DCO CAPITAL AND SKIN IN THE GAME AREAS FOR DISCUSSION

Report of the
Central Counterparty Risk and Governance Subcommittee,
Market Risk Advisory Committee of the
U.S. Commodity Futures Trading Commission

Acting Chairman Rostin Behnam, Sponsor

Lee Betsill & Alicia Crighton, Co-Chairs

This report was approved on July 1, 2021 by the CCP Risk and Governance Subcommittee of the Market Risk Advisory Committee (MRAC). The views, analyses, and conclusions expressed herein reflect the work of the CCP Risk and Governance Subcommittee of the MRAC, and do not necessarily reflect the views of the MRAC, the Commodity Futures Trading Commission or its staff, or the U.S. government. Reference to any products, services, websites, organizations, or enterprises, or the use of any, organization, trade, firm, or corporation name is for informational purposes only and does not constitute endorsement, recommendation, or favoring by the U.S. Government.

Central Counterparty Risk and Governance Subcommittee of the Market Risk Advisory Committee of the CFTC: Discussion regarding DCO Capital and Skin-in-the-Game

This report of the Subcommittee on "Recommendations regarding DCO Capital and Skin-in-the-Game" (the "**Report**") reflects the collective work of Subcommittee members to identify and analyze issues related to the capital framework for CCPs that are subject to regulation by the CFTC as derivatives clearing organizations ("**DCOs**") and to identify areas of policy agreement to the MRAC based on that work. The Report was drafted by a subset of MRAC members representing DCOs, clearing members and end-users (the latter two groups collectively referred to herein as ("**Market Participants**") and one independent.

The Report covers the following areas of discussion by the Sub-committee: DCO Skin-in-the-Game ("**SITG**"); DCO non-default losses ("**NDLs**"); DCO capital available to address losses exceeding the default fund (including assessments); and ex-ante resources for addressing a DCO's resolution.

The Report sets forth agreed upon policy views across certain elements of a DCO's capital framework, some of which represent current practices of some DCOs. Where agreement could not be reached by the Subcommittee with respect to certain issues, a summary of the discussion concerning those issues is noted below.

Discussion topics:

A. Skin-in-the-Game

I. Agreement regarding DCO SITG

There was broad agreement among Subcommittee members that the primary purpose of DCO SITG is to incentivize management of market and other risks, rather than serve as a significant resource to absorb losses arising from a clearing member's default. Such primary loss-absorbing resources should be paid-in by the defaulter in the form of initial margin and its default fund contribution. Global regulatory bodies, including the Financial Stability Board ("FSB"), have highlighted that SITG should not be considered a significant loss-absorbing resource.[1]. Notwithstanding that broad agreement was reached, there was no agreement among Subcommittee members on prescribing SITG into specific regulatory text.

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[1] *See* FSB discussion paper on "Financial resources to support CCP resolution and the treatment of CCP equity in resolution" at pg. 18 (Nov. 2018).

ii. No agreement on specific language to implement a rule to require DCOs to contribute a specific amount of SITG

Subcommittee members were unable to reach agreement on an appropriate methodology to utilize for sizing a DCO's SITG contribution to the default waterfall and the related matters, such as the specific size of any DCO's SITG contribution. Discussions considered the relative merit of establishing a risk-based sizing for SITG versus considering SITG sizing to reflect different DCO business models or risk management approach. Members also took into consideration and evaluated the relative merit of a new CFTC requirement for DCO SITG versus addressing SITG within a DCO's rulebook.

B. Non-default Losses

i. Agreement for DCOs concerning NDLs

Subcommittee members agree that DCOs should maintain appropriately sized capital requirements to cover NDLs for which they are responsible, and a DCO's default fund should not be used to cover NDLs. Applicable law in some jurisdictions, including under CFTC Regulation 39.11, prohibits the use of mutualized financial resources intended for default-related purposes to be used to cover NDLs. In addition, there was broad agreement, consistent with financial market practices, that a DCO should not be responsible for losses arising from the failures of third-party custodians and settlement banks, where the DCO has not acted negligently or in bad faith in the selection and monitoring of such third-parties.[2]

Subcommittee members agree that the DCO should be responsible for certain types of NDLs, such as market value investment losses related to the investments a DCO directs, not only for customer funds, but also for clearing members' own funds.[3] In addition, there is broad agreement that DCOs' distinct operations present different NDL profiles which should be considered in determining the responsibility for such NDLs.

