plan for winding-down the DCO in an orderly manner and would be used in a situation where recovery is not possible and resolution (if potentially available, as discussed below) has not been triggered. A Wind-down Plan <u>is not</u> a substitute for a comprehensive and effective Recovery Plan. Rather, given the potential for even the best plan to be ineffective in a particular circumstance, the Wind-down Plan is a fundamental part of the DCO's risk management and contingency planning process.

A DCO's Recovery Plan and Wind-down Plan are also important to resolution planning, another equally critical element of contingency planning for those DCOs that are SIDCOs. A resolution plan is drafted by the Federal Deposit Insurance Corporation ("FDIC"), the resolution authority for any SIDCO, pursuant to its authority under Title II of the Dodd-Frank Act.[8] A

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[5] While Regulation 39.39 only applies to SIDCOs and Subpart C DCOs, the guidance set forth herein is also intended to be a useful resource for other DCOs that voluntarily develop Recovery Plans and Wind-down Plans.

[6] 17 C.F.R. § 39.39(c)(1).

[7] 17 C.F.R. § 39.39(f).

[8] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010). This resolution plan, drafted pursuant to Title II of Dodd-Frank, is distinguishable from the plan that a Bank Holding Company is required to produce pursuant to Title I of the Dodd-Frank Act ("a § 165(d) Plan" or a "Living Will"), which is also referred to as a resolution plan. *See* 12 U.S.C. § 5365(d). *See also* 12 C.F.R. § 360.10. The Living Will, which must be submitted annually for review to the Board of Governors of the Federal Reserve and the FDIC must provide for the rapid and orderly resolution of the Bank Holding Company, under the U.S. Bankruptcy Code, in the event of material financial distress. This process is designed to foster resolution planning and enables agencies to assess whether a firm could be resolved under bankruptcy without severe adverse consequences for the financial system or the U.S. economy.

See also Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, Appendix I-Annex 4, 1.8 (Oct. 14, 2014) (setting forth international agreement regarding the role of resolution plans).

resolution under Title II can only occur if the failure of the company, including a DCO, could not proceed under applicable state or federal law, including the U.S. Bankruptcy Code, without causing serious adverse effects on financial stability in the United States.[9] A DCO's Recovery Plan and Wind-down Plan are critical information that the resolution authority uses in developing the resolution plan.[10] Regulation 39.39(c)(2) requires certain DCOs, including SIDCOs, to have procedures for providing the Commission and the FDIC "with information needed for purposes of resolution planning."[11]

As DCOs have actively developed their Recovery Plans and Wind-down Plans, the Division of Clearing and Risk ("DCR") has conducted preliminary reviews of the Recovery Plans and Wind-down Plans. DCR has also reviewed draft proposed rule changes that the DCOs have submitted in order to implement their Recovery Plans and Wind-down Plans.

In the course of DCR's preliminary review of Recovery Plans, Wind-down Plans, and proposed rule changes, staff have discussed with DCOs, clearing members, and other market participants a number of issues pertaining to recovery tools a DCO may seek to use including: (1) the use of gains based haircutting as a tool to allocate losses, (2) the tools available to the DCO in order to re-establish a matched book following a participant default, (3) the governance for the determination that wind-down, rather than recovery, is appropriate or necessary, (4) the structure of the DCO's waterfall, including the amount and location of the DCO's capital contribution within the waterfall, and (5) the governance surrounding the recovery process, including use of emergency powers in recovery. DCR has also received requests from DCOs for guidance regarding these issues and to clarify the types of information and analysis that should be included in the Recovery Plans and Wind-down Plans.

In addition, in light of the public interest in these topics, DCR sponsored a public roundtable on March 19, 2015 to discuss and explore critical issues regarding recovery and wind-down tools.[12] Following the roundtable, DCR staff have continued to consider and to

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[9] *See* 12 U.S.C. § 5363(b)(4).

[10] The Living Will is an analogous input into the FDIC's resolution planning for Bank Holding Companies. *Cf.* Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 FR 76614, 76615-16 (Dec. 18, 2013).

[11] 17 C.F.R. § 39.39(c)(2). Although this memorandum does not address resolution planning, DCR notes that Commission staff has been actively engaged with FDIC staff regarding resolution planning for DCOs. In addition, staff of both agencies are working with international regulators and authorities on resolution planning for central counterparties, including those registered with the Commission as DCOs, in several fora. DCR also notes that while Title II does not "specify how a resolution should be structured," or dictate the form of the FDIC's resolution plans, Title II does set forth certain policy goals for resolution. 78 FR 76615. "The FDIC must resolve the covered financial company in a manner that holds owners and management responsible for its failure accountable—in order to minimize moral hazard and promote market discipline—while maintaining the stability of the U.S. financial system. Creditors and shareholders must bear the losses of the financial company in accordance with statutory priorities and without imposing a cost on U.S. taxpayers." *Id.*

[12] Transcript available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/transcript031915.pdf. The goal of this roundtable was to gather different industry viewpoints, including those of the DCOs, their clearing members (most of which are futures commission merchants ("FCMs")), and the clients of their FCM clearing members (including money managers and end-users). Prior to the roundtable, end-users, including those in the agricultural, metals, and energy industries, had not been vocal participants in the discussion. The roundtable provided a forum for all the participants to challenge one another's views and enabled staff to consider the viewpoints of end-users as staff continues to review DCOs' Recovery Plans and Wind-down Plans, and the proposed rule changes to implement such plans.

discuss the issues regarding recovery tools, including those issues raised at the public roundtable, in a number of domestic and international fora, including working groups of the U.S. Financial Stability Oversight Council and the Financial Stability Board, as well as the Policy Standing Group on Financial Market Infrastructures of the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions.

