September 26, 2023

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Mr. Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Proposed Covered Clearing Agency Resilience and Recovery and Wind-Down Plans, Release No. 34-97516; File No. S7-10-23, 88 FR 34708 (May 30, 2023)

Proposed Derivatives Clearing Organizations Recovery and Order Wind-Down Plans, Information for Resolution Sharing, RIN 3038-AF16, 88 FR 48968 (July 28, 2023)

Ms. Countryman and Mr. Kirkpatrick:

The Securities Industry and Financial Markets Association ("**SIFMA**"),[1] including SIFMA Asset Management Group ("**SIFMA AMG**"),[2] appreciates the opportunity to provide comments to both the Securities and Exchange Commission (the "**SEC**") and the Commodity Futures Trading Commission (the "**CFTC**," and together with the SEC, the "**Commissions**") on the SEC release titled "Covered Clearing Agency Resilience and Recovery and Wind-Down Plans" (the "**SEC Proposal**")[3] and the CFTC release titled "Derivatives Clearing Organizations Recovery and Order Wind-Down Plans,

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association ("**GFMA**").

[2] SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

[3] *Covered Clearing Agency Resilience and Recovery and Wind-Down Plans*, available at Exchange Act Release No. 34-97516 (May 17, 2023), 88 FR 34708-34743 (May 30, 2023) (the "**SEC Proposing Release**").

Information for Resolution Sharing" (the "**CFTC Proposal**," and together with the SEC Proposal, the "**Proposals**").[4] [5]

SIFMA supports the Commissions' shared goals to strengthen the risk management of the clearing agencies subject to the respective Proposals ("**Clearing Agencies**") through changes to margin practices and more detailed requirements for recovery and wind-down plans ("**RWPs**"). SIFMA believes that the adoption and implementation of the Proposals is an important step towards improving the ability of Clearing Agencies to withstand significant stress events and to continue operations through them. SIFMA believes that by anticipating potential challenges, as the Proposals require, Clearing Agencies would be in an improved position to manage issues and set expectations for clearing members and market participants.

Increasing the resilience of Clearing Agencies in a default or non-default loss scenario is an objective of fundamental importance as a failure of a Clearing Agency not only subjects clearing members and market participants to material financial damage, but it could also harm the stability of the U.S. financial markets. In this regard, the SEC's Proposal is increasingly relevant in light of the SEC's recent proposal to require increased clearing of the Treasury market, which would occur through a single SEC-regulated Clearing Agency.

While clearing financial products provides meaningful risk reduction to the market, it transitions and concentrates significant financial risk management into a handful of entities. Clearing mandates serve to amplify this concentration and make rigorous regulatory oversight critical to managing potential systemic risks.

The Commissions must go beyond merely requiring a Clearing Agency to identify and describe its risk management practices – including its practices with respect to margin and winddown. The Commissions should establish standards reflecting industry best practices, require stress and back-testing with respect to such standards, and periodically review and refresh such standards based on market conditions. It is inappropriate for market participants to be required to clear while allowing Clearing Agencies to exercise excessive flexibility in establishing and performing critical risk management procedures.

Given comments at each Agency's open meeting, we recognize that our memberships generally prefer principles-based regulations. However, the Commissions must consider the relative absence of

[4] *Derivatives Clearing Organizations Recovery and Order Wind-Down Plans, Information for Resolution Sharing*, available at [88 FR 48968-49055](88 FR 48968-49055) (July 28, 2023) (the "**CFTC Proposing Release**").

[5] SIFMA and SIFMA AMG, along with several other trade associations, submitted a letter to the SEC in June requesting an extension of the SEC's comment period to align with the CFTC's comment period. *See* Letter from the Futures Industry Association, International Swaps and Derivatives Association, Investment Company Institute (ICI), Managed Funds Association, Securities Industry and Financial Markets Association (SIFMA), and SIFMA Asset Management Group, to Vanessa Countryman, Secretary, SEC (June 28, 2023), *available at* https://www.sec.gov/comments/s7-10-23/s71023-216139-439924.pdf. We subsequently filed a brief letter with the SEC on July 17 explaining that we planned to submit a single letter to both the SEC and CFTC addressing both the CFTC Proposal and the SEC Proposal, which we do today. *See* Letter from William C. Thum, Managing Director and Assistant General Counsel, SIFMA AMG, to Vanessa Countryman, Secretary, SEC (July 17, 2023), *available at* https://www.sec.gov/comments/s7-10-23/s71023-225939-473322.pdf.

competitive forces to drive consistent voluntary risk management enhancements, the existing practice of many clearing agencies to mutualize certain risks to clearing members and market participants, and the challenges long faced by clearing members and market participants to elicit requested voluntary risk management enhancements. For these reasons, it is time for the Agencies to enact mandatory requirements - many of which reflect existing best practices – to establish the most resilient level playing field for this systemically-important market.

Executive Summary

The SEC Proposal sets out two related, but distinct, risk management requirements: (i) that each of the Clearing Agencies adopt defined procedures for the collection of intraday margin; and (ii) that each of the Clearing Agencies define any problem that could cause an interruption or cessation of the services provided by that Clearing Agency and explain how the Clearing Agency would prevent or respond to each such problem in a manner that allows the continuation or resumption of the Clearing Agency's services (such a response is a "recovery and wind-down plan" or "**RWP**") with the minimum damage to clearing members, their customers, and the markets generally. The CFTC Proposal is focused on the development of an RWP, though of course margin requirements are one of the essential elements to making it less likely that a Clearing Agency will be forced to implement its RWP. Both of the Commissions' proposed requirements build on, and make more specific, existing regulations.

SIFMA's members, both clearing members and market participants, are directly at risk of the fallout from a Clearing Agency failure, especially as non-defaulting clearing members and their non-defaulting market participants may be called on to contribute to the Clearing Agency through default fund assessments, gains haircutting (for CFTC-regulated clearing houses), partial tear-ups, or otherwise. Thus, they have an immediate interest in the safe and prudent operation of the Clearing Agencies. Our members are in agreement with the Commissions' determination that there is a very significant benefit to requiring the Clearing Agencies to better define their risk management procedures. Our comments on the Proposals seek greater specificity with respect to a Clearing Agency's RWP plans, policies, procedures, and tools; standards to be established, tested, reviewed, and revised by the Commissions; and increased involvement by clearing members and market participants in the development and oversight thereof.

