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DERIVATIVES & FUTURES LAW COMMITTEE
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NAPLES, FL

Clearing, Customer Protection & Bankruptcy
January 26, 2019
9:45 a.m. – 11:00 a.m.

Chair
Deborah North (Allen & Overy)

Panel:
Ruth Arnould (BoA)
Brian Bussey (CFTC)
Vince Lazar (Jenner)
John McKinlay (CME)
Hina Mehta (UBS)
William Thum (Vanguard)
I. Background on the Committee and the Part 190 Project

On September 29, 2017, the Part 190 Subcommittee (“Committee”) of the American Bar Association Business Law Section, which was established in February 2015 as a joint subcommittee of the Derivatives and Futures Law and Business Bankruptcy Committees of the Business Law Section, submitted its work product to the Commodity Futures Trading Commission (“CFTC” or “Commission”) for consideration.

The Commission is actively considering these proposed rule changes, and has engaged in several communications and meetings with Committee members during the past few months seeking clarifications about certain aspects of the proposed changes.

The Committee has asked the Commission to consider a revamped set of Part 190 Rules to govern a commodity broker bankruptcy under subchapter IV of chapter 7 of the Bankruptcy Code (“Model Part 190 Rules”). The Part 190 Rules apply to the liquidation of a U.S.-based FCM or a U.S.-based clearing house that is registered with the CFTC as a derivatives clearing organization (“DCO”), in a proceeding (a “subchapter IV proceeding”) governed by subchapter IV of chapter 7 of the U.S. Bankruptcy Code (“Bankruptcy Code”). The CFTC first adopted the Part 190 Rules in 1983, pursuant to its authority under Section 20 of the Commodity Exchange Act (“Act” or “CEA”), and amended them several times over the years. The rules are of critical importance for managing the liquidation of a futures commission merchant (“FCM”) or DCO in a subchapter IV proceeding.

The Model Part 190 Rules were the product of a two-year plus initiative undertaken by the Committee to holistically re-evaluate the current rules, in light of significant market and regulatory developments since they were first adopted over 30
years ago, and with the benefit of industry experience living through the bankruptcies of several FCMs.

The Committee initially consisted of approximately 35 members, but over time expanded to more than 45 members. The Committee was comprised of attorneys who work extensively in the areas of derivatives law, bankruptcy law or both, including lawyers at law firms, FCMs, clearing houses and exchanges, government agencies and industry associations. Committee members participated in the project with the shared goals of developing model rules that work together as an integrated whole, are clear and unambiguous in setting out objectives, and avoid unnecessary complexity that could hinder or delay timely, prudent action by the trustee for the failed commodity broker.

II. Overview of the Model Part 190 Rules

The Model Part 190 Rules represent a proposed comprehensive overhaul of the existing rules. The Committee took care to adhere to the core concepts first laid out when the Part 190 Rules were adopted in 1983. The proposed changes do, though, represent some departures from older existing policies.

A. General

1. Reorganization

The proposed Model Part 190 Rules are organized into three subparts: Subpart A, which contains general provisions applicable to all proceedings under the rules; Subpart B, which contains provisions specific to a proceeding in which the debtor is an FCM; and Subpart C, which contains provisions specific to a proceeding in which the debtor is a DCO.

2. Limiting Part 190 to FCMs and DCOs

The definition of commodity broker in section 101(6) of the Bankruptcy Code covers categories of commodity brokers beyond FCMs and DCOs, specifically, commodity option dealers and leverage transaction merchants. The Committee recommended that the Model Part 190 Rules be limited to subchapter IV proceedings of commodity brokers that are FCMs or DCOs, with respect to commodity contracts that are
cleared. The Committee suggested that if the regulatory framework changes such that it becomes viable for a person to operate as a commodity option dealer or leverage transaction merchant, the Commission could expand the Model Part 190 Rules at that time to add a subpart containing rules specific to a subchapter IV proceeding of such a commodity broker.

3. **Context to Aid Administration**

The Committee proposed a new Rule 190.00 which would provide context and describe the general framework for the Part 190 Rules to assist a trustee or bankruptcy court in understanding the reasons for specific requirements set forth in the other rules. New proposed Rule 190.00 would explain the Commission’s statutory authority to adopt the Part 190 Rules; the organization of the rules into the subparts; the core principles reflected in the rules; and the scope of the rules in terms of proceedings, account classes, customer property and commodity contracts.

