



asset management group



MANAGED FUNDS
ASSOCIATION

Submitted via portal

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Committee on Payments and Market Infrastructures (CPMI)
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

International Organization of Securities Commissions (IOSCO)
C/ Oquendo 12
28006 Madrid
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Re: Response to discussion paper on central counterparty default management auctions

Dear Secretariats:

The Securities Industry and Financial Markets Association's Asset Management Group ("SIFMA AMG") and the Managed Funds Association ("MFA" and, together with SIFMA AMG, the "Associations")¹ appreciate the opportunity to provide comments to the Committee on Payments and Market Infrastructure ("CPMI") and the International Organization of Securities Commissions ("IOSCO") on their joint discussion paper regarding central counterparty ("CCP") default management auctions (the "Discussion Paper").²

SIFMA AMG and MFA members, on behalf of their clients, use futures and swaps cleared at CCPs, for a range of purposes, including as a means to manage or hedge investment risks, such as changes in interest rates, exchange rates, and commodity prices. Members of the Associations have been vigorous supporters of central clearing as a key component of the reforms implemented in the over-the-counter derivatives markets following the 2008 financial crisis because we believe that central clearing mitigates systemic, counterparty, and operational risks and promotes market transparency.

CCP clients³, including our members, are significant users of CCPs and their clearing services, and therefore, have a strong interest in ensuring the continued safety, soundness, and resilience of CCPs, in particular following a clearing member's default. In the event a CCP were to be unsuccessful in managing the default of one of its clearing members, our members' and/or their clients' capital could be at risk. Given the implications that such a failure would have on clients, we are providing these comments on the Discussion

¹ See Annex A for descriptions of SIFMA AMG and MFA.

² Committee on Payments and Market Infrastructures, A discussion paper on central counterparty default management auctions (Jun. 5, 2019), available at <https://www.bis.org/cpmi/publ/d185.pdf>.

³ The term "client" is used to refer to buy-side market participants (including asset managers) that access CCPs through clearing members, and thus, are indirect participants in the CCP.

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Paper to ensure that relevant authorities consult, reflect the views of, and balance the assumed risks of, all market participants, including clients, as discussions around these issues progress.

We appreciate CPMI and IOSCO's focus on CCP default management in the Discussion Paper, and in particular, commend CPMI and IOSCO for noting the benefits of client participation in CCP default management auctions.⁴ Clients have been participating in CCP default management auctions for decades, and in many circumstances, have provided the best bids for defaulted clearing member portfolios. Limiting participation in CCP default management auctions to clearing members only would restrict market depth and liquidity available to CCPs, which would likely increase the cost of the relevant auction and the overall cost to the CCP and defaulting clearing member's estate.

Therefore, as further discussed below, the Associations believe strongly that CCPs should have default management processes that include clients as part of auctions and CCP governance, and urge CPMI and IOSCO to recommend such inclusion.

RESPONSES TO SPECIFIC QUESTIONS REQUESTED IN THE DISCUSSION PAPER

Question 21. For which markets, asset or product classes and customer types would client participation be most feasible and/or desirable? What would be the incentives for client to participate in auctions? Does this differ for direct vs indirect client participation? Please elaborate in your response.

Following the default of one of its clearing members, a CCP's main objective is to mitigate the risk of that default at the lowest possible cost in light of the prevailing market circumstances. Expedient default management will minimize market stress resulting from the default, and default management auctions often serve as the most effective way to liquidate a given portfolio. Vital to the default management process is the auction design, including bidder selection.

Prior to commencing any auction, a CCP will seek to ensure the success of the auction by selecting bidders for a given auction portfolio. As noted in the Discussion Paper, some CCPs require their clearing members to bid in an auction, while other CCPs will ask for auction participants on a voluntary basis.⁵ In addition, some CCPs will select bidders based on product class, where auction participation is mandatory for some products, while participation will be voluntary for other products. In either case, our members believe that clients should always be eligible to participate as potential bidders for all product classes. We think client participation in a CCP auction is critical to the auction's success for the following reasons:

- **Client Incentives Aligned** – Clients' incentives are aligned with clearing members. Specifically, when participating in an auction, clients' incentives are to ensure the CCP's resiliency and to have the opportunity to profit from the auction. Although clients may be more removed in the CCP waterfall process, their interest is certainly not nominal. In the event that a CCP auction fails, a CCP may use client assets as a recovery tool, by subjecting clients' positions to gains-based haircutting or partial tear-up.⁶ Therefore, clients are motivated to provide strong bids in order to ensure the CCP's viability, to minimize the possibility of the CCP's failure and associated haircuts and/or tear-ups, and most importantly, to avoid general market disruption that would affect both clients and clearing members alike.