In order to aid DCOs in revising and improving their Recovery Plans and Wind-down Plans, and in preparing proposed rule submissions in order to implement their Recovery Plans and Wind-down Plans, DCR has prepared two sets of guidance. First, section I below provides guidance regarding the subjects and analysis that should be included in a viable Recovery Plan and Wind-down Plan. Second, section II sets forth questions that DCOs should consider (1) in evaluating whether particular tools for recovery and orderly wind-down should be included in the Recovery Plans and Wind-down Plans and (2) in designing proposed rule changes to support the inclusion of particular tools in such plans.[13]

I. Subjects and Analysis to Be Addressed in Recovery Plans and Wind-down Plans

DCR encourages DCOs to address fully within their Recovery Plans and Wind-down Plans each of the subjects listed below and to perform all related analysis thoroughly. The Recovery Plans and Wind-down Plans should include detailed descriptions of such analysis and any relevant information, data or documentation. DCR cautions, however, that this guidance is designed to highlight certain broad topics of general applicability that should be addressed in each Recovery Plan and each Wind-down Plan. This guidance is not intended as an exhaustive checklist of the information and analysis that would be necessary to form either a complete and viable Recovery Plan or a complete and viable Wind-down Plan.[14] The analysis referred to above should consider the DCO's individual risk profile, operations, organizational structure, financial resources, business model and practices, interconnections and interdependencies, and any other relevant factors.

1. *Scenarios*.

Regulation 39.39(c)(1) requires each DCO to "identify scenarios that may potentially prevent [the DCO] from being able to meet its obligations, provide its critical operations and services as a going concern and assess the effectiveness of a range of options for recovery…." One of the primary objectives of a Recovery Plan is to provide a workable, *ex ante* framework for recovery that can be implemented quickly and effectively in the event that a scenario should occur. Two fundamental and indispensable steps toward achieving this aim are: (1) to identify the range of specific scenarios that may adversely impact the DCO and (2) to assess fully their respective impacts on the DCO, the DCO's clearing members, and other relevant stakeholders.

As noted above, Regulation 39.39(b) requires DCOs to maintain viable plans for: (1) recovery necessitated by uncovered credit losses or liquidity shortfalls and "separately" (2) recovery necessitated by general business risk, operational risk, or any other risk that threatens

[13] DCR notes that proposed rule changes submitted to the Commission, including those of the type that are discussed in this memorandum, are required to be published concurrently on the DCO's website. *See* 17 C.F.R. §§ 40.5(a)(6), 40.6(a)(2), 40.10(a).

[14] Accordingly, this memorandum should not be construed in any way as limiting the Commission's ability to pursue actions for violations of Regulation 39.39.

the DCO as a going concern. While the recovery frameworks applicable to (1) and (2) may be discussed within a single document, each recovery framework should be analyzed independently. For each type of risk set forth in (1) and (2), a DCO should identify and evaluate the full range of distinct, relevant scenarios that would prevent the DCO from being able to meet its obligations and to provide its critical operations and services.[15]

DCR notes that, for this purpose, a DCO need only identify and address the types of scenarios referenced in Regulation 39.39(c)(1), not each market scenario that would result in losses. Thus, a DCO is not expected to analyze the number of specific scenarios or events that may be necessary for stress testing, such as the testing required by Regulations 39.13(h)(3) and 39.36(a).

In addition to uncovered credit loss and liquidity shortfall scenarios, a Recovery Plan should include separate analyses of multiple scenarios resulting in or from each of the following:

a. specifically identified "general business risks," as defined in Regulation 39.39(a)(1);[16]

b. specifically identified "operational risks," as defined in Regulation 39.39(a)(4);[17] and

c. any other risks that might threaten the DCO's viability as a going concern.[18]

While the exact combination of relevant recovery scenarios may be exclusive to a particular DCO, DCR has identified certain commonly applicable scenarios that should be included in all Recovery Plans. These include, but are not limited to, general business risk scenarios and operational risk scenarios such as:

a. a settlement bank failure;

b. a custodian bank failure;

c. scenarios resulting from investment risk;

d. poor business results;

e. the financial effects[19] of cybersecurity events;

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[15] *Cf.* 17 C.F.R. § 39.13(b).

[16] "General business risk," is defined in Regulation 39.39(a)(1) to mean "any potential impairment of a [SIDCO's] or [Subpart C DCO's] financial position, as a business concern, as a consequence of a decline in its revenues or an increase in its expenses, such that expenses exceed revenues and result in a loss that the [DCO] must charge against capital."

[17] "Operational risk" is defined in Regulation 39.39(a)(4) to mean "the risk that deficiencies in information systems or internal processes, human errors, management failures or disruptions from external events will result in the reduction, deterioration, or breakdown of services provided by a [SIDCO] or [Subpart C DCO]."

[18] All risks should be specifically identified and separately addressed. A Recovery Plan that is limited to broadly characterized scenarios such as "business and operational risks," for example, would be insufficiently detailed.

f. internal fraud, external fraud, and/or other actions of criminals or public enemies;

g. legal liability not specific to the DCO's business as a DCO (*e.g.*, tort liability, liability related to intellectual property); and

h. losses resulting from interconnections and interdependencies among the DCO and its parent, affiliates, and/or internal or external service providers (*e.g.*, the financial effects of the inability of an internal or external service provider to supply key systems or services to the DCO).

The DCO also should describe the actions that it has taken to determine its general business and operational risks and to ascertain any other risks that might threaten its viability.

