sifma

asset management group

KISS Initiative – Appendix 3

CLEARING[1]

I. Central Counterparty Standards: Encourage Efficiencies of Central Clearing Through Fostering Resilient DCOs with Robust Customer Protections

A. Commission's Regulatory Goals

The Commission, in its oversight of derivatives clearing organizations ("DCOs") pursues its goals of fostering robust and stable swaps and futures markets while protecting customers of the DCO's clearing members from losses unrelated to the customer's exposure. These goals are related to the Commission's post-Dodd-Frank aim of encouraging central clearing of derivatives and the Commission's longstanding aims of protecting the assets of clearing members' customers, pursuant to CEA Section 4d, and overseeing the integrity of DCOs pursuant to CEA Section 5b.

B. Excessive Regulatory Burdens and Adverse Impact

The absence of regulatory standards that foster resilient DCOs with robust customer protections may cause some risk-adverse investors to avoid cleared products in favor of uncleared derivatives; if investors' margin posted to DCOs will be exposed to losses due to the failure of the DCO, some investors may decide that their interests are better served by an uncleared product with margin held in a triparty collateral account. This result would run counter to the G-20 reforms, including the promotion of central clearing.

AMG has set forth its concerns regarding weak DCO standards—including concerns with any use of customer margin to cover DCO losses—in a number of letters submitted with the Commission and international bodies; we submitted our most recent summary of concerns and recommendations

[1] Should you have any questions regarding AMG's response, please contact Tim Cameron at 202-962-7447 or tcameron@sifma.org, or Laura Martin at 212-313-1176 or lmartin@sifma.org. or Ruth Epstein, Stradley Ronon Stevens & Young, LLP, at 202-292-4522 or repstein@stradley.com.

jointly on June 5, 2017 with the American Council of Life Insurers, Investment Company Institute and Managed Funds Association.[2]

C. Recommendations

AMG recommends that the Commission:

1. Strengthen minimum funding requirements and risk management processes in order to foster resilient DCOs and reduce the likelihood of DCO failure, including by:

    a. Requiring risk-aligned capital contributions from the DCO (*i.e.*, DCO skin-in-the-game) and contributions from clearing members, both of which should be prefunded.

    b. Requiring DCOs to exclude non-defaulting customer assets from default waterfall resource calculations.

    c. Requiring DCOs to have margin requirements that are appropriately sized and foreseeable.

    d. Requiring DCO risk and default management committees to consider feedback provided by clearing members' customers.

2. Require DCOs to provide expanded public disclosure that is reliable, readily available, and comparable, specifically:

    a. For the purpose of public disclosure, require DCOs to run new "benchmarking" stress tests.

    b. Require DCOs to make their Public Quantitative Disclosures available on a central website, and should require those disclosures to be accurate, with quality controls supported by penalties for material misstatements.

    c. Require DCO rulebooks to disclose clearly, the impact of recovery and resolution tools on clearing members' customers.

    d. Require DCOs to disclose publicly, lessons learned from default drills and include investors and asset managers in DCO default drills.

3. Require DCO recovery standards to provide full protection of customer interests when a DCO is in recovery (pre-resolution), including:

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[2] See Letter from SIFMA AMG, the American Council of Life Insurers, Investment Company Institute, Managed Funds Association regarding Central Counterparty Standards for Derivatives (June 5, 2017), *available at*: https://www.sifma.org/resources/submissions/sifma-amg-and-other-associations-submit-recommendations-on-central-counterparty-standards-for-derivatives/.

a. Strictly prohibiting DCOs from taking non-defaulting customer assets to cover DCO shortfalls.

b. Requiring open auctions and mechanisms to continue the payment of variation margin to and from the customers of a defunct clearing member.

c. Exercising discretion to temporarily suspend swap clearing mandates during a DCO recovery.

d. Pre-designating a regulatory authority to initiate resolution proceedings when deemed necessary.

4. Require DCOs to have clear protocols for the porting of customers' positions, Legally Segregated, Operationally Commingled ("LSOC") treatment for all customer collateral, and rationalized capital requirements that recognize the exposure-reducing effects of posted initial margin.

5. Proceed with DCO resolution based on clear protocols that balance market and systemic interests with customer protections.

II. Additional Clearing Recommendations

In addition to the foregoing, AMG recommends that the Commission:

1. Maintain strong residual interest requirements, finalized by the Commission in 2016.[3]

2. Maintain the LSOC model for segregation of customer collateral posted for cleared swaps,[4] and consider expansion of LSOC to futures.

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3 *See* Residual Interest Deadline for Futures Commission Merchants; Final Rule, 80 Fed. Reg. 15507 (Mar. 24, 2015).

4 *See* Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions; Final Rule, 77 Fed. Reg. 6336 (Feb. 7, 2012).