⁴ *Supra* note 2.

⁵ *Id* at section 4.2.5, page 10.

⁶ *Id* at section 6.2, page 18, note 23.

- **Importance of Participant Diversity** – In designing an auction, a CCP should seek to ensure that there is a diverse set of market participants with sufficient knowledge and experience to provide robust bids in any auction. Correspondingly, the likelihood of the auction’s success is naturally increased by including clients who can properly manage, price and bid on the relevant products (as compared to allowing only a relatively homogenous group of clearing members to participate that may be similarly impaired by market events). In fact, according to CCP quantitative disclosures, for many of the products cleared by the most prominent CCPs, clients account for a significant majority of the market depth as evidenced by the margins posted by clients relative to the margin posted by clearing members to the CCPs.⁷ These statistics quantitatively demonstrate the depth and expertise that clients have in the portfolios that a CCP might auction in the event of a default.

CCPs have a general obligation to obtain reasonable market prices when disposing of a defaulting clearing member’s positions (and, in the event of a failed porting, the positions of such defaulted clearing member’s clients). Thus, encouraging greater auction participant diversity by including clients should increase auction success by resulting in better bidding and higher auction returns.

- **Importance of Auction Demand** – Based purely on the principle of supply-and-demand, increased demand for the auctioned positions makes it more likely that the CCP will achieve a market clearing auction price, and result in a successful auction. Therefore, broadening auction participation to clients increases the likelihood of competitive bids and successful auctions. In fact, where CCPs have allowed clients to participate in default management auctions, the result has been successful auctions, which shows that CCPs benefit from buy-side inclusion.⁸

As stated in Section 4.2.3 of the Discussion Paper, “[f]ollowing a default, a CCP seeks to ensure that participation is sufficiently broad to promote the auction’s success. All things being equal, the more auction participants, the more competitive the bids are expected to be.”⁹ We agree and insist that broadening the scope of participation to all clearing members and their clients is necessary for all CCPs. For example, following the default of a member at Nasdaq Clearing AB (“Nasdaq”), Nasdaq’s default management auction in September 2018 consisted only of clearing members and the result was an unsuccessful auction.¹⁰ Specifically, Nasdaq invited only four clearing members, with only two submitting bids.¹¹ If Nasdaq had included clients in the auction, we believe that the auction would have had a greater likelihood of success.

⁷ See CME Group Quantitative Disclosure Q1 2019, available at, <https://www.cmegroup.com/clearing/cpmi-iosco-reporting.html>; Eurex Quantitative Disclosure Q1 2019, available at, <https://www.eurexclearing.com/clearing-en/about-us/compliance-standards>; ICE Clear EU Quantitative Disclosure Q1 2019, available at, <https://www.theice.com/clear-europe/regulation>; ICE Clear US Quantitative Disclosure Q1 2019, available at, <https://www.theice.com/clear-us/regulation>; LCH LTD Quantitative Disclosure Q1 2019, available at, <https://www.lch.com/resources/rules-and-regulations/ccp-disclosures>. Section 6.1 of the CPMI-IOSCO Quantitative Disclosure for Q1 2019 indicate that – CME Group’s clients accounted for 86% of IRS margin; Eurex AG’S clients accounted for 64% of total margin; ICE Clear EU’s clients account for 82% of F&O margin; ICE Clear US’s clients accounted for 60% of F&O margin; and LCH Ltd.’s clients accounted for 54% of SwapClear margin.