Certain scenarios that pose a threat to DCOs (*e.g.*, cybersecurity issues) may be systemic in nature. Accordingly, the suite of scenarios included in a Recovery Plan should not be limited to idiosyncratic events. Certain scenarios also may have contagious effects. Thus, a DCO's Recovery Plan should not assume that the adverse effects of all of its scenarios can be contained to the DCO. An event may, for example, adversely affect the DCO's affiliates or service providers.[20] It is also possible that an event that is idiosyncratic to the DCO performing the analysis or a systemic event could have an effect on other DCOs, including unaffiliated DCOs. Accordingly, the Recovery Plan should include and address scenarios that affect a DCO and other entities, if the effect on the other entities ultimately impacts the DCO.

Each scenario and its resulting circumstances should be analyzed individually and in detail in the DCO's Recovery Plan. Such analyses should include, at a minimum:

a. a description of the scenario;

b. the events that are likely to trigger the scenario;

c. the DCO's process for monitoring for such events;

d. the market conditions, operational and financial difficulties and other relevant circumstances that are likely to result from the scenario;

e. the potential financial and operational impact of the scenario on the DCO and on its clearing members, internal and external service providers and relevant affiliated companies, both in an orderly market and a disorderly market (*e.g.*, where markets are unavailable or there are few solvent counterparties); and

f. the specific steps that the DCO would expect to take when the scenario occurs or appears likely to occur including, without limitation, any governance or other procedures that may be necessary to implement the relevant recovery tools and to

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[19] The business effects of cybersecurity events would be in addressed the DCO's business continuity plan, which is outside the scope of this memorandum.

[20] If a clearing member fails in its obligations to a DCO, it may fail in its obligations to other DCOs as well. *See* the discussion of a DCO's interconnections and interdependencies, in section I.4 *infra*.

ensure that such implementation occurs in sufficient time for the recovery tools to achieve their intended effect.

While there may be commonalities between the actions the DCO expects it would take in each scenario, DCR expects that the DCO will analyze each scenario individually and that the Recovery Plan will describe the differences between the approaches and the rationale for such differences.

2. *Recovery Tools*.

DCR believes that the DCO's ability to implement its Recovery Plan promptly and effectively will be significantly enhanced if the DCO, during a time of "business as usual" and prior to the occurrence of a particular scenario: (a) has performed the thoughtful analysis necessary to determine *ex ante* the specific recovery tools that it intends to activate in particular scenarios and the sequencing thereof, and (b) has evaluated thoroughly any impediments or risks to the timely or successful use of those tools. While each scenario event will, almost inevitably, involve unique and unforeseen circumstances that will require a certain degree of flexibility in the DCO's approach to addressing that event, DCR believes that maintaining an established and carefully considered recovery toolkit to guide its recovery efforts will result in the ability to react to an unexpected event more rapidly; provide transparency to clearing members and other participants; and assist in ensuring that the Rules, policies and procedures necessary to implement the recovery tools are in place. Accordingly, for each scenario, a Recovery Plan should identify and analyze:

a. the particular recovery tools that the DCO would expect to use in the event that the scenario happens;[21]

b. the specific order in which the DCO would expect to use such tools; the event that would trigger the use of each tool in the sequence; and any discretion that the DCO has in the use and/or sequencing of the tools, the parameters for the exercise of such discretion, the factors that guide such discretion and the governance processes for the exercise of such discretion;

c. whether each tool is mandatory or voluntary;[22]

d. the specific steps that would be required to implement each tool;

[21] A variety of recovery tools may be available to a particular DCO (*e.g*., assessments, gains-based haircutting, voluntary optional payments, partial tear-up, intercompany loan agreements, or other means of capital infusion by a parent or an affiliate or insurance). As noted above, the suitability and feasibility of certain recovery tools generally or for a particular DCO is beyond the scope of this memorandum.

[22] In this context, "mandatory" recovery tools are those recovery tools in which participation is required under the DCO's rules or procedures. For example, a DCO may have the rule-based authority to compel its clearing members to provide additional funds up to a certain cap when assessed by the DCO or the rule-based authority to impose gains-based haircuts. "Voluntary" recovery tools are those recovery tools for which participation by the DCO or its members, as applicable, is discretionary. Voluntary recovery tools could include, for example, voluntary optional payments by clearing members to reduce losses, voluntary partial tear-ups, borrowing under intercompany loan agreements, or the reduction or elimination of dividend payments.

e. the roles, obligations, and responsibilities of the parties that are involved in the use of each tool (*e.g.*, non-defaulting participants);

f. the time frame within which each tool could be used (*e.g.*, taking into account notice and internal approval requirements or negotiation with clearing members in connection with voluntary tools);

g. the key risks associated with the use of each tool (*e.g.*, that clearing members will not satisfy their assessments or other obligations or participate in voluntary tools, or that the use of assessments or other recovery tools will result in additional defaults or otherwise exacerbate the adverse impacts of the scenario);

h. the steps that the DCO would expect to take before an event occurs to mitigate such identified risks;

i. any constraints on the use or effectiveness of each tool (*e.g.*, caps on the amount or frequency of assessments and gains-based haircutting, the willingness of counterparties to enter into repurchase agreements to satisfy liquidity requirements, covenants within certain loan agreements that may restrict the ability to borrow under such agreements or limits on the types of events for which insurance would be available and the amount of insurance coverage);

j. an evaluation of the likelihood that, given the factors identified in h. – i. above, the recovery tool would be effective within the relevant timeframe;

k. the expected impact on the DCO, its clearing members and their customers, its parent, affiliates, and owners, and the financial system more broadly if a particular tool is used; the manner in which the DCO would mitigate any adverse impacts; and the mechanisms by which the DCO would enable its clearing members to understand, measure, manage, and control the exposure created by the tool;

l. any incentives that would be created by the availability or the use of the tool; and

m. the relevant rules or rule amendments that support (or are needed to support) the use of each tool.

