MINUTES OF THE JULY 13, 2021 MEETING OF THE U.S. COMMODITY FUTURES TRADING COMMISSION'S MARKET RISK ADVISORY COMMITTEE

The Market Risk Advisory Committee (MRAC or Committee) of the U.S. Commodity Futures Trading Commission (CFTC or Commission) held a public meeting on Tuesday, July 13, 2021, at 9:30 a.m. (EDT) via videoconference. The MRAC received reports from its Interest Rate Benchmark Reform (IRBR) and Central Clearing Counterparty (CCP) Risk and Governance Subcommittees. In addition, the MRAC considered the IRBR Subcommittee's recommendation on its "SOFR First" initiative, a market best practice aimed at prioritizing interdealer trading in the Secured Overnight Financing Rate (SOFR) rather than the London Interbank Offered Rate (LIBOR).

MRAC Members in Attendance

Nadia Zakir, MRAC Chair, Executive Vice President and Chief Compliance Officer & Global Head of Compliance, Pacific Investment Management Company LLC (PIMCO)
B. Salman Banaei, Executive Director, Global Head of Clearance and Settlement, IHS Markit
Stephen Berger, Managing Director and Global Head of Government & Regulatory Policy, Citadel
Richard Berner, Clinical Professor of Management Practice in Finance and Co-Director of the Stern Volatility and Risk Institute, NYU Stern School of Business (Special Government Employee)
Lee Betsill, Managing Director and Chief Risk Officer, CME Group
Peter Borish, Chief Strategist, Quad Group
Biswarup Chatterjee, Managing Director, Global Head of Innovation, Markets & Securities Services, Citigroup
Alicia Crighton, Global Co-Head of Futures and Head of OTC and Prime Clearing Businesses, Goldman Sachs, representing Futures Industry Association (FIA)
Andrew Danzig, Vice President, Markets Group, Federal Reserve Bank of New York
Chris Dickens, Chief Operating Officer, Global Markets, EMEA, HSBC
Shelly Goodwin, Compliance Director, Refining & Products Trading Americas and Global Crude, BP IST Global America
Matthias Graulich, Member of the Executive Board and Chief Strategy Officer, Eurex Clearing AG
Frank Hayden, Vice President, Trading Compliance, Calpine Corporation
Amy Hong, Managing Director and Head of Market Structure & Strategic Partnerships for the Global Markets Division, Goldman Sachs
Lindsay Hopkins, Clearing House Counsel, Minneapolis Grain Exchange
David Horner, Chief Risk Officer, LCH Limited
Annette Hunter, Senior Vice President and Director of Accounting Operations, Federal Home Loan Bank of Atlanta
Angie Karna, Managing Director, Legal Department, Nomura Global Financial Products, Inc.
Demetri Karousos, Chief Risk Officer, Nodal Clear, LLC, and Chief Operating Officer, Nodal Exchange, LLC
Eileen Kiely, Managing Director, Deputy Head of Counterparty & Concentration Risk, BlackRock
Elisabeth Kirby, Managing Director and Head of Market Structure, Tradeweb

Derek Kleinbauer, Global Head of Fixed Income & Equities Electronic Trading, Bloomberg LP and Vice President, Bloomberg SEF LLC
Laura Klimpel, Managing Director, The Depository Trust & Clearing Corporation
Robert Mangrelli, Director, Chatham Financial
Kevin McClear, Corporate Risk Officer, Intercontinental Exchange, Inc.
Craig Messinger, Senior Advisor, Virtu Financial
Dale Michaels, Executive Vice President, Financial Risk Management, The Options Clearing Corporation
John Murphy, Managing Director and Global Head of Futures Division, Mizuho Americas, representing Commodity Markets Council
Dr. Sam Priyadarshi, Principal, Global Head of Portfolio Risk Management and Derivatives, Vanguard
Marnie Rosenberg, Managing Director and Global Head of Clearinghouse Risk & Strategy, JP Morgan
James Shanahan, Vice President – Financial Regulatory Compliance, CoBank ACB
Dr. Betty Simkins, Head of Finance Department, Professor and Williams Companies Chair in Business, Oklahoma State University, Spears School of Business (Special Government Employee)
Tyson Slocum, Director, Energy Program, Public Citizen
Robert Steigerwald, Senior Policy Advisor, Financial Markets, Federal Reserve Bank of Chicago