4. **Scope**

   a. **Proceedings**

As noted above, the Committee recommended limiting Part 190 to commodity brokers that are FCMs or DCOs. Thus, proposed Rule 190.00(d)(1)(i) states that the rules apply to proceedings commenced by or against an FCM or DCO under subchapter IV of chapter 7 of the Bankruptcy Code.

In addition, proposed Rule 190.00(d)(1)(ii) explains that the rules apply to an FCM that is subject to a proceeding under the Securities Investor Protection Act of 1970 ("SIPA"). An insolvency proceeding involving a dually-registered FCM-broker-dealer ("BD") will likely be initiated under SIPA, as was the case with the Lehman and MF Global proceedings. Part 190 is relevant in a SIPA case because the trustee in a SIPA proceeding has the same duties as a trustee in a subchapter IV proceeding when the debtor is also a commodity broker, to the extent consistent with the provisions of SIPA or as otherwise ordered by the court.
Proposed Rule 190.09(d)(1) also explains that the rules may serve as guidance with respect to distribution of property in a proceeding in which the Federal Deposit Insurance Corporation ("FDIC") acts as receiver for an FCM or DCO pursuant to Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").

b. Account Class and Trust Property Limitations

Proposed Rule 190.00(d)(2) provides that the trustee may not recognize any account class that is not enumerated in the definition of account class in Rule 190.01. The account classes are limited to (i) futures accounts; (ii) foreign futures accounts; (iii) cleared swaps accounts; and (iv) delivery accounts, which the Committee further recommended splitting into physical delivery and cash delivery account classes.

Proposed Rule 190.00(d)(2) further provides that so long as there is any shortfall in customer property to satisfy customer net equity claims in the enumerated account classes, a creditor is not entitled to distribution of property on the basis that the debtor holds the property in a constructive or similar equitable trust. The proposed rule, though, does not restrict a creditor’s rights to property not covered by an account class that the debtor holds on an express trust basis pursuant to statute, government rule, regulation or order, or legally binding agreement between the debtor and such person.

c. Scope of "Commodity Contract"

Proposed Rule 190.00(d)(3) limits commodity contracts within the scope of Part 190 to commodity contracts that are cleared by a DCO or by a foreign clearing organization.

Proposed Rule 190.00(d)(3) explains that uncleared options on commodities and leverage transactions are excluded from the definition of commodity contract for purposes of Part 190. It also states that commodity contracts do not include security futures products when they are carried in a securities account. For avoidance of doubt, it also states that retail foreign exchange transactions described in CEA Sections 2(c)(2)(B)
or (C), and security-based swaps or other securities (other than security futures products carried in an enumerated account class), are not commodity contracts.

In addition, proposed Rule 190.00(d)(3)(iii) makes clear that the term commodity contract does not include retail commodity transactions described in CEA Section 2(c)(2)(D), unless the transactions are executed on or subject to the rules of a designated contract market (“DCM”) or foreign board of trade (“FBOT”) as, or as if, they are futures. Because they are exchange-traded, it follows that the transactions will be cleared.

Cleared contracts within the scope of the Model Part 190 Rules include certain commodity contracts that may not fit within the CEA classifications for futures, options on futures or swaps. Commodity contracts for purposes of the Model Part 190 Rules include:

- As part of the cleared swaps account class, swaps that are cleared, along with non-swap/non-futures contracts that are traded on an over-the-counter (“OTC”) basis and cleared by a DCO or a foreign clearing organization the same as if they are swaps; and

- As part of the futures or foreign futures account class, futures or options on futures executed on or subject to the rules of a DCM or FBOT, including retail commodity contracts traded on such markets as or “as if” they are futures, as well as exchange-listed contracts that may be classified as forward contracts under the Act and which are cleared by a DCO or a foreign clearing organization the same as if they are futures.

5. **Clearing Relationships**

The Model Part 190 Rules recognize the different types of clearing relationships that exist today, as well as those could potentially exist in the future. The Model Part 190 distinguish between clearing and non-clearing FCMs, and expressly acknowledge that a debtor FCM could clear commodity interest transactions through a foreign broker or foreign clearing organization.
The Model Part 190 Rules contemplate that in the future a DCO potentially could have foreign broker clearing members that clear trades for their non-U.S. customers, and that foreign clearing organizations potentially could clear swaps for customers of FCM clearing members pursuant to a CFTC exemption from DCO registration.