The considerations set forth in a. – m. above apply to both voluntary and mandatory recovery tools. In addition, for each voluntary recovery tool, the Recovery Plan should analyze: (1) the process by which clearing members agree to become subject to the tool and (2) the basis for the DCO's confidence that such tools would be available including, without limitation, any incentives that clearing members may have for volunteering to participate in such tools (*e.g.*, debt or equity instruments that provide an economic return or governance or other rights that could be given as incentives).

A DCO ultimately may determine that it would be appropriate to take the same course of action (*e.g.*, use the same recovery tools in the same order) in a multitude of scenarios. Such general conclusions, however, are appropriate only if the DCO has performed the analysis set forth above. Such analysis also is necessary, in part, to fulfill a DCO's obligation under Regulation 39.39(c)(1) to "assess the effectiveness of a full range of options for recovery."

DCOs may wish to describe in their Recovery Plans any recovery tools that they have analyzed but decided not to use. An understanding of the recovery tools that will be used in various scenarios, the risks of their use, and the likely limits of their effectiveness is essential for an accurate analysis of the sufficiency of a DCO's financial resources to implement its Recovery Plan.[23]

Further, a DCO should consider whether certain scenarios that it has identified are likely to occur in tandem or successively. A DCO should consider the effect of such circumstances on its recovery needs and the use and timing of its recovery tools.

3. *Wind-down Scenarios and Options*.

With respect to Wind-down Plans, Regulation 39.39(c)(1) also requires each DCO "to identify scenarios that may potentially prevent the DCO from being able to meet its obligations or to provide its critical operations and services as a going concern."[24] A DCO is required to assess the effectiveness of a "full range of options" for orderly wind-down. The scenarios and related recovery tools described in the DCO's Recovery Plan typically will serve as a springboard for the DCO's analysis of the events that would trigger the implementation of its Wind-down Plan and the use of the DCO's wind-down options. A Wind-down Plan should describe, for each scenario: (a) the point or points in the Recovery Plan for that particular scenario where recovery efforts would be deemed to have failed and the Wind-down Plan would be triggered; (b) in that particular scenario, the wind-down options that would be available to the DCO (*i.e.*, the actions that the DCO could take to effect, in an orderly manner, the permanent cessation, sale or transfer of the DCO's clearing and other services); and (c) for each option, the specific actions that the DCO plans to take.

A DCO's analysis of its wind-down options should contain many of the elements of the DCO's analysis of its recovery tools. The Wind-down Plan should identify and analyze in detail, with respect to each scenario:

a. the particular wind-down options that the DCO would expect to use in the event that its recovery efforts fail;

b. the specific order in which the DCO would expect to employ such options and any discretion that the DCO has with respect to the use and/or sequencing of such options, the parameters for the exercise of such discretion, the factors that guide such discretion, and the governance processes for the exercise of such discretion;

c. the specific steps that would be required to implement each option (*e.g.*, disclosure, risk reduction, trade reduction, transfer or close-out of positions, and the liquidation of investments);

d. the time that would be required to complete each step (*e.g.*, in light of disclosure, contract termination and other relevant requirements) and the time frame within which the DCO believes that an orderly wind-down could be effectuated;

[23] *See* 17 C.F.R. § 39.39(d)(2).

[24] 17 C.F.R. § 39.39(c)(1).

e. the roles, obligations, and responsibilities of the various parties, including non-defaulting participants, in the use of each option;

f. any limits on the use of each option to effectuate an orderly wind-down;

g. an evaluation of the likelihood that the option would result in an orderly wind-down;

h. the impact of each option and the steps needed to effectuate it on the DCO; the DCO's clearing members and their customers, parent, affiliates, and owners; and the financial system more broadly; and

i. the relevant DCO rules or rule amendments that support (or are needed to support) the use of each option.

The Wind-down Plan should address the manner in which liquidity requirements would be managed during service closure. A Wind-down Plan also should identify essential support services (*e.g.*, personnel, facilities, utilities, and communications technologies) and address the manner in which the DCO would maintain such services during the wind-down period.

Regulation 39.39(b) requires that DCOs maintain Wind-down Plans that are viable. Accordingly, Wind-down Plans should address fully any obstacles to the DCO's Wind-down options (*e.*g., the likelihood that a transfer or sale could not be effectuated in light of the financial and operational capacity that would be required of a transferee or the status of the DCO as a distressed seller) and explain the viability of the options in light of such obstacles.

4. *Interconnections and Interdependencies*.

Both a DCO's Recovery Plan and its Wind-down Plan should identify the financial and operational interconnections and interdependencies among the DCO and its relevant affiliates, internal and external service providers and other relevant stakeholders, and analyze the impact that such relationships may have on the Recovery and/or Wind-down Plan. Without limiting the generality of the foregoing, a Recovery Plan should, for example:

a. identify and address the extent to which such relationships may increase the adverse consequences of each scenario, decrease the availability or effectiveness of particular recovery tools in certain scenarios (*e.g.*, where multiple affiliated entities are affected by a scenario, multiple affiliates may seek to borrow under the same intercompany loan agreements or may rely on insurance policies with group coverage limits) or increase the DCO's recovery needs;

b. specifically identify and address the multiple roles and relationships that a single financial entity may have with respect to the DCO (*e.g.*, a single entity may act as a settlement bank, custodian bank, liquidity provider, and/or counterparty);

c. account for the possibility that, if any relevant entity in the financial sector fails, all of that entity's affiliates would fail and the entity and those affiliates would default on all obligations in all their capacities to the DCO; and

d. identify specifically the DCO's critical internal and external service providers, the risks that the failure of each provider poses to the DCO, how such failures would

be addressed, and how the DCO would ensure that the services provided by its internal and external service providers would continue to be provided in recovery.