Invited Speaker in Attendance

Thomas Wipf, Chairman, IRBR Subcommittee; Chairman, Alternative Reference Rates Committee (ARRC); Vice Chairman, Institutional Securities, Morgan Stanley

CFTC Commissioners and Staff in Attendance

Rostin Behnam, Acting Chairman and MRAC Sponsor
Dan M. Berkovitz, Commissioner
Brian D. Quintenz, Commissioner
Dawn D. Stump, Commissioner
Alicia L. Lewis, MRAC Designated Federal Officer (DFO), Special Counsel, Office of Acting Chairman Behnam

I. Welcome and Opening Remarks

Ms. Lewis called the meeting to order. The Sponsor, Acting Chairman Behnam, welcomed meeting attendees, introduced the MRAC's new members and thanked departing members, and thanked MRAC members, Subcommittee chairs, and Ms. Zakir and Ms. Lewis. He stated that the MRAC will first consider the IRBR Subcommittee's "SOFR First" recommendation. After giving an overview of the recommendation, he noted that the Commission has received feedback regarding how the SOFR First initiative implicates mandatory clearing requirements and related made-available-to-trade determinations. In anticipation of the end of LIBOR and its replacement with SOFR, he plans to have staff present the Commission with a rule proposal addressing mandatory clearing of SOFR swaps, for finalization in 2022. In the period preceding this rulemaking, CFTC staff expects that swap execution facilities (SEFs) will treat SOFR swaps as intended to be cleared or as mandatorily cleared swaps for purposes of the Commission rule prohibiting post-trade name give up on SEFs. Turning to the second agenda item, he stated that the CCP Risk and Governance Subcommittee will present reports on capital and skin-in-the-game and on stress testing and liquidity for acceptance by the full MRAC.

Commissioner Quintenz praised the Sponsor for his stewardship of both Subcommittees. Commissioner Stump stressed the importance of revisiting the CFTC's clearing mandates as the use of LIBOR ceases, including the appropriateness of mandates for those required to clear and execute on platforms. She noted that there are diverse views on CCP governance, but is pleased that the Subcommittee reached consensus on a number of items. Commissioner Berkovitz stressed the importance of making progress on both implementation of SOFR and CCP governance. Ms. Zakir thanked everyone for their work on behalf of the MRAC.

II. Report from the Interest Rate Benchmark Reform Subcommittee

Mr. Wipf began by recapping key developments in the transition away from LIBOR since the last MRAC meeting. In March 2021, the Financial Conduct Authority confirmed that all LIBOR settings will either cease to be provided by any administrator or no longer be representative immediately after December 31, 2021, in the case of all sterling, euro, Swiss franc, and Japanese yen settings, and 1-week and 2-month U.S. dollar (USD) LIBOR settings, and immediately after June 30, 2023 for the remaining USD settings. In March, the New York State legislature passed a bill to reduce risks associated with the transition away from USD LIBOR. In April, the ARRC published key principles for an ARRC-recommended SOFR term rate, and then in May described the market indicators that it will rely on in officially recommending a SOFR term rate. One indicator that was viewed as particularly challenging was the changing of market conventions for quoting U.S. derivative contracts from LIBOR to SOFR, which became the key focus of the IRBR Subcommittee's "SOFR First" initiative. Lastly, the ARRC announced that it selected CME Group as the administrator for the SOFR term rate which it plans to recommend once market indicators are met. The recommendation of a SOFR term rate is the final step in the ARRC's paced transition plan and will be a critical milestone for the market's transition away from LIBOR to SOFR.

Mr. Wipf then presented the IRBR Subcommittee's SOFR First recommendation. He noted that the Subcommittee initially focused on changing the market convention for quoting USD derivatives contracts from LIBOR to SOFR in the inter-dealer market. After the Subcommittee voted to recommend the SOFR First Initiative to the MRAC for interdealer brokers to replace trading of USD LIBOR linear swaps with trading of SOFR linear swaps on July 26, 2021 and thereafter (Phase 1), it subsequently voted to extend its SOFR First recommendation to cross-currency swaps (Phase 2), non-linear derivatives (Phase 3), and exchange-traded derivatives/other products (Phase 4).