6. Definitions

The proposed Model Part 190 Rules include a number of changes to the definitions used in Part 190, including:

- **Account Class.** The definition of the term “account class” is proposed to be expanded to include specific definitions for the terms “futures account,” “foreign futures account,” “cleared swaps account,” and “delivery account.” The definitions further distinguish between accounts carried on the books of an FCM and on the books of a DCO. The delivery account definition provides that the account class is further divided into separate physical delivery and cash delivery account classes;

- **Commodity Broker.** The current definition of the term “commodity broker” is proposed to be replaced with a definition that is consistent with the Committee’s recommendation to limit Part 190 to FCMs and DCOs;

- **Commodity Contract; Futures Contract and Swap Contract.** The current definition of the term “commodity contract,” which currently simply cross-references the Bankruptcy Code definition, is proposed to be replaced with a definition that is consistent with the scope of this term in the proposed rules. The Model Part 190 Rules also add definitions for the terms “futures contract” and “swap” that are consistent with the recommended scope;

- **Foreign Board of Trade.** The Model Part 190 Rules add a definition for the term “foreign board of trade” that is consistent with the standard in Section 4(a) of the Act and the definitions in CFTC Rules 1.3(ss) and 48.2(a);

- **Foreign Clearing Organization.** The Model Part 190 Rules add a definition for the term “foreign clearing organization” that covers a clearing house or
similar entity that is located outside the U.S., its possessions or territories, is not registered as a derivatives clearing organization, and clears and settles transactions in futures or options on futures executed on or subject to the rules of a foreign board of trade or transactions in swaps;

- **House Account.** The current definition of the term “house account” is replaced with one that separately defines the term in relation to an FCM and in relation to a DCO;

- **Physical Delivery Property and Cash Delivery Property.** New definitions “physical delivery property” and “cash delivery property” are proposed in connection with the recommendation to divide the delivery account class into two subclasses, the physical delivery and cash delivery account classes. The terms are also relevant for proposed changes to the rules pertaining to making or taking physical delivery under commodity contracts, including deliveries that may occur outside a delivery account. Elements from the current definition for “specifically identifiable property” that are relevant for the delivery account class, as updated, were moved to the physical delivery property definition. The proposed definition also specifically recognizes that title documents for commodities are now commonly held in dematerialized, electronic form;

- **Public Customer and Non-Public Customer.** The Model Part 190 Rules explain who is considered a public customer of an FCM, with relevant cross-references to other Commission rules, and then define an FCM’s non-public customers as a customer that is not a public customer. The proposed definitions also seek to clarify who is considered a public customer or non-public customer in relation to a clearing member of a DCO, including in the context of a clearing member that is a foreign broker;
• **Specifically Identifiable Property.** The Model Part 190 Rules include a new definition of “specifically identifiable property” that updates and streamlines the definition in current Rule 190.01(ll); and

• **Other.** The Model Part 190 Rules add new definitions for the terms “cash equivalent” (used in the definition of cash delivery property), “Exchange Act,” “FDIC,” “SIPA” and “variation settlement.” The definitions of the terms “equity” (not used elsewhere in the Model Part 190 Rules) and “premium” (which term is commonly understood) are deleted.

**B. Proceeding Involving an FCM**

1. **Claims Process**

The Model Part 190 Rules delete many the detailed and often outdated existing rules (e.g., publication of notices in newspapers) concerning how a trustee must communicate with the customers of a failed FCM. As proposed, the trustee, after consultation with the Commission, may follow his or her own reasonably designed procedures for providing notice to, and receiving claims from, the FCM’s customers.

The Committee also recommended a streamlined template proof of customer form that the trustee may use, to be attached to the rules as Appendix A. The trustee continues to be given flexibility to modify the proof of claim form to take into account the particular facts and circumstances of the case.

2. **Changing the Special Treatment for Hedge Positions**

The Committee proposed modifying the treatment of hedge accounts and positions. Current Part 190 treats hedge positions as a type of specifically identifiable property, where the customer is theoretically is given special rights to prevent the liquidation of its hedge positions by the trustee. The proposed Model Part 190 Rules instead to give the trustee the authority, when practical under the circumstances, to treat public customer positions carried in a hedge account as specifically identifiable property, following consultation with the Commission.
The Committee proposed other changes that are intended to make the process simpler for the trustee to identify hedge positions, moving away from the requirement that FCMs provide a hedge instructions form when a customer first opens an account, and allowing an FCM to designate an account as a hedge account in reliance on a representation from the customer that the account will contain hedge positions. The proposed rule also includes a grandfather provision that allows an FCM to continue to rely on hedge instructions for existing accounts.