Improved risk management at the Clearing Agencies depends not only on a Clearing Agency's internal consideration of risks, but also on the active participation by clearing members and market participants in the consideration of potential problems and in response planning. Accordingly, our comments deal not only with the specifics of the Proposals as regards to both intraday margin and RWPs, but also with related matters of resolution planning generally, stress testing, default management, capital and skin-in-the-game, non-default losses, and, not least, good governance, which should include input from clearing members and market participants.[6]

[6] *See* also prior SIFMA AMG letters to the SEC, CFTC, CMPI and IOSCO: SIFMA AMG re: *Implementation of LSOC Protections for Excess Customer Margin by Derivatives Clearing* (Jun. 4, 2013); SIFMA AMG, re: *CFTC Roundtable of Recovery of Derivatives Clearing Organizations* (Mar. 19, 2015); SIFMA AMG, re: *Essential Aspects of CCP Resolution Planning (FSB Discussion Note)* (Oct. 17, 2016); SIFMA AMG, re: *Framework for Supervisory Stress Testing of Central Counterparties* (Sep. 22, 2017); SIFMA AMG, re: *Response to Discussion Paper on Central Counterparty Default Management Auctions* (Aug. 9, 2019); SIFMA AMG, re: *Part 190 Bankruptcy Regulations (Proposed Amendments – RIN 3038-AE67)* (Jul. 13, 2020); SIFMA AMG, re: *AMG Recommendations for CCP Evaluation Framework* (Feb.1, 2021); SIFMA AMG, re: *DCO Capital and Skin in the Game* (Jul. 13, 2021); SIFMA AMG, re: *Consultative Report on Review of Margin Practices* (Jan. 26, 2022); SIFMA AMG, re: *Letter to CPMI and IOSCO on Client Clearing* (Feb. 7, 2022); SIFMA AMG, re: *Central*

Following a summary of SIFMA's views on the Proposals, in Section I we discuss the SEC's proposed intraday margin requirement and in Section II we discuss both the Commissions' proposed requirements for recovery and wind-down plans. As these Proposals provide for needed enhancements to certain aspects of Clearing Agency resiliency, in Section III we provide a comprehensive outline of our thinking on related recommendations to still further enhance Clearing Agency resiliency particularly as to funding and capital requirements.

Our comments in Section III are essential to the RWP Proposals put forward by both the Commissions. That is, it is critical to address Clearing Agency resiliency holistically, as a firm foundation of mandated risk management standards is needed both to mitigate the risk of a Clearing Agency recovery and wind-down and to ensure that if such events ever arise, thorough planning has been done and capital is sufficient to provide for the best achievable outcome.

An outline of our comments is as follows:

- **Clearing Agencies should be required to collect intraday margin.**

Intraday margin (both initial margin and variation margin) should be affirmatively required to be collected from any clearing member whose start of day margin has become insufficient as a result of position changes or market movements. Failure to collect and maintain adequate margin from one clearing member transfers the risk of that deficiency to the other clearing members and market participants.

Initial margin requirements should be robust and transparent so clearing members may reasonably anticipate margin calls (including intraday margin). As further detailed below, SIFMA supports procedures that it believes are most likely to result in the "right-sizing" of margin requirements and in their transparency, which we believe should result in very limited use of discretionary margin calls. Intraday margin calls should be regularly scheduled while ad-hoc intraday calls should be made only in extreme circumstances. Margin models must be transparent and predictable.

- **Clearing Agencies should be required to establish detailed RWPs.**

Standards should be established for a Clearing Agency's recovery and winddown rules, policies, procedures, and tools. As stated in the CFTC Proposal, "the disorderly failure of a [Clearing Agency] would likely cause significant disruption in [the markets it serves] . . . and could lead to severe systemic disruptions . . . Ensuring [Clearing Agencies] can continue to provide critical operations and services as expected, even in times of extreme stress, is therefore central to financial stability."[7][8]

Counterparty Practices to Address Non-default Losses (Oct. 3, 2022); SIFMA AMG, re: *Governance Requirements for Derivatives Clearing Organizations* (Oct. 13, 2022); SIFMA AMG, re: Standards for Covered Clearing Agencies for *U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule with Respect to U.S. Treasury Securities* (Dec. 23, 2022).

7 CFTC Proposal at text accompanying footnote 10.

8 SIFMA acknowledges that several Clearing Agencies have been designated as being systemically important financial market utilities ("**SIFMUs**") and are subject to a heightened oversight regime for risk

The procedures should clearly distinguish between the treatment of default losses resulting from the failure of a clearing member and non-default losses caused by the Clearing Agency's internal business decisions. Financial responsibility for non-default losses ("**NDLs**") should be borne by the Clearing Agency and not by clearing members and market participants.

The Clearing Agencies cannot be expected to adopt sufficient procedures without input from clearing members and market participants. SIFMA urges that the Commissions' requirements with respect to RWPs, as ultimately adopted, require the participation of clearing members and market participants in the development of RWPs.

The Commissions must play an active oversight role both in the review of the plans and in the consideration of their sufficiency. The Commissions' oversight role is essential to the process.

- <u>**Comprehensive enhancements to the Clearing Agency capital regime are necessary for an effective RWP.**</u>

Rules are needed to require Clearing Agencies to reserve for required skin-in-the-game ("**SITG**") levels, to reserve appropriate amounts for non-default losses ("**NDLs**"), to cap clearing member assessments and require Clearing Agencies to solicit shareholders for meaningful contributions to the default waterfall, and to arrange ex-ante resources for use in RWPs.

Discussion

I. <u>Clearing Agencies should be required to collect intraday margin.</u>

A. Intraday margin (both initial margin and variation margin) should be affirmatively required to be collected from any clearing member whose start of day margin has become insufficient as a result of position changes or market movements.

Margin, both initial margin ("**IM**") and variation margin ("**VM**"), is the primary tool by which a Clearing Agency protects itself, and its clearing members and their market participants, against financial loss. Accordingly, it is of great significance to market participants that Clearing Agencies collect and maintain adequate margin, at set intervals both end of day and intraday.[9] While the collection of adequate margin is of great importance, margin should neither be excessive nor unpredictable to avoid undue liquidity pressure on market participants. Similarly, IM that is unpredictable raises costs because of aforementioned liquidity concerns.

management, safety, and soundness by the Financial Stability Oversight Council ("**FSOC**"). SIFMA recognizes the merit in harmonizing the regulatory approach for Clearing Agencies across applicable regulators.

[9] Where technically possible, the gains from collected intraday variation margin should also be paid out to clearing members.

Consistent with the above, SIFMA's primary concern is with the rightsizing of IM.[10] This means that IM calculations must take account of factors beyond the volatility of each individual position; the determination must take account of the size and concentration of a firm's position in the relevant security or other asset and of the liquidity of the position. It is likewise important to emphasize that margin calculations be based on periods of risk that allow for sufficient time to liquidate the relevant portfolios. Calculations must also address anti-pro-cyclicality elements to mitigate excessive margin volatility in times of market stress.

SIFMA also wants to emphasize that good practices, metrics, and disclosures must be embodied in effective baseline anti-procyclicality ("**APC**") requirements tailored for products and markets, with such APC tools required to be reviewed and adjusted as conditions require. While most Clearing Agencies already have APC measures in place, in response to the CPMI-IOSCO Principles for Financial Market Infrastructures ("**PFMIs**") recommendations, the experiences of March 2020 make it abundantly clear these measures are inadequate – both in concept and in application. And particularly in light of the relatively muted IM volatility demonstrated in the less standardized and less liquid non-cleared market; it is plain that more effective APC controls are not only possible but have demonstrated effectiveness.[11]

Assuming that there are procedures for the right sizing of IM, and that these determinations are based on reasonably current positions, and the amount of such determinations can be reasonably anticipated by clearing members (potentially through the use of Clearing Agency provided margin predictor tools), SIFMA supports the authority of Clearing Agencies to make intraday scheduled margin calls. And to be clear, while scheduled intra-day calls apply to all clearing members, ad-hoc calls will only apply to those clearing members where their margin has eroded to a certain pre-determined percentage. Intra-day calls should address a complete reevaluation of the clearing member's portfolio including VM and IM on new and existing positions.