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[2] By way of background, as a matter of course, entities relying on the services of third-party custodians and banks for collateral that has been posted to them often disclaim all liability for the failure of those third-party institutions, where they have not acted negligently. This is standard practice for customer relationships across the financial industry. By way of example, futures commission merchants broadly disclaim liability for depositing customer funds with a third-party depository unless that futures commission merchant has acted in bad faith, similar to how a custodian disclaims liability for its use of third-party sub-custodians and a bank disclaims liability for its use of third-party correspondent banks.

[3] CFTC Regulation 1.29 requires that DCOs bear losses related to investment of customer funds. DCOs are further required to maintain conservative investment portfolios for customer funds pursuant to CFTC Regulation 1.25, thus minimizing the risk of investment losses.

ii. No agreement on specific language to implement additional rules concerning NDLs

Subcommittee members were unable to agree on whether there should be more specific CFTC rules with respect to loss allocation for specific NDLs or whether capital reserves should be set aside for such specific NDLs. Members took into consideration and evaluated the relative merit of amendments to the existing CFTC NDL rule requirement versus addressing a DCO's approach to NDLs within a DCO's rulebook.

C. Residual DCO Capital

i. Agreement for DCOs to solicit shareholders for voluntary contributions

Subcommittee members agree in principle that to the extent a DCO's losses exceed available resources after capped assessments have been made that a DCO's shareholders should be solicited to contribute voluntarily to address such losses.

ii. No Agreement on specific language to implement a rule to utilize CCP residual capital

Subcommittee members were unable to agree whether residual DCO equity at the end of the waterfall should be required to be used to address uncovered losses.

D. DCO Ex-ante Resources

i. No Agreement to require DCOs to arrange ex-ante resources for use in Resolution

Subcommittee members were unable to agree on whether it is appropriate to establish distinct ex-ante resources that would be available in resolution to continue to operate the resolved DCO and noted that CCP resolution does not fall under the jurisdiction of the CFTC.

[1] U.S. Commodity Futures Trading Commission, Release Number 8087-19 (December 2, 2019), available at: https://www.cftc.gov/PressRoom/PressReleases/8087-19

SUPPORTING STATEMENTS

BlackRock

July 1, 2021

BlackRock Statement in support of CFTC MRAC CCP Risk and Governance Subcommittee Papers

BlackRock commends Acting Chair Behnam for establishing the CFTC's CCP Risk & Governance Subcommittee to provide reports and recommendations regarding issues impacting clearinghouse risk management and governance. BlackRock believes that stable and secure financial markets are paramount to the protection of end-users' investment activity and is pleased to have had the opportunity to engage in constructive dialog with industry participants to advance market integrity and financial stability.

Over the course of the last 18 months, Subcommittee members representing Central Counterparties (CCPs), clearing members and end-users (the latter two collectively referred to as "market participants") have worked to find agreement on CCP risk issues that have previously been identified by market participants as areas of concern. The CFTC provided a unique forum in which stakeholders in cleared markets could come together to debate often controversial and divisive topics.[1] At the February 23, 2021 MRAC meeting, the Subcommittee presented papers on CCP Margin Methodologies and CCP Governance; at the July 13, 2021 MRAC meeting, two additional papers are being presented: CCP Liquidity and Stress Testing, and CCP Capital and Skin in the Game. While the Subcommittee members spent a meaningful amount of time discussing CCP Transparency, members were unable to reach any areas of agreement.

The Subcommittee papers represent an important part of a broader endeavor to enhance financial stability that is supported by CCPs, clearing members and end-users alike. BlackRock therefore encourages the CFTC and other relevant regulatory authorities to: (1) pursue rulemaking to implement recommendations put forth in the papers, (2) explore whether additional regulation could further buttress areas of agreement put forth in the papers, (3) consider regulatory intervention where the papers put forth specific areas of disagreement, and (4) conduct further diligence on the members' perspectives on CCP Transparency, where no paper could be put forth.

[1] Many of the discussion topics mirrored recommendations in A Path Forward for CCP Resilience, Recovery, and Resolution, a paper that BlackRock co-authored with a group of a buy-side and sell-side firms, released in 2019. The paper proposed twenty recommendations to enhance CCPs' resilience, recovery and resolution.