3. **Collection of Margin and Variation Settlement**

The Committee proposed changes that are intended to streamline, clarify and update the provisions allowing a trustee to collect margin from a debtor FCM’s customers. The important concept that margin payments made by a customer in response to a trustee’s margin call are fully credited to the customer’s funded balance for distribution purposes is retained.

4. **Liquidation and Valuation of Positions**

The proposed Model Part 190 Rules provide more detail relating to the liquidation of positions by a person other than the trustee, *i.e.*, by a DCO, a foreign clearing organization, another FCM or a foreign broker. The changes include provisions for the trustee to assign liquidating positions to the debtor FCM’s customers when only a portion of the open contracts are liquidated, and for addressing circumstances where a carrying FCM or foreign broker fails to use commercially reasonable efforts to liquidate positions to achieve competitive pricing.

The proposed Model Part 190 Rules also clarify the manner in which customer positions and other customer property are valued for purposes of determining the amount of a customer’s claim.

5. **Deliveries Under Physical Delivery Commodity Contracts**
   
   a. **The Delivery Process**

   The Committee recommended material changes relating to the delivery process under expiring commodity contracts. The delivery provisions in Part 190 have remained
largely unchanged since they were adopted in 1983. The existing rules reflect the prevailing delivery practices of the time, when delivery was effected largely by tendering paper warehouse receipts or certificates. Today, though, most deliverable title documents are held in electronic form, typically (but not always) with the clearing organization serving as the central depository for such instruments, and delivery occurs by electronic transfer.

The proposed Model Part 190 Rules include an updated definition of physical delivery property to recognize electronic as well as other forms of title. The proposed rules also address deliveries where the party with the contractual obligation to make delivery will physically transfer the tangible commodity to meet its obligations.

The proposed rules retain the policy that the trustee should use his or her best efforts to liquidate open commodity contracts that settle by physical delivery (and which are not transferred) before they move into a delivery position. However, for situations where open positions are caught in a delivery position, the proposed Model Part 190 Rules recognize that the manner in which delivery of a commodity is effected under a physical delivery contract varies based on the circumstances and relevant market, and also that deliveries may be effected in different types of accounts.

The proposed delivery rules apply to any type of commodity that is subject to physical delivery, including U.S. treasury securities and foreign currencies. This is captured in the definition of physical delivery property. Given the different ways in which delivery may take place, physical delivery property is not limited to property that an FCM holds for or on behalf of a customer in a delivery account.

Current Rule 190.05(b) requires a DCO, DCM or swap execution facility (“SEF”) to enact rules that permit parties to make or take delivery under a commodity contract outside the debtor’s estate, through substitution of the customer for the commodity broker. Rule 190.05(b) may be of limited value because many customers rely on their FCMs to hold physical delivery property on their behalf in electronic form. Thus, the provisions of current Rule 190.05(b) have been omitted in the Model Part 190 Rules.
Instead, the proposed rules direct the trustee to use reasonable efforts to allow a customer to fulfil its delivery obligation directly, outside administration of the estate, when the rules of the relevant clearing house or market allow delivery to be fulfilled (i) in the normal course directly by the customer; (ii) by substitution of the customer for the commodity broker; or (iii) through agreement of the buyer and seller to alternative delivery procedures.

For deliveries that occur as part of the administration of the debtor’s estate, the proposed rules contain provisions for the trustee to deliver physical or cash delivery property on a customer’s behalf, or return such property to the customer so that the customer may fulfill its delivery obligation. The rule includes restrictions designed to assure that a customer does not receive a distribution of customer property that exceeds the customer’s pro rata share of the relevant customer property pool.

**b. Delivery Account Class**

The delivery account class is relevant when an FCM establishes delivery accounts through which it effects physical delivery under commodity contracts, or in which it holds physical delivery property, on behalf of a customer. Customer property held in a delivery account is not subject to CFTC segregation requirements. Physical delivery property, in particular when held in the form of electronic title documents as is prevalent today, is more readily identifiable and less vulnerable to loss, compared to cash delivery property that an FCM may hold in an operating bank account. For these reasons, the Model Part 190 Rules divide the delivery account class into separate physical delivery and cash delivery account classes, for purposes of pro rata distributions to customers in the delivery account class on their net equity claims.