In fact, SIFMA believes that the making of such calls is essential to prudent risk management by a Clearing Agency and thus provides meaningful benefits not only to the Clearing Agency, but also to market participants and serves the interests of financial stability by protecting the Clearing Agency from default risk.

The Clearing Agencies should publish regular statistics as to the performance of initial margin requirements. For example, a Clearing Agency should provide details on the level of back testing breaches on a reasonable number of their major contracts (as opposed to only portfolio breaches). There should be regular testing that includes (i) the usage of extended lookback periods, and (ii) the inclusion of stressed periods of risk. Any initial margin call should use current up to date pricing and position level details.

[10] SIFMA AMG, re: *Consultative Report of the CPMI-IOSCO, BCBS, and CPMI re: Review of Margin Practices* at 7 (Jan. 26, 2022); *see also* JPMorgan Chase & Co et al., *A Path Forward for CCP Resilience, Recovery, and Resolution* (Mar. 10, 2020) (We generally endorse the recommendations made in this document).

[11] SIFMA AMG, re: *Consultative Report of the CPMI-IOSCO re: Resilience and recovery of central counterparties* at 8 (Oct. 17, 2016); SIFMA AMG, re: *Consultative Report of the CPMI-IOSCO, BCBS, and CPMI re: Review of Margin Practices* at 10 (Jan. 26, 2022).

B. Initial margin requirements should be robust and transparent so clearing members may reasonably anticipate margin calls (including intraday margin).

The establishment of intraday margin procedures cannot be viewed as distinct from the establishment of margin procedures taken as a whole. The reduction of surprises with respect to intraday margin depends on having transparent margin procedures generally and on having the start of day margin be as near correct as is possible. Accordingly, our suggestions below are applicable to margin determinations generally.[12]

i. Development and maintenance of margin models

In developing IM models, the Clearing Agencies should be required to take input from market participants (including clearing members and market participants) that have significant experience in market risk management.

ii. Accurate, robust pricing

Clearing Agencies should have a robust framework for determining pricing, and the framework must address situations where there has been no trading in the market. "Stale prices" are not acceptable.

iii. Margin period of risk ("**MPOR**")

The MPOR should be aligned with the time needed to liquidate the relevant positions in the market (fully closing out the portfolio), either via an auction or a central order book. The MPOR should be tailored to the particular product and stable notwithstanding market conditions. A one-day MPOR seems unrealistic in cases where a clearing member fails at the end of day.

iv. Calibration scenarios (lookback periods)

Calibrating IM based primarily on very recent data (inappropriately short lookback periods) can be highly pro-cyclical. Calibrating margin using data from very long lookbacks reduces procyclicality but may leave the Clearing Agency exposed during volatility spikes. To reduce procyclicality, Clearing Agencies should ensure that the scenarios used in margin calibration include stress scenarios. That is, calibration data should cover a highly diverse set of potential market conditions.

v. Margin add-ons, such as concentration and liquidity risks

Clearing Agencies should endeavor to include any margin add-ons in their core margin methodologies so that such add-ons can be understood and anticipated. Transparent methodologies for add-ons can allow clearing members and market participants to manage their risk more effectively. Concentration margin add-ons, a type of add-on that is designed to address the risks of liquidating relatively large positions, should be based on a realistic estimate of the likely impact that liquidation would have on the price achieved in the market. Timely communication of the triggers for the implementation of add-ons is of crucial importance when add-ons will be applied to initial margin requirements so that market participants can be prepared for the calls on their liquidity.

12 *See* also MRAC, re: *Recommendations Regarding CCP Margin Methodologies* (Feb. 12, 2021).

vi. Offsets

Offsets should require intuitive, strong, and reliable economic justification, such as the ability to arbitrage among the positions, not merely statistical correlation, and be well documented. Correlation benefits and their underlying economic rationales should be carefully considered, using an appropriate amount of historical and stressed scenarios, taking into account that correlation will exhibit fat tails and are prone to breaking down in stressed periods. Margin offsets across products with related underlying should only be granted if the benefits are highly likely to exist in the economic conditions following a member default. Diversification benefits may be limited by correlated movements in stressed conditions.

vii. Anti-procyclicality measures

There needs to be a far greater degree of transparency into the design and usage of APC measures. For this reason, we recommend the Commissions require the following Clearing Agency disclosures: a Clearing Agency's risk appetite for procyclicality generally, beyond which their models are designed to mitigate, and the clearing agency's performance relative to their procyclicality appetite; the APC tools applied in the Clearing Agency's IM methodology, with any differences depending on product or market, so that market participants can predict IM calls during stress periods (e.g., are margin levels model driven vs. floor driven, and to what degree margin buffers are being used); confirmation of any adjustments made to refine the application of the APC tools, such as volatility floors or scaling schemes (decay factor); reporting on a Clearing Agency's analysis of margin reactivity to extreme volatility scenarios (e.g., 10%, 20% or 30% increase in volatility) for each product and market cleared; and confirm details as to a Clearing Agency's calculation of base IM and use of any margin add-ons.

viii. Margin returns

Where technically possible or operationally feasible, excess margin (both initial and variation) should be required to be returned by the Clearing Agencies to the clearing members on the same intraday schedule on which they collect margin.

ix. Interoperability

SIFMA encourages efforts to enhance cooperation between Clearing Agencies on margin calls and to prioritize consideration to reduce "double margining" opportunities.

C. Intraday margin calls should be regularly scheduled while ad-hoc intraday calls should be made only in extreme circumstances.

Our recommendations below relate specifically to the process of collecting and returning margin on an intraday basis, both initial and variation margin.

i. Intraday margin calls should be scheduled and clearly defined to all participants:

A regularly scheduled intraday call should be made at the same time every day. The scheduled intraday call should be made in the early afternoon at a consistent time. An intraday call should be based on the most reasonably available positions and prices; e.g., they should not be based on positions from the prior day. Clearing members should have access to Clearing Agency intraday margin calculators via API to enable the replication of Clearing Agency intraday margin calls at client level.

One of the most important elements of right sizing is that margin determinations should be made as to positions and pricing that are as current as is reasonably possible. It is not meaningful to recalculate margin based on current volatility if the calculations are being made with respect to position and pricing information that is stale. Therefore, any margin determination, including any intraday determination, should be made with respect to a clearing member's current positions, and the current value of those positions, to the extent practicable.

An intraday call should clearly separate the IM and VM components of the call. Clearing Agencies should net VM gains against VM losses when issuing intraday calls to avoid the gross up effect. To the extent that a clearing member is owed IM or VM, these amounts should be returned to the member. To the extent that one such amount is owing from the clearing member and the other owing to the clearing member, these amounts should be netted against each other. We recommend Clearing Agencies implement a threshold for triggering intra-day margin calls to reduce the frequency for intraday calls in de minimis amounts.

To mitigate liquidity concerns, Clearing Agencies should allow a broader range of liquid collateral, such as money market funds and U.S. government securities funds, to cover intraday calls for IM.

ii. <u>Unscheduled or ad hoc calls should be available but only in extreme situations:</u>

Ad hoc intraday calls should be necessary only in times of extreme market dislocation or when the Clearing Agency has a large, uncovered exposure to a clearing member or potential exposure to a clearing member. While Clearing Agencies should be encouraged to perform frequent portfolio valuation / margin calculations for monitoring purposes, IM calculations should be robust and therefore sufficient to ensure that ad hoc intraday calls occur relatively infrequently.