July 1, 2021

CME Group Statement on CFTC MRAC CCP Risk and Governance Subcommittee Papers

CME Group Inc. ("CME Group")[1] commends Acting Chairman Behnam for establishing the Market Risk Advisory Committee's ("MRAC") CCP Risk and Governance Subcommittee ("Subcommittee"). The Subcommittee provides a useful and effective forum for discussing areas of interest and providing recommendations to the broader MRAC with a focus on the stability of the broader financial system.

We applaud members of the Subcommittee, which includes representatives from across the industry, for successfully working together to recognize the importance of the risk management practices utilized by derivatives clearing organizations ("DCOs") and preserving the incentives endemic to the central clearing model that promote effective risk management. Most recently, the Subcommittee successfully worked together to publish papers on CCP capital and skin-in-the-game and stress testing and liquidity risk management. While these are topics that have been discussed amongst the industry for a number of years, the Subcommittee reached agreement in a number of areas, reflecting a consensus from the Subcommittee of the importance of best practices in risk management.

The areas of agreement reached by the Subcommittee in regard to CCP capital, stress testing and liquidity risk management allow DCOs to continue to follow their regulatory mandate to prioritize the safety of their markets and stability of the broader financial system, while preserving the incentives that are critical to ensuring that risk-takers effectively manage their risks. We are pleased with the cohesion demonstrated by the Subcommittee in agreeing on unbiased risk management best practices rather than focusing on policy proposals that skew incentives and negatively impact the ability of DCOs to manage risks and continue to successfully navigate market stress events in the future. We look forward to ongoing engagement on how to further solidify the robust risk management practices utilized by DCOs to enhance financial stability and reduce systemic risk.

[1] Chicago Mercantile Exchange Inc. is a registered derivatives clearing organization.

EUREX

Eurex Clearing statement on the Report of the Market Risk Advisory Subcommittee on its RECOMMENDATIONS REGARDING DCO CAPITAL AND SKIN IN THE GAME

Eurex Clearing agrees that both CCPs and Clearing Members (CMs) should have balanced incentives to preserve the loss mutualization function of CCPs. Let's not forget that during the COVID-19 market turmoil financial stability and integrity of global financial markets were maintained throughout 2020. The recent crisis has thus proven the G20 Pittsburgh reforms as the right decision, especially when it comes to central clearing. In this context, we believe that global markets generally benefit from global minimum standards. However, while international standards such as the PFMI principles or FSB guidance are providing some global minimum standards, as an EU CCP, Eurex Clearing is even subject to higher regulatory requirements set by EU regulation (EMIR and CCP Recovery and Resolution (RR)) for the STIG, NDLs and use of CCP capital in resolution, which are not directly applicable to non-EU CCP even when they are registered within the EU due to existing equivalence agreements. Hence, as alluded to by the subcommittee, the results of the MRAC report may not be applicable to EU CCPs given the differences in existing regulatory requirements.

Eurex Clearing would like to emphasize that in a global market like derivatives similar global standards are critical to avoid competition on risk standards and allow for a competitive level playing field. Therefore, Eurex Clearing encourages the CFTC to continue to engage with international standard setters and other regulators to achieve further convergence of defined and required minimum standards.

A. Skin in the Game

Eurex Clearing considers the STIG as an important component of the CCP's risk management structure. We agree with the subcommittee members that its purpose is to ensure that the CCP is incentivized to perform robust risk management and not to serve as a loss absorbing tool. Eurex Clearing thus believes that the calibration of the SITG should be proportionate to the size of the CCP and should reflect the role of the CCP as risk manager. As pointed out in the MRAC report, CCPs typically contribute an appropriately sized SITG, which is used prior to non-defaulting CMs default fund. While international standards are indeed silent regarding a minimum amount of SITG, PFMI principles require CCPs to maintain sufficient financial resources to cover their credit exposure to each participant fully with a high degree of confidence and encourages systemically important CCPs to maintain additional financial resources sufficient to cover a wide range of potential stress scenarios. The PFMI guidance refers to national legislation to set the respective amount of the STIG. In the EU, regulators set a specific methodology and size for the SITG under EMIR. EU CCPs therefore have to provide 25% of the CCP's regulatory capital which Eurex Clearing is overfulfilling approx. 4 times. In addition, with the newly introduced CCP RR framework, EU CCPs are even required to install a second SITG of up to 25% of regulatory capital for both default and non-default loss scenarios.