**6. Transfers**

The proposed Model Part 190 Rules explicitly identify a clear policy that the trustee should use best efforts to transfer open commodity contracts and property held by the failed FCM for or on behalf of its public customers to one or more solvent FCMs. In addition, the proposed rules:
• Clarify that they do not limit the contractual right of a DCO (or other registered entity such as a DCM or a SEF) to liquidate or transfer open commodity contracts;
• Add provisions relating to assignment of customer agreements to a receiving FCM, and the FCM’s reliance on such records prior to conducting its own customer due diligence;
• Expand and clarify the provisions relating to the treatment and transfer of customer letters of credit;
• Add a provision that requires the trustee to use reasonable efforts to prevent physical delivery property from being separated from commodity contract positions under which the property is deliverable; and
• Include a “no prejudice to other customers” provision that prohibits the trustee from making a transfer that would result in insufficient customer property being available to make equivalent percentage distributions to all net equity claim holders in the applicable account class.

7. **Scope of Customer Property and Residual Interest**

Current Rule 190.08(a) defining the scope of “customer property” includes a provision that deems any cash, securities or other property in the debtor’s estate to be customer property to the extent that customer property under the other definitional elements is insufficient to satisfy in full all claims of the FCM’s public customers. In 2000, the Bankruptcy Court in *In re Griffin Trading Co.*\(^1\) ruled that the CFTC exceeded its statutory authority by adopting this provision, and held that it was invalid. Although the decision was vacated on appeal, and thus is of no precedential value, the issue is widely understood to be unsettled.

The proposed Model Part 190 Rules retain this provision. The Model Part 190 Rules also add a provision to the customer property definition that deems property in the

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debtor’s estate to be customer property to the extent of the FCM’s obligation to maintain a targeted residual amount in segregation pursuant to CFTC Rule 1.11, or its obligation to cover debit balances or under-margined amounts in customer accounts under CFTC Rules 1.22, 22.2 or 30.7.

As a related change, the proposed rules clarify that the trustee is not required to transfer cash or other property into a segregated account to maintain a debtor FCM’s compliance with its targeted residual amount obligations under CFTC Rule 1.11 or its other top-up obligations under CFTC Rules 1.22, 22.2 or 30.7. However, the proposed Model Part 190 Rules also confirm that such amounts still constitute customer property.

8. Provisions Generally Applicable to FCMs

The proposed Model Part 190 Rules include the following new or amended provisions generally applicable to all FCMs:

- **Current Customer Records.** The proposed rules require an FCM to maintain current records relating to its customer accounts, and provides that those records may be provided to another FCM to facilitate transfer of open customer positions. The provision is not intended to expand an FCM’s recordkeeping obligations under other Commission rules;

- **Designation of Hedge Accounts.** The proposed rules require an FCM to provide a customer an opportunity to designate an account as a hedge account when the customer first opens the account. They provide that the FCM may rely upon the customer’s written representation that positions in the account are hedge positions, in lieu of obtaining written hedge instructions as required under current Rule 190.06(d). The proposed rules also allow an FCM to re-designate an existing account as a hedge account if it obtains an appropriate representation from the customer that the account contains hedge positions. The proposed rules expressly recognize that an FCM may continue to designate existing accounts as hedge accounts based on the hedge instructions;
• The proposed rules provide that an account may be designated as a hedge account if positions in the account constitute hedging as defined under any relevant Commission rule or rule of a DCO, foreign clearing organization, DCM, SEF or FBOT; and

• Deliveries. The proposed Model Part 190 Rules recognizes that delivery under a customer’s physical delivery contract, when facilitated by an FCM, can be effected in a futures account, foreign futures account or cleared swaps account (or a securities account if the commodity being delivered is a security). They further provide that if the delivery does not occur in one of those accounts, the FCM must (when facilitating the delivery) effect the delivery through a delivery account. The Committee also recommended that the Commission delete the requirement in current Rule 190.10 that an FCM must (except as provided in other CFTC rules) provide its customers with a special disclosure statement regarding treatment of non-cash collateral they may post, in the event of the FCM’s bankruptcy.

9. Appendix A Forms

The Committee recommended deleting Forms 1 through 3 contained in Appendix A and replacing Form 4 with a streamlined proof of claim form. The forms that would be deleted include: (i) a schedule of the trustee’s duties in operating the debtor FCM’s estate, (ii) a form for requesting customer instructions regarding non-cash property; and (iii) a form for requesting instructions from customers concerning transfers of hedge positions.