Clearing Agencies should provide full transparency for triggers of ad hoc intraday margin calls, including as to the possibility of any add-ons to IM. This will assist clearing members and market participants in actively tracking and monitoring liquidity demands. Clearing Agencies should proactively engage with clearing members ahead of applying any such margin calls to alleviate the potential liquidity risk for clearing members.

D. Margin Models must be transparent and predictable.

It is of the greatest importance that margin calls, whenever they are made, be predictable. In order for them to be predictable, they must be established by an algorithm (which may include add-ons, so long as the triggers are known) that is transparent. Further, the Clearing Agency should provide, to the extent possible, timely information as to likely calls, including the possibility that a call may have included within it an add-on factor.

There is limited value in getting the IM amount "correct" if clearing members can not anticipate what the amount will be. Accordingly, a Clearing Agency should establish and use published triggers and thresholds to calculate both start of day and intraday margin requirements. An unpredictable amount means that clearing members must either maintain ready collateral in uncertain quantities or be prepared to liquidate assets with uncertain timing. Neither is a good result for clearing members or market participants.

IM models should be transparent, so that clearing members and market participants can anticipate calls. We note that as the Clearing Agencies are generally single providers in the products that they clear, there is no benefit in being less than fully transparent as to the basis of margin determinations. "Transparency" means, at a minimum, that clearing members have sufficient insight into the margin model used by a Clearing Agency so that an individual firm can understand how the model reacts to market conditions and can assess with some reasonable degree of certainty whether it will be subject to a margin call and in what amount.

The Clearing Agencies should publish regular statistics in a consistent format as to the performance of margin requirements. For example, clearing members should be able to see how many clearing members were subject to margin calls of what size, did clearing members go into a margin deficit, and how frequently. There should be regular back testing that includes (i) the usage of extended lookback periods, and (ii) the inclusion of stressed periods of risk.[13]

Whenever a Clearing Agency determines to make a discretionary intraday margin call, the Clearing Agency should be required to provide the relevant Commission, and to the extent possible the clearing members, an explanation of the reasons for the discretionary margin call so that there can be an evaluation of whether the need to make such a call might have been averted by improved procedures.

II. <u>Clearing Agencies should be required to establish detailed RWPs.</u>

A. Standards must be established for a Clearing Agency's recovery and winddown rules, policies, procedures, and tools.

Before moving to the specifics of the proposal, we think it is useful to address an important overarching issue: whether the rules should be "principles-based" and simply establish goals for which the clearing agencies should strive, or whether the rules should establish very specific requirements.

In the ordinary course, SIFMA membership favors principles-based regulation as it allows regulated entities to determine how best to comply with regulatory requirements in the light of their individual circumstances. But in the ordinary course, the impetus for firms to improve their conduct, and most importantly to operate in a safe manner, is driven by market competition. Generally, if a regulated entity is perceived to operate in a manner that is unsafe, perhaps because it has insufficient capital or it suffers from operational failures, the firm will lose business as its customers will transfer their transactions and accounts to a competitor.

Those competitive pressures are simply not meaningful to the Clearing Agencies that are single providers in the products that they clear. Customers are effectively required to the use the Clearing Agencies' products' as to each of the relevant types of transactions as clearing mandates prohibit customers from executing bilateral trades.

[13] For a fuller discussion of the types of information that CCPs should be required to provide, as well as the testing that they should be required to undertake *see* FIA, SIFMA AMG, Re: *CCP Disclosures – Margin Transparency* (Mar. 24, 2023).

We also observe that while the Clearing Agencies are intended to reduce credit exposures and thus systemic risk in the market, they can also be a source of systemic risk. Because, as a result of clearing mandates, each Clearing Agency is generally a single provider in the products that it clears, the failure of a Clearing Agency would create very material market disruption because there are no workarounds. Mandated central clearing means that firms generally do not have alternative procedures in place that would allow them to continue settling transactions in the event of the failure of a Clearing Agency.

Finally, the membership of SIFMA, as well as of other industry associations, have for many years communicated our concerns and attempted to work with the Clearing Agencies to adopt voluntary enhancements to their risk management practices. While some voluntary enhancements have been made, given the expanding clearing mandates and sole-provider status, we support the Commissions' efforts to promulgate consistent enhanced standards applicable to all Clearing Agencies.

Accordingly, it is our firm belief that the only way to improve the Clearing Agencies is through regulatory mandate that effectively codifies many existing voluntary best practices to enhance resiliency and create a threshold level playing field for Clearing Agency resiliency. In light of SIFMA's concerns as to the safety of the Clearing Agencies, and belief that needed improvement will happen only if specific regulatory requirements are imposed, we now turn to those specific requirements.

SIFMA supports the Commissions' Proposals to enhance requirements related to Clearing Agencies' RWPs. Developing robust RWPs is critical to safeguarding financial stability and to ensure appropriate transparency and predictability for Clearing Agencies' members and users. This is an important step towards enhancing Clearing Agencies' overall resilience and recoverability.

In particular, we support the Commissions' proposal to require a Clearing Agency to identify and describe the rules, policies, procedures, and tools the Clearing Agency would use in recovery or orderly wind-down. SIFMA believes that there are substantial advantages in requiring meaningful detail in the rules, policies, procedures, and tools that a Clearing Agency may use in dealing with default or non-default losses. In addition, as noted above, SIFMA urges the Commissions to set base-line standards and require testing to demonstrate effectiveness for such rules, policies, procedures, and tools, so that Clearing Agencies must adhere to required standards based on common best practices rather than establishing voluntary disparate practices.

To the extent that these tools have financial implications on clearing members and market participants, SIFMA believes it is essential that these tools not only be identified, but further information is included in the RWP on: (i) a description of the tools that a Clearing Agency would expect to use in each scenario; (ii) the order in which each tool would be expected to be used; (iii) the time frame within which the tool would be used and any dollar value or time cap; and (iv) the governance and approval processes and arrangements. Specifically, with regard to item (iv), we believe that an RWP should include governance practices that obtain and address input from market participants on relevant risk issues and entail oversight of the systemic regulator in relation to tools like partial tear-up that may have broader market impact.

RWPs will only be triggered in circumstances of severe stress after a Clearing Agency's routine default management processes have failed to cover a default loss or when a non-default loss has exhausted such Clearing Agency's own financial resources. Certain tools and procedures to facilitate a Clearing Agency's recovery involve allocating losses to its clearing members or market participants, and therefore must be transparent, predictable, and implemented with appropriate limitations and oversight to ensure that they do not inappropriately push losses to clearing members and market participants, which would have further destabilizing consequences. It is important to ensure that loss allocation procedures appropriately balance the incentives of Clearing Agencies' owners and market participants to manage risk effectively and prevent a crisis from occurring. Further, these loss allocation procedures should be well defined, as well defined as in an indenture. A Clearing Agency should not have autonomy to allocate losses away from its shareholders.

We believe the RWP requirements should be further enhanced to safeguard financial stability through addressing the following areas of risk (each described in greater detail in Section III):

- **Non-Default Losses:** Clearing Agencies should be required to specify the tools they would use in a non-default loss ("**NDL**") scenario, for example losses in respect of a Clearing Agency investments, cyber-attacks, or litigation judgements, among others. Except in the most extreme cases, the mutualized resources of clearing members should not be used to cover NDLs, as doing so would result in a significant misalignment of risk management incentives and an increase moral hazard. The Commissions should make clear that Clearing Agencies must depend on their own resources in the case of NDLs and require that Clearing Agencies be adequately capitalized for this purpose.