In addition to the above and as discussed in section I.1, a DCO's Recovery Plan and Wind-down Plan should address both systemic scenarios and scenarios that are idiosyncratic to the DCO in which other DCOs (including unaffiliated DCOs) are impacted. The Recovery Plan and Wind-down Plan should address how the effect that the scenario has on the other DCOs would influence the actions taken by the DCO in recovery or wind-down (*e.g.*, the recovery tools and wind-down options that would be available to the DCO or that the DCO would choose).

A Wind-down Plan should, without limitation:

a. identify and address the effect that the DCO's interconnections and interdependencies may have on the DCO's ability to implement its wind-down options (*e.g.*, the impact that such relationships may have on the value of the DCO and its ability to be sold) and the financial resources available to the DCO to implement its Wind-down Plan; and

b. address the impact that such relationships may have on the DCO's ability to maintain essential support services during the wind-down process.

5. *Agreements to Be Maintained during Recovery and Wind-down.*

A DCO will have a variety of contractual arrangements that must be maintained during ordinary operations, in times of stress and in order for the DCO to continue operations in recovery and wind-down. Such arrangements include contractual arrangements with clearing members (*e.g.*, the DCO's rules and procedures); affiliates (*e.g.*, agreements to provide operational, administrative and staffing services and intercompany loan agreements); linked central counterparties (*e.g.*, mutual offset agreements or cross-margining agreements); counterparties; external service providers (*e.g.*, credit agreements); and other third parties. A DCO's Recovery Plan and Wind-down Plan should identify and analyze the implications of such arrangements.

The DCO should: (a) review and analyze such agreements to determine whether any of them include covenants, material adverse change clauses or other provisions that would permit a counterparty to alter or terminate the agreement as a result of any of the circumstances or stress that is caused by or results from the DCO's need to implement its Recovery Plan or its Wind-down Plan; and, (b) if so, analyze the impact on the DCO's ability to effectuate a successful recovery or orderly wind-down (*e.g.*, analyze whether the termination of such agreements render the continuation of operations impracticable). The Recovery Plan and Wind-down Plan should include such analysis and describe the actions that the DCO has taken to ensure that its operations can continue during recovery and wind-down despite the termination or alteration of relevant contracts.

6. *Financial Resources.*

Regulation 39.39(d)(2) requires DCOs "to maintain sufficient unencumbered liquid financial assets, funded by the equity of its owners, to implement its recovery or wind-down plans…." While the financial resources that a DCO is required to maintain pursuant to Regulation 39.11(a)(2) may be sufficient, the DCO is required to "analyze its particular

circumstances and risks and maintain any additional resources that may be necessary to implement the [P]lans" and to include within its Recovery Plan and its Wind-down Plan "evidence and analysis" to support the DCO's conclusion that the amount the DCO considers necessary to implement both its Recovery Plan and its Wind-down Plan is, in fact, sufficient.

The above-referenced analysis should account for all extraordinary costs that may be incurred by the DCO during recovery and wind-down. DCR believes that, in considering and analyzing the magnitude of the costs associated with recovery and wind-down, it is important to consider both the relevant increases in costs (*e.g.*, legal fees, accounting fees, financial advisor fees, the costs associated with employee retention programs, and other incentives to maintain staff) as well as potential decreases in costs that might result from the contraction or (in the case of a wind-down) the cessation of operations in a period shorter than six months.

A DCO should not rely on the same resources to implement both its Recovery Plan and its Wind-down Plan. A DCO must assume that the resources that it has consumed for recovery will not be available should recovery efforts fail and the DCO proceeds to wind-down. In calculating the resources that would be required to implement the DCO's Wind-down Plan, however, a DCO need only address any added, marginal costs that may be associated with the wind-down process that are above and beyond the costs incurred in recovery.

Having considered the financial resources available to the DCO for recovery and wind-down purposes in light of the expected costs, the DCO's Recovery Plan and Wind-down Plan should include, at a minimum, the following evidence and analysis:

a. a demonstration of the amount of unencumbered liquid financial assets, funded by the equity of the DCO's owners, that would be necessary to implement the DCO's Recovery Plan and its Wind-down Plan (this demonstration should be based upon a thorough and realistic analysis of the full financial impact, both in terms of financial resources and liquidity needs, of the relevant recovery scenarios and tools and wind-down options); and

b. (i) a demonstration that the financial resources that the DCO is required to maintain pursuant to Regulation 39.11(a)(2) are sufficient for this purpose and the supporting analysis or, (ii) if such financial resources are not sufficient, a demonstration that the DCO maintains the additional resources necessary to maintain its Recovery Plan and Wind-down Plan.

All financial information included in a DCO's Recovery Plan and its Wind-down Plan should be as up-to-date as practicable to ensure the accuracy of the financial calculations and analysis. Both a DCO's Recovery Plan and its Wind-down Plan should include a viable plan for raising additional financial resources including, where appropriate, capital, in a scenario in which the DCO is unable, or virtually unable to comply with any of the Part 39 financial resource requirements.[25] This financial resource plan should be approved by the Board of Directors of the DCO. In developing this plan, the DCO should consider a strategy for raising additional capital from plausibly interested parties under plausible potential structures.