Mr. Wipf noted that for Phase 1, the Subcommittee recommended that on July 26, 2021, interdealer brokers change USD linear swap trading conventions from LIBOR to SOFR. The Subcommittee recommended keeping interdealer brokers' screens for USD LIBOR linear swaps available for informational purposes, but not trading activity, until October 22, 2021. After this date, interdealer broker screens for USD LIBOR linear swaps should be turned off altogether.

Following Phase 1, additional transition events would occur in a phased rollout beginning with certain cross-currency swaps on September 21, 2021, and other products at dates to be determined by the Subcommittee based on market conditions. Mr. Wipf stated that it is important that all four phases of SOFR First occur prior to December 31, 2021.

During the discussion, several members supported the SOFR First recommendation, noting that adoption would promote the liquidity of SOFR, alleviate market uncertainty, and support the transition to SOFR in accordance with banking regulators' supervisory guidance urging no new USD LIBOR contracts as of December 31, 2021. One member expressed hope that the recommendation would speed adoption of alternative reference rates in other derivative and cash markets and facilitate the ARRC's endorsement of the CME's SOFR term rate. Another member supported the SOFR initiative but suggested that it would benefit from continuous consideration of the recommendation published by the ARRC's Capital and Liquidity Subgroup, especially as it relates to the G-SIB-related surcharges. The MRAC then voted to adopt the Subcommittee's SOFR First recommendation and submit the recommendation to the Commission for consideration. The recommendation was approved with 31"yes" votes, 0 "no" votes, and 0 abstentions.

III. Report from the CCP Risk and Governance Subcommittee

Mr. Betsill, co-chair of the CCP Risk and Governance Subcommittee, explained that after the February 2021 meeting, the Subcommittee continued discussions on four remaining workstreams—liquidity and stress testing, capital and skin-in-the-game, transparency, and default management. The workstreams on liquidity and stress testing, as well as CCP capital and skin-in-the-game, have concluded. Next, Ms. Crighton, co-chair of the Subcommittee, presented the Subcommittee's report on DCO capital and skin-in-the-game, which was drafted by a subset of MRAC members representing derivatives clearing organizations (DCOs), clearing members and end users (Market Participants), and one independent. She summarized the paper's recommendations in four areas:

- *DCO Skin-in-the-Game (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, have highlighted that SITG should not be considered a significant loss-absorbing resource. However, no agreement was reached among the Subcommittee members on prescribing SITG into specific regulatory text, nor was there any agreement on language to implement a rule to require DCOs to contribute a specific amount of SITG. On the latter point, discussions considered the relative merits of establishing a risk-based sizing for SITG versus considering SITG sizing to reflect different DCO business models or risk management approaches.

- *DCO Non-default Losses (NDLs)*. Subcommittee members agreed 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 these. 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. Members also agreed that the DCOs should be responsible for certain types of NDLs (*e.g.*, market value investment losses related to the investments a DCO directs, not only for customer funds, but also for clearing members' own funds). There was also broad agreement that DCOs' distinct operations present different NDL profiles which should be considered. 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 evaluated the relative merit of amendments to the existing CFTC NDL rule requirements versus addressing a DCO's approach to NDLs within a DCO's rule book.

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

- *DCO Ex-ante Resources*. 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 CFTC jurisdiction.

During the Committee discussion, one member stated that CCP contribution to the default waterfall should be increased; CCPs should be well capitalized for NDLs; capital should be available as a last resort to absorb losses; and Subcommittee challenges in breaking through the impasse and advancing recommendations underscores the need for regulatory action on outstanding issues. Another member cautioned that the failure to agree on needed recommendations reflects the asymmetric misalignment of incentives between many CCPs and clearing members that is manifested in their limited SITG and overall insufficient resource levels, which, together with their lack of meaningful transparency, create safety and soundness risks that could jeopardize trust in CCPs and derivatives markets. He stated that there are significant operational risks in CCPs that require significantly stepped-up resilience, and that here too misaligned incentives could undermine financial stability. He urged the CFTC, in collaboration with the SEC, U.S. banking regulators, and regulatory authorities abroad, to first, implement the recommendations in the papers and go beyond them; second, address misalignments represented by the paper's specific areas of disagreement; third, address the market participants' perspectives on CCP transparency; and finally, bring to the Financial Stability Oversight Council recommendations for changes to increase the resilience of CCPs and the overall financial system. Following the discussion, the MRAC voted to adopt the Subcommittee's paper on DCO capital and SITG and submit it to the Commission for consideration. The paper was approved with 28 "yes" votes, 0 "no" votes, and 3 abstentions.