⁸ See Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner’s Report Volume 5 (Mar. 11, 2010), available at <https://web.stanford.edu/~jbulow/Lehmandocs/menu.html>, Section III B(3)(g)(5) subsection (h) indicates that for the voluntary auctions conducted by of Lehman Brothers Inc. positions, a majority of auctions (3 out of 5) were won by a non-clearing member. These auctions consisted of foreign exchange, interest rate derivatives and agricultural products.

⁹ *Supra* note 2, at section 4.2.3, page 8.

¹⁰ See Two defaults at CCPs, 10 years apart, (Dec. 16, 2018), available at https://www.bis.org/publ/qtrpdf/r_qt1812x.htm.

¹¹ *Id.*

- **Importance of Private Capital** – Allowing clients to participate in CCP auctions ensures that more sources of private capital are available. The availability of private capital helps to minimize potential negative externalities of the CCP’s distress, such as the possibility that the CCP would need to access public capital to facilitate its recovery or resolution.

Because of this benefit, CCPs should support and develop solutions that would facilitate client participation in their auctions. The successful Lehman Brothers auction (which included clients), and the failed Nasdaq auction (which did not include clients) demonstrate that client participation in auctions is a critical and necessary component of successful CCP default management design.¹² Given the breadth and varied trading expertise of clients, we believe that clients should be included in auctions for all asset classes, and CCPs should continuously investigate which non-clearing members would be suitable bidders for each of the CCPs asset classes. We believe that direct participation by clients is the best method because it avoids any conflict of interest between the clearing member and the client where both are bidding for the same auction portfolio. While the clearing member may need to pre-authorize the client to bid for risk management purposes, the clearing member should not have access to a client’s bid when acting as a competitor for the portfolio.

Question 22. The discussion paper describes some ways to address the risks borne by a clearing member arising from its clients bidding in an auction. Are there additional ways to address the risks? Are there incentives that a CCP could employ to encourage client participation in an auction (e.g. ways to encourage clearing members to facilitate their customers’ participation)?

a. One option for addressing a disparity in incentives between clearing members and customers is to require clients to contribute an established amount to the default fund prior to participating in an auction. What are the implications of this requirement (such as regulatory, economic or contractual implications) and how can a CCP address these implications?

The Discussion Paper refers to certain considerations for client participation in auctions: liability of clearing member, incentives to bid competitively, legal readiness, operational readiness, and information leakage. We address each of these considerations separately below.

Liability of Clearing Member

Since clearing members guarantee the trades of their clients, it is appropriate for clearing members to pre-authorize clients to participate in CCP auctions to ensure that, where a client wins an auction, the client can manage its risk. As discussed above, during business as usual (“BAU”), CCPs should analyze the respective markets, identify prospective clients, and solicit interest from such clients for each product and product class cleared by the CCP. CCPs and clients should then work with the clients’ clearing members during BAU to ensure a smooth process for the clients to bid in auctions. We agree with the Discussion Paper that clients and their clearing members should prepare for this contingency by developing processes (e.g., communication of any risk management limits or requirements) and a form of agreement to ensure that the clearing member will not reject bids a client submits to a live auction. Such processes will ensure that the clearing member vets its clients effectively prior to an auction, which will enable clients to bid without complication during an actual default scenario.

In addition, a necessary component of clients’ successful participation is their inclusion in the CCPs default management drills. Participation in these drills will enable the client and its clearing member to work out any bidding contingencies long in advance of any actual default. Thus, CCPs should include any potential bidding client in all default management drills for the relevant product class(es).

¹² *Supra* note 2.

Incentives to Bid Competitively

Question 22.a. suggests a manner to address the “disparity in incentives” between a clearing member and its clients is to have the clients contribute to the CCP guaranty fund prior to bidding in an auction. Historically, some clearing members have made similar suggestions because they contend that the penalties that clearing members suffer for not participating or bidding poorly (*e.g.*, “juniorization”¹³ of guaranty fund contributions, loss of guaranty fund contributions and potential for assessment rights) create incentives for clearing members that would not similarly be present for clients.