[25] *See* 17 C.F.R. § 39.39(e).

7. *Governance.*

DCR believes that governance is necessarily a part of a complete Recovery Plan and a complete Wind-down Plan, and that pre-defined governance arrangements will assist DCOs in reacting quickly to scenarios, provide transparency to the recovery and wind-down processes, and assist in ensuring that recovery and wind-down decisions (both in the planning and implementation stages) are vetted properly and with appropriate consideration of the interests of affected parties. Accordingly, both a DCO's Recovery Plan and its Wind-down Plan should set forth all relevant governance arrangements. Both a DCO's Recovery Plan and its Wind-down Plan should analyze issues pertaining to the DCO's corporate structure that may have impacts on the use of recovery tools and wind-down options. Without limiting the generality of the foregoing, a DCO's Recovery Plan and Wind-down Plan, as applicable, should:

a. identify the persons responsible for the development, review, approval, and ongoing monitoring and updating of the DCO's Recovery Plan and Wind-down Plan;

b. describe the involvement of the DCO's clearing members in the development, review, and updating of the Recovery Plan and the Wind-down Plan, and in assessing the effects of the Recovery Plan and Wind-down Plan on clearing members;

c. describe how the costs and benefits of various recovery tools are taken into account during the decision-making process;

d. describe the Recovery Plan and Wind-down Plan approval and amendment processes;

e. describe the specific roles and responsibilities of the DCO's Board of Directors, relevant committees (*e.g.*, the risk committee), and other employees and clearing members in activating the Recovery Plan and Wind-down Plan and in implementing various aspects thereof including, without limitation, the use of recovery tools and wind-down options; and

f. the discretion of such persons and entities in activating the Recovery Plan and Wind-down Plan, the parameters for exercise of such discretion, where such discretion may be exercised, the factors that guide such discretion, and the governance processes for the exercise of such discretion.

A DCO should consider the use of a "decision tree" as a communication tool in this context.

Such a decision tree might outline the procedures for the decisions that must be made and the actions that must be taken in order to:

a. activate the Recovery Plan or Wind-down Plan when a scenario is likely to be triggered;

b. activate the Recovery Plan or Wind-down Plan when circumstances warrant; and

c. implement each step within the Recovery Plan or Wind-down Plan.

The decision tree also might identify the persons or entities responsible for making such decisions or taking such actions. To the extent that the decision making process differs in particular recovery or wind-down scenarios, such differences should be identified within the relevant Recovery Plan or Wind-down Plan, as applicable.

8. *Notifications*.

A DCO's Recovery Plan and Wind-down Plan should include procedures for informing the Commission when the Recovery Plan is initiated or wind-down is pending, consistent with Regulation 39.39(c)(1), and for providing such notice to clearing members[26] and other stakeholders. The Recovery Plan and Wind-down Plan also should include procedures for providing the Commission and the FDIC with information needed for the purposes of resolution planning.[27]

9. *Assumptions*.

Neither a DCO's Recovery Plan nor its Wind-down Plan should assume action or participation by the Commission or any other foreign or domestic regulator. To the extent that the DCO would need regulatory approvals in order to take certain actions specified in a Recovery Plan or Wind-down Plan, the Recovery Plan or Wind-down Plan, as applicable, should identify what approvals would be necessary and the procedures that the DCO would follow to obtain such approvals. In addition, and as discussed above, neither a DCO's Recovery Plan nor its Wind-down Plan should assume that events are idiosyncratic; that the DCO's relevant affiliates or internal or external service providers would not be affected by an event; that, in a scenario, internal and external service providers would continue to perform as expected pursuant to existing contracts or that replacements easily could be found (particularly in the context of a wind-down); or any other facts or circumstances that plausibly may not be present in the scenario or that would cause the DCO to underestimate the impact of a scenario.

10. *Updates*.

Both a DCO's Recovery Plan and its Wind-down Plan should be based upon the rights and obligations contained in the current rules, policies, and procedures of the DCO and, as applicable, other pre-existing contractual arrangements. That is, neither a Recovery Plan nor a Wind-down Plan should assume that proposed or future rules, policies, or procedures will be put in place.[28] In addition, both a DCO's Recovery Plan and its Wind-down Plan should include procedures for evaluating and updating the Recovery Plan or Wind-down Plan at regular intervals and additionally, promptly when warranted by changes to the DCO's rules, policies, and procedures; contractual arrangements; business model and practices; financial resources; risk profile; operations; organizational structure; interdependencies and interconnections; product offerings; or other circumstances. Both a DCO's Recovery Plan and its Wind-down Plan should

[26] *See* 17 CFR § 39.21.

[27] *See* 17 C.F.R. § 39.39(c)(2).

[28] However, DCR notes that when the DCO initially develops its Recovery Plan and Wind-down Plan, the DCO may need to propose rule changes in order to implement its Recovery Plan or Wind-down Plan. Following this initial development phase, DCR expects that, as stated above, the Recovery Plan and Wind-down Plan will be based upon the current rules, policies, and procedures of the DCO.

include pinpoint citations, where applicable, to the DCO's rules, policies, procedures, and agreements.

11. *Testing.*

The Recovery Plan and Wind-down Plan also should include procedures for regularly testing the viability of the Recovery Plan or Wind-down Plan. Where applicable, such tests should be conducted with the participation of clearing members. Both the Recovery Plan and Wind-down Plan should identify the types of testing that will be performed; the frequency with which the Recovery Plan or Wind-down Plans, as applicable will be tested; to whom the findings are reported; and the procedures for updating the Recovery Plan or Wind-down Plan in light of such findings.