Mr. Betsill presented the Subcommittee's discussion paper on DCO Stress Testing and Liquidity, which reflects the varying perspectives of Subcommittee representatives from DCOs, clearing members, and end users. The paper includes areas of consideration for the CFTC, and also identifies topics on which Subcommittee members could not agree, but does not make specific recommendations to the MRAC. There was broad agreement that stress testing at DCOs is a critical element to ensuring the resilience of DCOs and the financial system. Many of the practices for stress testing by DCOs identified by the Subcommittee are practices that are already employed by many DCOs, particularly by systemically important DCOs (SIDCOs) and electing Subpart C DCOs. These broad areas of agreement reflect the Principles for Financial Market Infrastructures (PFMI) and are set out in the paper. Despite these areas of agreement, there remain areas in which the DCOs and market participants disagree. Mr. Betsill highlighted the following areas of discussion:

- *Credit Stress Testing*: It was broadly agreed that it is appropriate for most, if not all, DCOs to employ stress tests that are designed to calibrate its financial resources to withstand the default of its two largest clearing members (Cover 2 standard), which is already required of SIDCOs and electing Subpart C DCOs. Therefore, the CFTC should consider whether the Cover 2 standard should apply to all DCOs.

- *Stress Scenarios*: Stress testing should be aimed at identifying tail risks for CCPs that could be exposed by shocks in stress periods. A number of considerations and risks (*e.g.*, liquidity, concentration, and correlation) were identified in sizing financial resources for stress tests if those considerations and risks are not sufficiently captured by initial margin. Furthermore, a relevant look-back period in such tests should be 30 years or the longest period of available, reliable, and relevant data history.

- *Reverse Stress Testing*: A DCO should consider analyzing its stressed loss distribution by member (and its credit risk) using reverse stress tests.

- *Stress Period of Risk (SPOR)*: SPOR should be at least equal to the margin period of risk (MPOR) that is assumed when calculating relevant initial margin levels. The SPOR could, in some instances, be longer than the MPOR, reflecting the stress-related increase in volatility and reduction in market liquidity.

- *Default Fund Re-sizing*: It is preferable for a DCO to regularly re-size its default fund resources on a monthly, rather than on a quarterly, basis.

- *Liquidity Stress Testing*: There was broad agreement that liquidity risk management at DCOs is critical for both DCOs and the financial system. In considering liquidity risk management, the following actions should be considered: to strive for global best practices; to promote a further global discussion on liquidity stress testing; and to promote global consistency across borders on what is considered liquid collateral.

- *Access to Central Bank Accounts*: It was agreed that CCP access to central bank accounts with appropriate oversight and governance should be broadened across jurisdictions.

- *Transparency*: The merits of DCOs providing greater transparency on matters related to stress testing were discussed, but no agreement was established.

During the discussion, a member noted that the Subcommittee was unable to agree on disclosure and transparency recommendations, as market participants believe they need more disclosure and transparency, while CCPs tend to believe they provide enough. This member recommended that regulators review whether the CCP disclosure framework provides the information needed for the market to assess risks, as there are limits to what the private sector can accomplish absent an update to formal requirements. The MRAC then voted to adopt the Subcommittee's paper on DCO stress testing and liquidity and submit it to the CFTC for consideration. The recommendation was approved with 29 "yes" votes, 0 "no" votes, and 2 abstentions.

IV. Closing Remarks

Commissioner Berkovitz said that LIBOR transition is a top priority, and despite the lack of consensus on some critical issues for CCPs, he looks forward to continuing the dialogue. Commissioners Stump and Quintenz praised the Sponsor on his work with the MRAC. The Sponsor noted the divergence of views on CCP issues, but said that identifying the issues and perceived risks and potential regulatory policies is very helpful to the Commission. He thanked everyone for their time and effort. Ms. Lewis adjourned the meeting at 11:16 a.m.

I hereby certify that the foregoing minutes are accurate.

Nadia Zakir
MRAC Chair

11/30/21
Date