- **Default Loss Recovery Tools:** In the SEC Proposal, the SEC sets out four characteristics that a Clearing Agency should consider for evaluating the appropriateness of recovery tools, including their: effectiveness; reliability, timeliness, and legality; transparency; governance; and impact on the incentives of Clearing Agencies' clearing members, market participants (both direct and indirect participants), other stakeholders, and the financial system more broadly. These considerations should be codified within the Commissions' rules as they are critical to ensure that RWPs are fit for purpose.

- **Safeguards on Recovery Tools:** The Commissions should require Clearing Agencies to provide further specificity on the use of recovery tools within the RWP, to provide transparency and predictability for their clearing members, market participants, and the broader market and to ensure that these tools are not procyclical. The Commissions should require Clearing Agencies to specify safeguards and limitations on the use of any tools which allocate losses to their clearing members and market participants, such as cash calls, variation margin gains haircutting, and partial tear-ups.

    - Clearing Agencies should specify limits on any use of variation margin gains haircutting in time and amount, and such use should have the confirmed sanction of the Clearing Agency's resolution authority (*e.g.,* limited to 1 day).
    - Clearing member assessments for Clearing Agency recovery should be capped at a reasonable amount (see discussion in Section III).
    - The Commissions should indicate which tools are not fit for purpose *(e.g.,* initial margin haircutting should be explicitly prohibited).

- **Skin-in-the-Game:** A Clearing Agency's own-funds capital contribution to the default waterfall (known as skin in the game ("**SITG**")) is the principal mechanism to align a Clearing Agency's incentives with the risks presented by its activities. Maintenance of sufficient SITG is particularly important where a Clearing Agency's owners are not the primary providers of the mutualized loss resources. For this reason, clearinghouses in other jurisdictions, such as the UK and EU are legally required to hold a minimum quantity of SITG. The Commissions should require Clearing Agencies to maintain SITG equal to a material percentage of the default waterfall (see discussion in Section III).

- **Position Allocation Tools:** The Commission should ensure that the use of position allocation tools such as partial tear-ups ("**PTUs**") or forced allocation are subject to appropriate limitations or, in the case of forced allocation, complete bars. The use of such tools can subject clearing members and end users to inappropriate risk. The use of PTUs should be limited to the transactions that are too illiquid to close, such as when there is no price the market is willing to bear. Variation margin gains haircutting ("**VMGH**") must similarly be limited in amount and time (*e.g.*, no more than once a day). In addition, due to the potential impact of PTUs and VMGH on stability in the financial system and broader economy, approval from regulators, including those charged with monitoring for systemic risk, should be required.

    - **PTUs:** PTUs should be a last resort tool to re-establish a matched book when other tools have failed, as they expose clearing members and market participants to market and liquidity risk. If PTUs are to be used in recovery, they should be subject to review as to whether they restore the Clearing Agency to viability and be in the public interest. PTUs should be as narrowly applied as possible and the price for tear-up should not be determined by the Clearing Agency alone.[14]
    - **Forced allocation:** Clearing Agencies should be prohibited from using forced allocation of positions. Forcing clearing members to take on positions that they may not be suited to risk-manage and, in extreme market conditions, could themselves have further destabilizing consequences.

- **Compensation:** The externalization of losses to non-defaulting clearing members or non-defaulting market participants (beyond the above stated loss absorbing resources) should be treated as "financing resources" and be recoverable by those that contribute such financing resources. As referenced above, CPMI-IOSCO noted that those who contribute financing resources through such position allocation tools can be compensated from recovery and resolution resources.

[14] In its July 2017 Guidance on the Recovery of Financial Market Infrastructures (CPMI-IOSCO, Recovery of Financial Market Infrastructures, *supra* note 28, at § 4.5.18 through § 4.6.21), CPMI-IOSCO recognized the potential unfairness of PTUs based in part on the lack of control on the part of clearing members and market participants:

> "One of the drawbacks of partial tear-up is the lack of control that participants, both direct and indirect, have over whether their contracts will be torn up. Another drawback of partial tear-up is that it cannot be comprehensive unless all participants, direct and indirect, are subject to its application. As with forced allocation, however, those who are subject to partial tear-up can be compensated, to the extent possible, from the resources available through the default waterfall and recovery tools."
>
> "Participants whose positions are torn up will be vulnerable to replacement cost risk from the point of termination. However, the most significant potential drawback of partial tear-up is that the participants' netting sets will be broken and it may be difficult to re-establish them, particularly in a volatile market environment. This may be particularly concerning for participants who seek to maintain positions. Therefore, the partial tear-up tool may create exposure for participants that they are not well able to measure and manage."

To reduce uncertainty, RWP procedures should provide for well-defined crisis management processes. SIFMA strongly supports the requirement that Clearing Agencies ensure that they are able to maintain access to services, including personnel services, in a default scenario. Industry best practices from cyber and resiliency planning by Clearing Agencies provide a particularly useful example. In these cases, Clearing Agencies have outlined their expected actions and those of clearing members, which allows clearing members and market participants to anticipate their actions in the event of a cyber or technical resilience concern. This type of planning allows for clear expectations and saves critical time during the response to an incident.

In fact, one of the lessons that can be drawn from the Lehman Brothers failure that precipitated the 2008 financial crisis is that the largest losses may not be the ones that lead up to the insolvency event, but rather those that follow the insolvency event. In the case of Lehman Brothers, its inability following the insolvency event to keep its personnel from leaving and the difficulty it had in continuing servicing relationships were in large part the cause of the financial losses to its customers and market disruptions. Accordingly, it is important that a Clearing Agency have service contracts that cannot be terminated in the aftermath of an insolvency event and that it has sufficient going concern resources that will allow it to retain its key personnel.[15]

B. The SEC and the resolution authority (the FDIC) must play an active oversight role both in the review of the plans and in the consideration of their sufficiency.

We believe that the Commissions must play an active oversight role both in the review of the plans and in the consideration of their sufficiency. To take only the most obvious example, it cannot be enough for a Clearing Agency to say that its proprietary funds will be the first defense against financial problems if those funds are manifestly insufficient. Likewise, it cannot be sufficient for the Clearing Agency to say that it is aware of cyber or other operational risks if there are no operation contingency systems and facilities. Regulatory and market participant input and oversight is necessary into both substance and process. The entire Clearing Agency capital should be available as the last step in the default waterfall to fully ensure the alignment of incentives.

We likewise support the Proposals' requirement that a Clearing Agency should fully document its RWP. However, it is not sufficient that an RWP provides only a qualitative description of a Clearing Agency's response to negative events. It is essential that the Clearing Agency's financial and other resources be quantified, and that the Clearing Agency be able to justify the adequacy of its level of resources. Regulators cannot unquestioningly rely on Clearing Agencies to make the right determinations in light of generalized best practices, particularly when it may be advantageous to them to limit their exposures or investments. With the combination of clearing mandates and single product provider status, there is very limited business pressure on Clearing Agencies to invest in the optimum level of risk management. Rather, the impetus must come from regulatory oversight.