II. Questions DCOs Should Consider Regarding Recovery Tools

DCR recommends that each DCO consider the questions below as it analyzes and evaluates the feasibility and suitability of tools for inclusion in its Plans, and the scope of its analysis. This guidance is not intended to be exhaustive or to provide a checklist of factors that a DCO must consider in the analysis of the feasibility or suitability of tools for inclusion in its Recovery Plan or Wind-down Plan. Rather, DCR is recommending that each DCO consider the questions set forth below in light of its risk profile, organizational structure, financial resources, individual business model and practices, interconnections and interdependencies, and any other relevant circumstances. These factors should be considered in light of the DCO's obligation to have governance arrangements that "explicitly support the stability of the broader financial system and other relevant public interest considerations of clearing members, customers of clearing members, and other relevant stakeholders," and the DCO's board of directors' obligation to "make certain that the [DCO's] design, rules, overall strategy, and major decisions appropriately reflect the legitimate interests of clearing members, customers of clearing members, and other relevant stakeholders."[29]

To the extent that a DCO reaches the conclusion that rule changes are necessary, as the DCO undertakes the analysis of the questions set forth below, the DCO should design and submit proposed rule changes. When submitting such proposed rule changes to the Commission, SIDCOs should include the analysis of the questions below in the advance notice required by Regulation 40.10(a).[30] Subpart C DCOs should also include such analysis with rule changes submitted pursuant to Regulations 40.5 or 40.6.[31] DCR notes that when such proposed rule

[29] *See* 17 C.F.R. § 39.32(a)(1)(ii); (a)(2).

[30] *See* 17 C.F.R. § 40.10(a). In particular, Regulation 40.10(a)(1) states that the notice of a proposed rule change "shall specifically describe: (i) The nature of the change and the expected effects on risks to the [SIDCO], its clearing members, or the market; and (ii) How the [SIDCO] plans to manage any identified risks."

[31] *See* 17 C.F.R. §§ 40.5, 40.6.

For rule changes submitted pursuant to Regulation 40.5, Regulation 40.5(a)(5) requires a DCO to "[p]rovide an explanation and analysis of the operation, purpose, and effect of the proposed rule or rule amendment and its compliance with applicable provisions of the Act, including core principles, and the Commission's regulations thereunder, including, as applicable, a description of the anticipated benefits to market participants or others, any potential anticompetitive effects on market participants or others, and how the rule fits into the registered entity's framework of self-regulation." In addition, Regulation 40.5(a)(7) requires a DCO to "[p]rovide additional information which may be beneficial to the Commission in analyzing the new rule or rule amendment. If a proposed

changes are submitted to the Commission, the proposed changes are required to be published concurrently on the DCO's website.[32]

Questions for Consideration

1. *Transparency.*

    a. Does the design of the DCO's rule book, written procedures, and other materials provided to clearing members and clients enable those stakeholders to measure, manage, and control their exposures? If so, how?

    b. Are the loss allocation rules and procedures clear, transparent, and comprehensible? If so, what is the basis for this conclusion?

    c. Do the DCO's rules and procedures unambiguously set forth the timeframes in which particular tools will be used?

2. *Governance.*

    a. How do the governance arrangements with regards to (i) the adoption of Recovery Plans and (ii) the use of each Recovery tool include, to the extent appropriate and practicable, the views of all relevant constituencies? Are such governance arrangements, in each instance, clearly and comprehensively set forth in the DCO's rules?

        i. Do such governance arrangements include the participation, to the extent practicable, of all relevant constituencies?

            1. To the extent stakeholder participation is accomplished through consultation, what is meant by consultation? Specifically: What information is provided? What opportunity will the consultees have to evaluate the information? From whom (inside or outside of the DCO) will they be able to seek advice? What happens if some or all of the consultees disagree with the approach presented?

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rule affects, directly or indirectly, the application of any other rule of the registered entity, the pertinent text of any such rule must be set forth and the anticipated effect described."

For rule changes submitted pursuant to Regulation 40.6, Regulation 40.6(a)(7)(v) requires a DCO to provide "[a] concise explanation and analysis of the operation, purpose, and effect of the proposed rule or rule amendment and its compliance with applicable provisions of the Act, including core principles, and the Commission's regulations thereunder." In addition, Regulation 40.6(a)(8) requires a DCO to "provide, if requested by Commission staff, additional evidence, information or data that may be beneficial to the Commission in conducting a due diligence assessment of the filing and the registered entity's compliance with any of the requirements of the Act or the Commission's regulations or policies thereunder." This memorandum constitutes such a request. If no such analysis is provided at the time that a proposed rule change is filed with the Commission, a more formal and individualized request may be sent.

[32] *See* 17 C.F.R. §§ 40.5(a)(6), 40.6(a)(2), 40.10(a).

ii. How does the DCO make certain that such governance arrangements appropriately reflect the legitimate interests of clearing members, customers of clearing members, and other relevant stakeholders?

b. Do the DCO's rules permit the use of discretionary authority, including any emergency rules and procedures, to deviate from the *ex ante* Recovery rules in ways that increase members' and their clients' exposures, and thereby undermine predictability, including clearing members' and their clients' ability to measure, manage, and control those exposures?

i. If so, what are the limits on the use of such discretionary authority? Are the limits clearly defined in the *ex ante* rules? Who is the decision maker and how was that decision maker chosen? Are there checks to the decision maker's authority?

ii. How does the DCO balance the need for members and their clients to measure, manage, and control exposures with the DCO's discretionary authority in an emergency?