B. NDLs

A CCP's rulebook and recovery plan governs the allocation of different types of NDLs. In the case of

such NDLs, CCPs allocate the losses in ways that preserve the incentive structure of central clearing for market participants to appropriately manage their risks. Generally, Eurex Clearing believes that loss allocation for NDLs should be proportional to the level of responsibility and/or benefits extracted from a service of each stakeholder (polluter-pays principle). Hence, we agree with the subcommittee members that CCPs should maintain appropriately sized capital requirements to cover NDLs for which they are responsible and that there might also be cases where a CCP should not be responsible, such as for losses arising from the failures of third party custodians and settlement banks.

EU CCPs are well placed to meet NDLs. In line with the PFMI principles and EMIR, EU CCPs hold capital proportionate to the non-default risks that the CCP is exposed to. The EU regulation thus requires EU CCPs already to ensure sufficient financial resources for operational risks, market risk, credit risk, wind down and business risk. Note that in the EU, also the new CCP RR provides a list of recovery and resolution tools for default and non-default events and the amount up to which they can be used.

C. Residual CCP Capital and D. CCP ex-ante resources

Also, the use of CCP capital has already been defined in detail in EU regulation. Assessment powers are defined in a CCP's rulebook and recovery plan. Generally, the rules for EU CCPs under the new CCP RR framework, following the FSB guidance on CCP equity in resolution, establish a list of available tools and the amount up to which they can be used as well as rules for compensation of non-defaulting CMs, providing predictability for CMs and ensuring that both the CCP and the CMs have balanced incentives to contribute in a recovery or resolution situation.

JPMORGAN CHASE & CO.

July 1, 2021

JPMorgan Statement on CFTC MRAC CCP Risk and Governance Subcommittee Reports

JPMorgan commends Acting Chair Behnam for establishing the CFTC's CCP Risk & Governance Subcommittee (Subcommittee) and supporting the development of actionable recommendations on these topics. The topics discussed within the Subcommittee covered many of issues highlighted within A Path Forward for CCP Resilience, Recovery, and Resolution, a white paper that JPMorgan, together with a group of a buy-side and sell-side firms, released in 2019 (2019 White Paper).[1] The 2019 White Paper proposes twenty recommendations to enhance CCPs' resilience, recovery, and resolution, for consideration by policymakers and regulators.

Over the last eighteen months, JPMorgan has supported and contributed to the efforts of the Subcommittee, seeking to make progress on the important topics of CCP risk governance, CCP margin, CCP transparency, CCP capital and skin-in-the-game, and CCP stress testing and liquidity. While the Subcommittee presented agreed-upon recommendations to the MRAC and CFTC on CCP margin and CCP risk governance in February, all of which JP Morgan supported, we note that the Subcommittee was unable to agree specific actionable recommendations for the CFTC within the June reports on CCP Capital and Skin-in-the-Game or Liquidity and Stress Testing. Both reports provide summaries of what was discussed, noting where policy views are aligned between market participants and CCPs and specify where no agreement was reached. While we support the two June reports, on CCP Capital and Skin-in-the-Game specifically, we also reiterate the views expressed in the 2019 White Paper: increasing CCP contributions to the default waterfall to a meaningful quantum of CCP SITG; requiring CCPs to be responsible for non-default losses, supported by appropriately-sized regulatory capital requirements; residual CCP capital being available as a last resort to absorb outstanding losses; and requiring CCPs to set aside recapitalization resources (e.g., long-term debt that could be bailed in).

Importantly, despite a significant amount of work performed by the CCP transparency and disclosure work-stream and extensive discussion on this topic among Subcommittee members, the Subcommittee was unable to agree upon a report to be presented to the MRAC and CFTC. Similarly, as noted within the Liquidity and Stress Testing report, the Subcommittee discussed the merits of CCPs providing greater transparency on matters relating to stress testing, with no agreement being established. The Subcommittee's inability to advance recommendations on this topic, as well as on CCP capital and skin-in-the-game, underscores the need for policymakers to consider these topics alongside CCP risk governance and margin and determine whether regulatory intervention is required in the best interests of the market as a whole. Work on addressing the issues raised in the 2019 White Paper is critical and we stand ready to partner with regulators, policymakers, CCPs, and other market participants to further enhance CCP risk and governance and strengthen the US financial system.

[1] The paper was originally published in October 2019 and now has twenty signatories.