10. Appendix B Special Distribution Rules

Appendix B to the current Part 190 Rules contains special bankruptcy distribution rules for distributing customer funds when the debtor FCM participated in a futures-securities cross-margining program (Framework 1), and for allocating a shortfall in customer funds to customers when the shortfall is incurred with respect to funds held in a depository outside the U.S. or in a foreign currency (Framework 2).
The Committee recommended retaining Framework 1, with some clarifying changes. The Committee proposed deleting the specific limitation that customers must be market professionals, to provide flexibility should the Commission decide to expand the scope of customers that may participate in futures-securities cross-margining programs. The Committee also recommended including a placeholder for distribution rules relating to customer cross-margining programs for swaps and securities (e.g., security-based swaps).

The Committee recommended deleting the separate distributional Framework 2 addressing shortfalls relating to customer funds held outside the U.S. or in the form of a foreign currency.

C. Separate Rules to Govern a DCO Subchapter IV Proceeding

The current Part 190 Rules apply to any commodity broker liquidation proceeding administered under subchapter IV of chapter 7 of the Bankruptcy Code, including a proceeding involving a DCO. The Committee proposed a separate Subpart C in the Model Part 190 Rules, containing rules that are specific to a DCO proceeding.

Proposed Subpart C of the Model Part 190 Rules provides a basic liquidation framework, but preserves flexibility for the trustee to act as appropriate for the sui generis circumstances inherent in an DCO insolvency proceeding. Proposed Subpart C also provides some deference to a DCO’s wind-down and recovery plan, recognizing that the DCO’s plan and related rules will likely take into account unique considerations and issues that the DCO faces.

Finally, the proposed rules provide a new definition for the term “member property” in DCO bankruptcy cases.

III. Recommended Changes to Other Commission Rules

The Committee identified a relatively small number of related or cross-referencing CFTC Rules that the Commission should consider amending:

A. Definition of Foreign Option In Rule 30.1(d)
The Committee recommended that the Commission revise the definition of “foreign option” in Rule 30.1(d) to state explicitly that the definition covers options on futures.

B. Definition of Proprietary Account in Rule 1.3(y)

The Committee recommended that the Commission consider adopting a new definition of “proprietary account” in Rule 1.3(y) to narrow the scope of persons denied public customer protections when clearing their futures or swaps trades through an FCM with which they are affiliated. The Committee posited that the current definition is out of sync with the global consensus to treat affiliates of professional clearing intermediaries as public customers. The Committee recommended that at a minimum the Commission should consider excluding commodity pools from the current definition of proprietary account, as it appears that a commodity pool could be classified as a proprietary account of an FCM if any person identified in paragraphs (2)(i) – (viii) of Rule 1.3(y) owns 10% or more of the pool.

C. Definition of Variation Margin in Rule 1.3(fff)

The Committee suggested that the Commission consider amending the definition of variation margin in Rule 1.3(fff) to conform to the definition the Committee proposed in proposed Rule 190.01(uu).

D. Part 22 Rules

The Committee recommended that the Commission revise its Part 22 Rules to explicitly provide that the segregation framework for cleared swaps applies to non-swap (and non-futures) OTC transactions, such as foreign exchange forwards or foreign exchange swaps, if they are cleared by a DCO.

E. Part 31 Rules for Leverage Transaction Merchants

The Committee recommended that the Commission consider repealing the Part 31 Rules as outdated and of no current relevance.

F. Technical Housekeeping Changes

The Committee recommended the following housekeeping changes to other rules:
• **Rules 1.55(d), (d)(1) and (d)(2):** Delete the cross-references to Rule 190.06 (customer acknowledgement);

• **Rules 1.55(f), 1.65(a)(3) and 1.65(a)(3)(iii):** Delete the cross-references to Rule 190.10(c) (customer acknowledgement);

• **Rule 1.25(a)(2)(ii)(C):** Change the cross-reference from Rule 190.01(kk) (definition of specifically identifiable property) to 190.01(pp);

• **Rule 4.5(c)(2)(iii)(A):** Change the cross-reference and defined term for “in the money amount”;

• **Rules 4.12(b)(1)(i)(C) and 4.13(a)(3)(ii)(A):** Change the cross-reference and defined term for “in the money amount”; and

• **Rule 41.41(d):** Delete the cross-reference to Rule 190.06 recordkeeping obligations.