iii. Do the DCO's emergency rules and procedures provide a mechanism to require affirmative consent from clearing members and, to the extent practicable, other relevant stakeholders (or representatives thereof), in either case, whose rights and obligations would be materially affected as a result of the DCO's exercise of its discretionary authority?

c. To the extent that the foregoing governance arrangements rely on representatives of stakeholders (*e.g.*, consultation with or consent of a risk committee that includes such representatives), please answer the following questions:

i. How are the representatives chosen? Are the representatives' interests aligned with those of the relevant stakeholder constituency? What is the basis for this conclusion?

ii. Do the representatives' duties run to the DCO, its board or its owners? What is the basis for this conclusion? The DCO should provide relevant documents (*e.g.*, charter of a risk committee) as part of its rule submission.

d. How do the DCO's governance arrangements address potential for the DCO's board of directors to have inconsistent, and possibly conflicting, duties to the shareholders of the DCO and the clearing membership?

e. What are the potential impacts of the DCO's corporate structure on the use of particular recovery tools?

3. *DCO Capital Contribution.*

a. Does the DCO's Recovery Plan include capital contributed by the DCO? What is the position of the DCO's capital contribution in the waterfall (*i.e.*, is the DCO's capital contribution used prior to the mutualized resources contributed by the non-defaulting clearing members)?

4. *Timing and Gains Based Haircutting.*

   a. Does the DCO's Recovery Plan take into account the need and appropriate time window for (i) developing a private sector solution or (ii) allowing the relevant public authorities to perform the requisite analysis to determine whether resolution is appropriate, prior to making a decision to terminate services and Wind-down?[33] At what point does this time window begin relative to the DCO's initiation of gains based haircutting, if applicable?

   b. Do the DCO's Recovery and Wind-down Plans clarify when gains based haircutting will be initiated? Is gains based haircutting initiated prior to the projected exhaustion of pre-funded financial resources and assessments designed to address losses from the default that the DCO is managing?

   c. What are the duration and frequency limits on the use of gains based haircuts? Do the DCO's rules and Recovery and Wind-down Plans provide clarity regarding these limits that allow clearing members and their clients to measure, manage, and control their exposures? What is the basis for this conclusion?

5. *Application of Resources.*

   a. Do the DCO's rules permit or require the DCO to use the financial resources set forth in Regulation 39.11(b)(1), (*e.g.*, DCO capital, pre-funded resources, assessments, etc.) for one or more of the following purposes:

      i. Substitution for mark-to-market payments on the defaulter's liquidated positions;

      ii. Payments to participants with winning auction bids for the defaulter's positions; or

      iii. Compensation to participants (1) who receive positions through forced allocations or (2) whose positions are partially torn-up?

      If so, please explain.

   b. Do the DCO's rules permit or require the DCO to use the financial resources set forth in Regulation 39.11(b)(1), (*e.g.*, DCO capital, pre-funded resources, assessments, etc.) for any purpose other than those set forth in (a) above? If so, please explain.

   c. Reversing the Waterfall:

[33] DCR notes that Regulation 39.14(b) provides that a DCO "shall effect a settlement with each clearing member at least once each business day, and shall have the authority and operational capacity to effect a settlement with each clearing member, on an intraday basis, either routinely, when thresholds specified by the [DCO] are breached, or in times of extreme market volatility." DCR has interpreted Regulation 39.14(b) to prohibit the use of a suspension of clearing, including during the time period described in section II.4.a.

i. Do the DCO's rules require the DCO to take commercially reasonable steps to prosecute claims against the defaulter, directly or as part of the defaulter's insolvency, resolution, or similar proceeding?

ii. To the extent that funds are collected from the defaulter or as part of the defaulter's insolvency, resolution, or similar proceeding, are such funds (after reasonable expenses of collection) used to "reverse the waterfall" (*e.g.*, starting with gains based haircuts)? Are such funds used for any other purpose? Please explain.

iii. Similarly, are any default resources remaining after completion of the liquidation of the defaulter's positions and replenishment used to reverse the waterfall? Are such funds used for any other purpose? Please explain.

6. *Fully Addressing Losses*.

a. Do the DCO's Recovery and Wind-down Plans provide a means to fully address credit losses? What is the basis for this conclusion?

i. Do the DCO's Recovery and Wind-down Plans include voluntary tools, such as auctions or voluntary tear-up, possibly supplemented by incentives such as juniorization, to return to a matched book? Please explain which tools are used, the order in which they are expected to be used, and the basis for the DCO's decision to use these tools in this order?

ii. To the extent that such tools do not lead to full liquidation of the defaulter's positions, do the DCO's Recovery and Wind-down Plans also use compulsory tools, including complete tear-up, partial tear-up or forced allocation?

iii. Does the DCO's Recovery Plan include gains based haircutting? Does the DCO's Wind-down Plan include gains based haircutting?? In each case, if so, how? If not, what is the basis for the DCO's conclusion that it fully addresses all uncovered credit losses?

b. Is the DCO's Recovery Plan designed to promote the DCO's ability to maintain its critical services?

7. *Analysis of Tools*.

a. Has the DCO fully analyzed, individually and holistically, all tools included in its Recovery and Wind-down Plans, to understand the legal basis, impact on financial stability, and associated performance risk? What is the basis for this conclusion?

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This memorandum represents the position of DCR only and does not necessarily represent the views of the Commission or the views of any other division or office of the Commission.

If you have any questions regarding any of the information contained in this document, please contact Robert B. Wasserman, Chief Counsel, 202-418-5092 or Kirsten V.K. Robbins, Associate Chief Counsel, 202-418-5313.