We fundamentally disagree. Even though clients do not provide guaranty fund contributions, they are still subject to losses through haircuts and tear-ups should a CCP default management process not successfully allocate the defaulter’s positions. Clearing members may be subject to direct losses earlier in the default management waterfall; however, like clearing members, clients have an incentive to bid aggressively to ensure the resiliency of the CCP. As discussed above, the primary incentives to participate in CCP auctions are CCP resiliency and profit, which clearing members and clients similarly share. Moreover, many clients are prohibited from contributing to the guaranty fund by legal, regulatory, or corporate reasons. Requiring clients to contribute to the guaranty fund would only serve to exclude potential bidders from the auction at the expense of the CCP potentially receiving a worse price for the respective defaulted portfolios due to a smaller bidder pool.

The Discussion Paper also notes a concern that clients would not participate in the auctions in good faith, but rather to glean information about the portfolio the CCP is auctioning in order to enter the market and trade ahead of it (*i.e.*, engage in “front running”). We strongly disagree with this notion. Our members are in good faith seeking to participate in CCP auctions and the legal, regulatory, and reputational risks associated with not doing so are significant. We, therefore, believe CCPs should consider and stipulate the required policies, procedures, rights, obligations, and confidentiality protections for non-clearing member firms to participate directly in CCP default management auctions. Furthermore, as discussed above, CCPs are heavily involved in the selection process of auction participants and typically, only the largest and most sophisticated clients are invited to bid. Thus, the risk of engaging in front running hardly outweighs the reward of credibility and inclusion in the CCP auction process.

We also emphasize that the potential for front running in CCP auctions already exists with respect to clearing member participation in auctions, and thus, any restrictions related to use of auction information should apply to all auction participants (and not solely clients). Clearing members that participate but do not win at a CCP auction have access to the auctioned portfolio and could engage in front running. Therefore, front running is a potential issue created by the structure of CCP auctions generally and not by the inclusion of clients. We believe that the solution to this issue is for CCPs to impose appropriate restrictions on the use of auction information, and to monitor the trading activities of all auction participants conducted at the CCP both before and after the auction to identify trading activity that indicates that an auction participant is engaging in front running.

The Discussion Paper notes that to address the “free look” without serious bidding concern, one CCP requires clients to contribute an established amount prior to bidding, which the CCP can apply similar to guaranty fund contributions.¹⁴ We do not believe that such contributions are an appropriate mitigant to

¹³ By “juniorization” of guarantee fund contributions, we mean penalizing non-participating clearing members by using their guarantee fund contributions first (*i.e.*, before the contributions of participating clearing members) as part of a CCP’s default waterfall.

¹⁴ *Supra* note 2, at section 6.2, page 18.

“free looking” as the failure to provide a bid can result from many other reasons, including the risk associated with the portfolio. Imposing requirements associated with direct clearing membership on clients will only reduce or prevent auction participation by clients, which is contrary to the overriding goal of resolving the default at the lowest possible cost.

Legal Readiness

We agree with the Discussion Paper that a CCP should execute a bidding agreement during business as usual in order to avoid the need to negotiate such agreements during the default management process.

Operational Readiness

We agree with the Discussion Paper that it is critical for all participants to bid on time for an auction and that CCPs should establish and test communication channels with prospective client bidders, which should be the same for clients and clearing members. The best way to ensure understanding of the bidding process is to include all prospective bidding clients in the CCP’s periodic default management drills. This inclusion will allow the CCP, clearing members and clients to ensure seamless bidding during an actual default. Participation in drills will also assist with ensuring that clients have the experience and expertise to bid on the relevant product class and will ensure operational systems and processes are prepared in the event of a default. Further, client participation in drills will allow clients to increase their knowledge leading to a more robust default management process.

Information Leakage

We agree with the Discussion Paper that CCPs should enter into non-disclosure arrangements with all potential bidders to minimize any information leakage. Market regulators and market surveillance tools are best suited to control and detect information leakage.

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Should you have any questions, please do not hesitate to contact SIFMA AMG at Tim Cameron at (202) 962-7447 or tcameron@sifma.org or Jason Silverstein at (212) 313-1176 or jsilverstein@sifma.org, or MFA at Michael Pedroni or mpedroni@managedfunds.org or Carlotta King or cking@managedfunds.org at (202) 730-2600.

Respectfully submitted,

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Annex A

Descriptions of the Associations

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 customers 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.

MFA represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.