[15] Principle 15 of the PFMIs require each FMI to identify, monitor, and manage its general business risk and hold sufficient liquid net assets funded by equity to cover potential general business losses so that it can continue operations and services as a going concern if those losses materialize. Further, liquid net assets should at all times be sufficient to ensure a recovery or orderly wind-down of critical operations and services.

While we appreciate and submit to the involvement of market participants in the (annual) testing of a Clearing Agency's RWPs, this should not place an unreasonable onus on market participants in terms of time and resources spent.

III. Comprehensive enhancements to the Clearing Agency capital regime are necessary for an effective RWP.

For an RWP to be effective, it must have as its foundation a robust Clearing Agency default management approach that identifies risks and provides appropriate policies, procedures, tools, and capital to adequately mitigate such risks. Our motivation is to address identified weaknesses by building on existing best practices to enhance the overall resiliency of cleared markets and protect against a potential Clearing Agency failure, to better ensure the cleared product scope can be appropriately risk-managed, to right-size margin requirements and clearing costs for the risk being managed, to enhance risk transparency – both for clearing members and end-users – to better facilitate participation and competition, and to mitigate the risk that public funds are ever needed to address the losses and costs of a Clearing Agency failure.

Our efforts have focused on opportunities to better align risk management incentives, address non-default losses, confirm treatment of capital in recovery, and propose ex-ante Clearing Agency resources for use in resolution and winddown.

There are several reasons why regulatory action is necessary. First, notwithstanding a long history of effort, we have not experienced a robust willingness on the part of Clearing Agencies to negotiate and agree to rulebook changes in these areas. Second, even if such a voluntary collaborative effort were possible, absent regulatory mandate, Clearing Agencies could unilaterally change the rulebooks to retreat from such agreements. And third, especially as our recommendations reflect existing best practices, or directionally conform to regulatory requirements in some jurisdictions, we firmly believe that the regulatory foundation for the clearing infrastructure must demonstrate an appropriate degree of consistency to mitigate the potential systemic risk which is presented by the clearing mandates.

In general, SIFMA does not believe existing regulations adequately address Clearing Agency capital in a manner commensurate with the risk managed by the Clearing Agencies. An approach that effectively allows the Clearing Agencies to transfer liability for risk management failures to non-defaulting clearing members and non-defaulting market participants is inconsistent with corporate governance standards and the spirit of the applicable Clearing Agency core principles.

Clearing Agencies' arguments against formalizing recommendations into rulemaking include the claim that Clearing Agencies are not responsible for introducing risk into the system, and therefore it is inappropriate to require a sizeable Clearing Agency capital contribution which, they argue, would compromise the risk management incentives applicable to clearing members and market participants. We take issue with these arguments as although clearing members and market participants bring trades to clear, such trades are only accepted for clearing in products and at initial margin levels set by the Clearing Agencies. Clearing members and market participants have limited transparency into, and even less control over, a Clearing Agency's risk decisions. Requiring Clearing Agencies to contribute all remaining capital at the end of the default waterfall and removing limited recourse provisions will not change the incentives for clearing members and market participants but would serve to significantly enhance the incentives of Clearing Agencies themselves. Thus, it is only appropriate for Clearing Agencies to have capital obligations commensurate with their management power and their ability to profit from their activities.

Our members do not believe that existing voluntary SITG levels, or a Clearing Agency's franchise value or remuneration practices, or a Clearing Agency's general preference for systemic stability, provide adequate risk management incentives – especially compared to the high levels of liability imposed on non-defaulting clearing members and non-defaulting market participants who neither vet the products cleared nor set the initial margin levels. Unfortunately, neither the Commissions' regulations nor the Clearing Agency core principles prescribe a specific minimum amount of Clearing Agency capital as SITG to serve as an incentive for Clearing Agencies' risk management responsibilities.

Clearing members and market participants are of the view that it is wholly inappropriate for them to bear a Clearing Agency 's NDLs in excess of the amount required to be covered by the Clearing Agency in existing capital requirements. Participants are not responsible for the choices that led to the NDLs or for the ongoing oversight and management of the Clearing Agencies' clearing infrastructure. Clearing Agencies, in performing their regulated operations, select vendors and deploy / invest in technology as they manage the clearing infrastructure, including the daily management of collateral. Clearing Agencies, through their management decisions, are subject to the risk of potential NDLs – whether it be, for example, operational failures, fraud, theft, cyber-threats, and attacks that could lead to monetary loss or market value losses of investments and certain custodian or settlement bank failures.

A. A Rule is needed to require Clearing Agencies to reserve for required skin-in-the-game ("SITG") levels.

SIFMA members acknowledge that in considering incentives, it is appropriate to find a balance between the incentives relevant to each constituency. Incentives to further encourage a Clearing Agency 's management of market and other risks should be balanced against incentives to encourage clearing members and market participants to manage their risks, including the responsibility for clearing members to manage both their and their customers' default risk, so that incentives for one constituency do not mitigate the other's responsibilities.

SIFMA recommends that the Commissions each adopt a rule to require Clearing Agencies subject to their jurisdictions to contribute to the default waterfall an amount of risk-based capital (in addition to the clearing member-funded default fund) to serve as an additional risk-management incentive (yet not as a meaningful loss-absorption resource).

Specific recommendations are as follows:

- Require Clearing Agencies to reserve pre-funded dedicated own resources for application in a default event after access to the defaulting end-user's initial margin and the defaulting clearing member's initial margin and default fund contribution and before access to the non-defaulting clearing members' default fund contributions and any additional assessments; and require a link between SITG usage and senior executive compensation.

- Commence a study to include representation from Commissions' Staffs and industry practitioners which could recommend an appropriate risk-based methodology for calculating and structuring the amount of Clearing Agency pre-funded dedicated own resources taking into account the structure and the internal organization of Clearing Agencies and the nature, scope, complexity, and risk of their activities.

Specific recommendations regarding the size and structure of Clearing Agency SITG are as follows:

- **Sizing**: A SITG floor should be a risk-based, meaningful, proportion of the default fund to align the Clearing Agency's exposure to the level of risk that the Clearing Agency is responsible for managing without serving as a material layer of loss absorption.

- **Tranching**: To focus the incentive effect on different aspects of the Clearing Agency's risk management responsibilities, SITG should be divided between two tranches, each sized at half of the overall amount:

  - **Junior Tranche**: This tranche, applied after exhausting the defaulting clearing member's initial margin and default fund contribution, addresses the Clearing Agency's responsibility for the model risk that the defaulter's initial margin is inadequate to support its' positions.

  - **Senior Tranche**: This second tranche, applied after exhausting both the original default fund and the non-defaulting clearing member assessment, addresses the Clearing Agency's responsibility for the model risk that the non-defaulting clearing members' default fund contribution and assessment is inadequate to avoid supplemental loss mutualization through further contributions of non-defaulting clearing members and non-defaulting end-users.

- **Risk Adjusting**: To provide for the lowest, risk-based, SITG floor, the amount should be subject to adjustment to address risk management gaps identified through general risk reporting or in response to supervisory stress testing; *e.g.*, as demonstrated by product level back-testing breaches for initial margin as reported in the results to a set of enhanced metrics to the CPMI-IOSCO Public Quantitative Disclosures (1st SITG tranche) or in the results to the supervisory stress-tests (2nd SITG tranche):

  - **Increase from SITG Floor**:

    - **Junior tranche**: For example, in the event that enhanced metrics of the Clearing Agency's Public Quantitative Disclosures show, at a product level, through product specific back-testing results, either multiple small breaches or limited yet severe breaches and/or large procyclical increases of the initial margin levels, the junior SITG tranche should be temporarily increased by an appropriate percentage, and

    - **Senior tranche**: For example, in the event enhanced supervisory stress testing indicates that a certain percentage of the default fund is insufficient to address a default, the senior SITG tranche should be temporarily increased by an appropriate percentage.