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NASDAQ CLEARING MEMBER DEFAULT IN SEPTEMBER 2018

CLE MATERIALS

<table>
<thead>
<tr>
<th>Clause</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Background to the Clearing Member Default in September 2018</td>
<td>2</td>
</tr>
<tr>
<td>1.1 The events that triggered the default process</td>
<td>2</td>
</tr>
<tr>
<td>1.2 Nasdaq Clearing’s actions after the default</td>
<td>2</td>
</tr>
<tr>
<td>1.3 Current status and next steps</td>
<td>3</td>
</tr>
<tr>
<td>2. The Nasdaq Clearing Rules</td>
<td>3</td>
</tr>
<tr>
<td>2.1 Membership criteria for individuals</td>
<td>3</td>
</tr>
<tr>
<td>2.2 Sizing of margin</td>
<td>3</td>
</tr>
<tr>
<td>2.3 Overview of the default management process</td>
<td>4</td>
</tr>
<tr>
<td>2.4 Who is responsible for the default management process?</td>
<td>5</td>
</tr>
<tr>
<td>2.5 What are the options for close-out?</td>
<td>5</td>
</tr>
<tr>
<td>2.6 What are the stated objectives of the default management process?</td>
<td>6</td>
</tr>
<tr>
<td>2.7 How is valuation performed?</td>
<td>6</td>
</tr>
<tr>
<td>2.8 Who are the members of the CDC?</td>
<td>6</td>
</tr>
<tr>
<td>2.9 The auction process</td>
<td>7</td>
</tr>
<tr>
<td>2.10 Distribution of losses</td>
<td>7</td>
</tr>
<tr>
<td>3. How do Nasdaq Clearing’s rules compare to the ICE Clear Credit rules?</td>
<td>8</td>
</tr>
<tr>
<td>4. FIA Paper Recommendations</td>
<td>9</td>
</tr>
<tr>
<td>5. Selected EMIR requirements [have we had the Europeans have a look? If not we should ask Emma L to cast her eye over it]</td>
<td>10</td>
</tr>
<tr>
<td>6. Recommendations discussed in the market and media</td>
<td>12</td>
</tr>
</tbody>
</table>
1. BACKGROUND TO THE CLEARING MEMBER DEFAULT IN SEPTEMBER 2018

1.1 The events that triggered the default process

A Nasdaq Clearing member, Einar Aas (the Relevant Member) owned a portfolio which gave rise to a large spread position between Nordic and German Power (the portfolio contained both futures and forwards).

On September 10, 2018, there was an extreme movement in the markets in Nordic and German power, 17 times greater than the normal observed daily spread changes.

The fluctuations led to huge losses in the Relevant Member’s portfolio and meant the Relevant Member could no longer meet the margin requirement.

Under the Nasdaq Clearing rules, when a member cannot meet margin requirements that member’s portfolio must be closed out as soon as possible to minimise further risk of loss.

Nasdaq Clearing declared the Relevant Member in default on September 11.

1.2 Nasdaq Clearing’s actions after the default

On September 10 an Intraday Margin Call was issued to the Relevant Member, which was not met within the requisite 90 minutes. The Default Committee was convened that day and then met regularly throughout the following days. The member was declared to be in default on September 11 at 08:24.

Between the morning of September 11 and the evening of September 12 there was an ongoing process to close-out the Relevant Member’s portfolio, including two auctions to sell the portfolio. The portfolio of was closed-out on Wednesday evening after the second auction process resulted in the best committed bid.

The Default Committee made an assessment of the most appropriate process for closing out the relevant clearing member's position, this included (but was not limited to):

(a) an assessment of which members had sufficient capacity and were likely to be able to bid on a significant part of this position;

(b) how to minimise losses in the relevant clearing member’s defaulted portfolio by holding a closed auction in order to avoid creating extreme market movements and having to close-out in more volatile market conditions.

(c) how to ensure there was no information leakage on the default close-out and/or to get too many market participants in an insider position

Four members (out of 166) were invited to bid in the closed auction. It is Nasdaq Clearing’s assessment that the chosen strategy and the selected number of bidders was reasonable to obtain the best price possible at the relevant time. The main incentives for the bidders in an auction is to protect their own assets in the default fund and to maintain a well-functioning market. In general, the waterfall is designed in such a way as to create incentives for the participating members to bid.
However, the close out resulted in a loss for Nasdaq Clearing that exceeded the Relevant Member’s collateral and default fund contribution.