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June 29, 2021

Submitted electronically

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Re: ***CFTC MRAC CCP Risk and Governance Subcommittee: Vanguard Statement with respect to policy positions related to CCP Capital and Skin in the Game ("SITG")***

Dear Ms. Lewis:

Vanguard[1] appreciates the opportunity to serve on the Central Counterparty ("**CCP**") Risk and Governance Subcommittee (the "**Subcommittee**") of the Commodity Futures Trading Commission's ("**CFTC**") Market Risk Advisory Committee ("**MRAC**"). We commend Acting Chair Rostin Behnam for establishing the Subcommittee to develop actionable recommendations to address CCP risk issues.[2]

In multiple forums in recent years, Vanguard has consistently called on global regulators to address risks related to CCPs. In 2019, Vanguard joined with a group of concerned asset managers and futures commission merchants ("**FCMs**"), to publish "**A Path Forward for CCP Resilience, Recovery, and Resolution**" which sets forth twenty recommendations to address CCP incentives, transparency and governance to enhance the resiliency of cleared markets for the benefit of our investors.

While our support for clearing is resolute, we see compelling opportunities to enhance the resiliency of CCPs, and to better prepare for their recovery and resolution. Especially as non-defaulting market participants may need to backstop CCP failures, market participants should have an effective voice in CCP governance and a clear window into CCP risks. Market participants presently have inadequate transparency into CCP risk management practices and limited involvement in CCP risk management decision making given the absence of effective formal governance structures.

Policymakers also should consider enhancing the global ruleset to strengthen the incentives for CCPs to offer products they can effectively risk manage, as the downside of a CCP's risk management failure is presently disproportionately borne by non-defaulting market participants, including, potentially, mutual fund investors.

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[1] Vanguard is a global asset manager that offers more than 417 funds and serves more than 30 million investors globally. Our core purpose is to take a stand for all investors, treat them fairly, and give them the best chance for investment success.
[2] As a part of prudent management, Vanguard funds enter into derivatives contracts, including swaps and futures, to achieve a number of benefits for our investors, including hedging portfolio risk, lowering transaction costs, managing cash, and achieving more favorable execution compared with traditional investments. Vanguard has been fully supportive of global derivatives regulatory reform to bring much-needed transparency and regulation to the derivatives markets.

Vanguard supports the policy positions in the paper addressing CCP capital and skin in the game as being directionally appropriate, and firmly believes such policy positions should be implemented through regulatory action both to enhance the resiliency of the mandated global clearing markets and to establish a more consistent regulatory regime for such markets in harmony with regulatory requirements already enacted in Europe and elsewhere.

The incentive effect of a comprehensive capital regime is enhanced when it is not left to a more voluntary approach – no matter how strong are current practices. We respectfully urge the CFTC to assess potential regulatory gaps in Part 39 of its regulations to more appropriately address CCP capital in a manner commensurate with the risk managed by the CCPs. While the CCP core principles require CCPs to be accountable for their risk management decisions, beyond requiring modest CCP capital contributions and limited capital coverage for non-default losses ("**NDLs**"), CCP losses and costs in excess of the required coverage may transfer to non-defaulting market participants.

We are concerned that existing voluntary SITG levels, or a CCP's franchise value or remuneration practices, or even a CCP's general preference for systemic stability, do not provide adequate risk management incentives – especially compared to the levels of liability imposed on non-defaulting market participants who neither vet the products cleared nor set the initial margin levels for such products. Neither the Part 39 regulations nor the CCP core principles prescribe a specific minimum amount of CCP risk-based capital as SITG to serve as an incentive for CCPs' risk management responsibilities.

Likewise, we maintain it is inappropriate for non-defaulting market participants to bear a CCP's NDLs. Market participants are not responsible for the choices or management oversight that could lead to a CCP's NDLs, including operational failures, fraud, theft, cyber-threats and attacks that could lead to monetary loss or market value loss of margin investments.

We fully support the CFTC's further work to enhance the resiliency of cleared markets by strengthening the existing regulatory regime in the areas of CCP capital and incentives, governance and transparency, stress testing and liquidity, and default management. Vanguard also supports future work by global regulators to consider the need for, and develop as appropriate, international policy on the use, composition and amount of CCP financial resources to strengthen CCPs in default and non-default scenarios, including assessing new types of prefunded resources to facilitate the operation of a failed CCP in resolution.

If you have any questions about Vanguard's comments or would like any additional information, please contact Sam Priyadarshi, Principal, at (610) 669-4928 or sam_priyadarshi@vanguard.com.

Sincerely,

/s/ Sam Priyadarshi, Principal
Head of Portfolio Risk and Derivatives
Vanguard