  - **Decrease to SITG Floor**: In the event, over two consecutive quarters, subsequent Public Quantitative Disclosures or supervisory stress testing indicates the consistent resolution of the above referenced issues, the SITG tranches can return to the normal floor.

SIFMA members maintain that most for-profit Clearing Agencies lack sufficient amounts of SITG to appropriately incentivize performance of their risk management responsibilities against their natural incentive to maximize shareholder returns as publicly owned companies (or subsidiaries of such companies). A SITG amount based on a meaningful percentage of the default fund is compelling as being directly tied to the size of the risk managed by the clearing agency and can adjust over time as such risk levels change.

B. A Rule is needed to require Clearing Agencies to reserve appropriate amounts for non-default losses ("NDLs").

Clearing Agencies should be subject to appropriately sized capital requirements to cover NDLs for which they are responsible, and a Clearing Agency s default fund should not be used to cover NDLs, and applicable law in some jurisdictions prohibits the use of mutualized financial resources intended for default-related purposes to be used to cover NDLs.[16]

It is not enough to say the Clearing Agency is responsible for certain NDLs if there is not sufficient capital to cover such losses. Clearing Agencies' distinct operations present different NDL profiles which should be considered in determining the responsibility for such NDLs.[17]

In fact, the Commissions' current approach effectively serves as a safe-harbor protecting the Clearing Agencies from NDLs in excess of annual operating expenses and avoids any risk-based criteria in setting appropriate capital requirements. [18]

Specific recommendations are as follows:

- Require Clearing Agencies to allocate appropriate capital to address certain non-default losses arising from areas of Clearing Agency control. We maintain it is inappropriate for clearing members and customers to bear these NDLs since they are not responsible for the choices that led to them.

[16] In the EU, for non-default losses, European CCPs also hold capital proportionate to the risk stemming from the activities of the CCP. Article 16 of EMIR states that the total capital of CCP shall be high enough to address potential winding down or restructuring, operational and legal risks, credit, counterparty, and market risk as well as business risks (which naturally include non-default losses). In addition, Principle 15, PFMI states: An FMI should identify, monitor, and manage its general business risk and hold **sufficient liquid net assets funded by equity to cover potential general business losses so that it can continue operations and services as a going concern if those losses material**ise. Further, liquid net assets should at all times be sufficient to ensure a recovery or orderly wind-down of critical operations and services. (emphasis added).

[17] *See* CPMI and IOSCO, re: *Report on current central counterparty practices to address non-default losses* (Aug. 23, 2023) (Clearing Agencies must have policies, procedures and plans to ensure that they have the proper resources to address NDLs.).

[18] SEC Rule 17Ad-22 only requires that a Clearing Agency holding liquid assets equal to six months of its current operating expenses unless its Board determines to hold a higher amount. There is no requirement to hold assets to cover potential NDLs. CFTC Rule 39.11 provides that a Clearing Agency must be able to cover operating costs for at least one year and hold sufficient liquid resources to cover NDLs but does not provide any basis for the determination of a required amount.

- Require Clearing Agencies to identify relevant sources of business losses and reserve pre-funded dedicated own resources that are not related to clearing members' defaults. Consideration should be given to general business risk, operational failures, legal risk, cyber-threats, fraud, theft or other malicious acts of employees or external actors, credit deterioration or market value losses of CCA-directed investments; and custodian or settlement bank failure where the CCA has been negligent in selecting and monitoring such third parties.

- Require that the assessment of adequate resources to reserve for such losses shall reflect the structure and the internal organization of Clearing Agencies and the nature, scope, and complexity of their activities.

The consequence of the existing rules is that the full extent of NDLs, if not met by Clearing Agency resources, and potentially by clearing members and end-users, could become the responsibility of taxpayers in a Clearing Agency resolution.

SIFMA therefore recommends that Clearing Agencies should be required to have risk-based capital available which is sized to absorb any and all such NDLs. For example, a Clearing Agency should be required take account of the possibility of increased legal fees, accounting fees, financial advisor fees, the costs associated with employee retention programs, in order to maintain critical staff.

C. A Rule is needed to require Clearing Agencies to cap clearing member assessments and to solicit shareholders for default fund contributions.

A Clearing Agency's assessment of non-defaulting clearing members for additional resources after the exhaustion of the default fund across multiple defaults should be capped and defined ex-ante. In addition, to the extent losses exceed available resources after assessments are made, SIFMA recommends that a Clearing Agency shareholder should be solicited to absorb such losses.[19]

[19] In its July 2017 Guidance on the Recovery of Financial Market Infrastructures (CPMI-IOSCO, *Recovery of Financial Market Infrastructures* at § 3.3.13 (Oct. 2014, rev. July 2017)("July 2017 Recovery Guidance")), IOSCO's Committee on Payments and Market Infrastructures ("CPMI-IOSCO") recognized the advisability of limits on clearing member assessments, albeit on a negotiated rather than required basis:

> "The use of particular recovery tools by an FMI in certain stress scenarios may have particularly serious consequences for participants, markets, and financial stability more broadly. Accordingly, the recovery tools should be developed in a way that minimizes any negative impact to the broader financial system to the greatest extent possible. To avoid the use of recovery tools that are more disruptive to the financial system, an FMI may wish to explore procedures for its recovery plan that would allow for negotiation between the FMI and its owners and participants in order to agree to allocate losses and liquidity shortfalls and replenish financial resources by voluntary means."

CPMI-IOSCO also observed that for some [Clearing Agency] clearing some products, assessment rights are capped at an upper limit, beyond which the [Clearing Agency] would have to reduce its liabilities. They noted, however, that "where… cash calls are capped, their ability to fully meet a financial shortfall depends on whether, in the aggregate, the cap is below that of the shortfall. Because of this, cash call powers that are capped would need to be supplemented by other loss allocation tools."

Specific recommendations are as follows:

- Require Clearing Agencies to cap assessment rights against non-defaulting clearing members across multiple defaults at an amount no greater than the non-defaulting clearing member's default fund contribution immediately before the default.

- Require Clearing Agencies to solicit their shareholders to voluntarily contribute resources if the Clearing Agency's reserved resources and non-defaulting clearing member capped default fund assessments are insufficient to cover losses arising from a default.

- Require Clearing Agencies to apply their equity-funded assets to implement each Clearing Agency's recovery or wind-down plans in response to a recovery or orderly wind-down necessitated by uncovered credit losses or liquidity shortfalls if all of the Clearing Agency's other resources are depleted.

- Require Clearing Agencies to utilize their residual capital as a last resort ahead of resolution.

SIFMA maintains that if a Clearing Agency's pre-funded resources as well as a one-time clearing member assessment are insufficient to cover losses arising from a default, then the Clearing Agency will require additional resources to continue as a going concern. Clearing Agency shareholders should be given the opportunity to voluntarily contribute additional financial resources to the default waterfall.

Should such resources also not suffice, non-defaulting clearing members could, by means of a polling mechanism requiring a super majority to pass, decide to make one additional default fund contribution as additional loss absorbing resources.

At that point as well, SIFMA accepts that tools such as variation margin gains haircutting and partial tear-ups could be considered, provided such use is limited, is confirmed as necessary to restore the Clearing Agency to viability, is in the public interest, and compensation is provided through the provision of equity-like instruments.

"No creditor worse off" safeguards are at best an ill-suited fit in a market where non-defaulting market participant assets are utilized to backstop losses ahead of access to Clearing Agency equity holders, particularly where clearing members and their customers are forced to clear by regulatory mandates.

SIFMA believes that in any case, should all recovery tools be exhausted (inclusive of any voluntary measures), in line with corporate finance principles, Clearing Agency capital should be available in full prior to entry into resolution (and should therefore not be shielded through any limited recourse wording in the Clearing Agency's rules).

SIFMA therefore recommends that to avoid the risk of moral hazard, and to address any perceived legal constraint in achieving the FSB's guidance for Clearing Agency equity to be fully loss absorbing, the Commissions' Rules should be explicit that Clearing Agency equity is fully loss absorbing in resolution and shareholders' claims are fully subordinate to other creditors.

SIFMA also maintains that the Commissions' Rules should require that any further externalization of losses to non-defaulting clearing members or non-defaulting customers (beyond the above stated loss absorbing resources) should be treated as "financing resources" and be recoverable by those that contribute such financing resources. One compensation approach, for contributors that can accept equity instruments, would be through predefined equity-like instruments that would not render the Clearing Agency insolvent but would place the claims of contributors ahead of the claims of shareholders. Such compensation claims should be retained in the case of resolution.

SIFMA believes that given the highly pro-cyclical implications of uncapped non-defaulting clearing member assessments and non-defaulting customer contributions, treating them as unlimited loss absorbing resources must be prohibited. Maintaining a distinction between loss absorbing and financing resources will have a real impact on financial stability during both recovery and resolution as it will incentivize clearing members and customers to stay in their trades, rather than liquidate. "Adequacy" should be viewed through a lens of "availability" and absent compensation for financing resources, the expected providers of those resources will not be incentivized to provide them.

D. A Rule is needed to require Clearing Agencies to arrange ex-ante resources for use in RWPs.

SIFMA believes it is critical that resolution authorities require Clearing Agencies to set aside ex ante resources for recapitalization to be bailed-in by the resolution authority to continue to operate the resolved Clearing Agency.

One option in the case of for-profit Clearing Agencies would be for Clearing Agencies to issue long-term debt securities to unaffiliated institutional investors. The resolution authority would be able to "bail in" these prefunded securities and convert them to equity to ensure continuity of clearing and restore a Clearing Agency's access to resources.

Another option would be for Clearing Agencies to secure pre-guaranteed liquidity lines with a diversified pool of counterparties that would be available to meet short term liquidity as well as bail-in capital needs in the event of one or more members defaulting.

SIFMA finds unpersuasive the argument that such resources are not cost-effective given the low likelihood of their use. In the absence of such resources, non-defaulting clearing members and non-defaulting customers are concerned their resources could be used, or worse, taxpayer resources would be required.[20]

[20] In its July 2017 Guidance on the Recovery of Financial Market Infrastructures (CPMI-IOSCO, *Recovery of Financial Market Infrastructures* (Jul. 2017), supra note 10, at § 4.6.7.), CPMI-IOSCO supported the use of ex ante arrangements with existing debt holders:

> "Where an FMI has debt in its capital structure, a further appropriate means for raising equity capital could be for an FMI to develop ex ante arrangements with the existing debt holders regarding the bail-in of their instruments."

In addition, in the November 2018 discussion paper for public consultation (*Financial resources to support Clearing Agency resolution and the treatment of Clearing Agency equity in resolution—Discussion paper for public consultation* (Nov. 2018)) the Financial Stability Board ("FSB") emphasized the involvement of home jurisdictions and authorities:

Conclusion

SIFMA is fully supportive of the Commissions in putting forth the Proposals. We believe that Clearing Agencies should have in place procedures to require intraday margin of its members, that there should be improved procedures to right sizing margin, and that margin determinations are made as transparent and predictable as is possible. Margin calls should not be surprise events.

We likewise support the Proposals' requirement that a Clearing Agency must fully document its RWP. However, it is not sufficient that an RWP provide only a qualitative description of a Clearing Agency response to negative events. It is essential that the Clearing Agency's financial and other resources be quantified, and that the Clearing Agency can justify the adequacy of its level of resources. Regulators cannot simply rely on Clearing Agencies to make the right determinations in light of generalized best practices. With the combination of clearing mandates and single provider status, there is limited business pressure on Clearing Agencies to invest in the optimum level of risk management. Rather, the impetus must come from regulatory oversight.

Finally, SIFMA views governance as implicitly an essential aspect of the work that will be required to effectuate the requirements of the Proposals. Market participants, both clearing members and their customers, have the risk management and other skills that will be essential to making the requirements effective. Further, as market participants and their customers will bear the largest share of the resulting losses, it is critical that the Commissions require the Clearing Agencies to enhance their risk management procedures as outlined herein. Therefore, market participants are entitled to play a meaningful role in the implementation of the Proposals. We believe that the Proposals should be expanded to better define the role of risk management and other committees that include market participants. In establishing its margin procedures and its RWP, a Clearing Agency's board of directors should have in place procedures that require it to take account of all views and recommendations put forth by the risk management and other market participant committees.[21]

We appreciate the Commissions' consideration of our comments. SIFMA would be happy to discuss any of these issues with you further, and we thank the Commission for the opportunity to comment on this matter.

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> "For [Clearing Agency] that are determined to be systemically important in their home jurisdiction, the home resolution authority should develop, in cooperation with the [Clearing Agency's] oversight or supervisory authorities (where distinct from the resolution authority), a resolution plan that ensures continuity of the critical functions carried out by the [Clearing Agency]. For [Clearing Agencies] that are considered systemically important in more than one jurisdiction, in addition, Crisis Management Groups (CMGs) should be established to coordinate resolution planning and resolvability assessments across relevant jurisdictions. Resolution authorities and CMGs should coordinate closely with the relevant supervisory and oversight authorities and (where they exist) supervisory colleges for [Clearing Agencies], who may perform or have performed related assessments in the context of recovery planning."

[21] For a fuller discussion of governance issues, *see* SIFMA AMG, re: *Governance Requirements for Derivatives Clearing Organizations* (Oct. 13, 2022). In that letter, SIFMA AMG highlights the importance of market participant involvement in areas such as Clearing Agency margin methodology, default fund management, non-default losses and the development of RWPs.

On behalf of SIFMA AMG and SIFMA, we appreciate the opportunity to respond to the Proposals and your consideration of our comments and recommendations. If you have any questions or require additional information, please do not hesitate to contact us by calling William Thum at (202) 962-7381 or Tom Price at (212) 313-1260.

Sincerely,

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cc: Honorable Gary Gensler, Chair, U.S. Securities and Exchange Commission
Honorable Caroline A. Crenshaw, Commissioner, U.S. Securities and Exchange Commission
Honorable Jaime Lizárraga, Commissioner, U.S. Securities and Exchange Commission
Honorable Hester M. Peirce, Commissioner, U.S. Securities and Exchange Commission
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