Therefore, on September 14, Nasdaq Clearing temporarily contributed EUR 20m (SEK 200m) to its Junior Capital fund, in addition to the EUR 7m that Nasdaq Clearing already had replenished in the Default Fund as Junior Capital.

By 8.40am on September 17, the Member Default Fund was recapitalized to 90 per cent. by Nasdaq Clearing’s members. Later the same day, the member Default Fund was recapitalized to 100%, or EUR 107m.

In order to reduce the risk profile in the market following the default, Nasdaq Clearing decided to increase margin levels by increasing (i) margins on spread positions and (ii) confidence levels to shift risk of a particular portfolio from the mutualized default fund to the owner of the portfolio.

Nasdaq engaged a third-party validator; the management consultancy firm Oliver Wyman, to review all clearing house processes and risk practices.

1.3 Current status and next steps

Nasdaq Clearing is assessing its rights and available options to pursue recovery for members and clients to minimize any shortfall.

The defaulting member agreed to a consensual arrangement with creditors to liquidate certain assets to allow Nasdaq Clearing to recover the Default Fund Participants’ losses arising from the default.

Nasdaq Clearing stated that any funds that it recovered would be apportioned in accordance with the Default Fund Rules and therefore applied towards the Default Fund Participants on a pro rata basis.

Swedish power company Vattenfall is reported to have bought the position of defaulted trader Einar Aas.

2. THE NASDAQ CLEARING RULES

2.1 Membership criteria for individuals

The same membership criteria applies to private individuals as to Clearing Members, with the exception of higher capital requirements for private individuals.

The Clearing Rules require that a member has a minimum equity of EUR 1m. For private individuals, Nasdaq Clearing requires the member to have financial resources of at least EUR 70m.

Note Nasdaq has no other natural person CMs.

2.2 Sizing of margin

A Nasdaq Clearing proprietary version of the SPAN (Standard Portfolio ANalysis) margin methodology is used for the commodities market. The margin model was followed. The margin methodology guide can be found on the Nasdaq website. Uses a parametric approach to defining scenarios on which portfolios are margined.
The margin model is set to cover stressed market conditions, covering at least 99.2% of all 2-day market movements over the recent 12 month period. In the final step of the margin curve estimation a procyclicality buffer of 25% is applied.

The MPOR (Margin Period of Risk) for the relevant products is two days.

Nasdaq applies concentration add-ons if the size of calculated Margin Requirement exceeds a certain threshold for a particular product group. The policy is available on Nasdaq Clearing’s website. The threshold was not exceeded in this particular case. No add-ons related to credit worthiness are applied currently.

Margin discounts are calibrated on historical price deviations between relevant instrument prices. The default setting in Nasdaq's margin model for Commodities, i.e. the SPAN model, is that each contract is stressed individually. When all positions are stressed, margin offsets are applied. The offset between Nordic and German power was approximately 50% at the time of the default.

Nasdaq updates the parameters of the margin methodology on a monthly basis.

Nasdaq Clearing calculates the initial margin and market value of all cleared portfolios once an hour throughout the day. Nasdaq Clearing may calculate an Intraday Margin Requirement and did so on September 10 to the defaulted member.

2.3 Overview of the default management process

The default management process consists of the following steps:

(a) First, the Clearing Default Committee (CDC), the defaulting counterparty and other relevant stakeholders will be notified of the default.

(b) Nasdaq Clearing will then take possession of any collateral and the latest market prices will be obtained.

(c) Nasdaq Clearing’s Risk Management (RM) will perform a risk assessment of the defaulting party’s portfolio and based on the risk assessment, the portfolio will be divided into buckets and priorities will be assigned to the buckets with respect to hedge and close-out. The buckets depend on the following factors: sensitivity to changes in prices and implied volatility, size of positions, off-setting risks, time to delivery and liquidity.

(d) RM will recommend to the CDC appropriate close-out and hedge strategies for the buckets in question.

(e) Upon approval by the CDC, close-out and hedge strategies will be consequently executed.
2.4 **Who is responsible for the default management process?**

RM provides a risk assessment of the defaulting counterparty’s portfolio to the CDC, along with a proposed close-out and / or hedge strategy. The CDC is then responsible for deciding the strategy to be used for the close-out or hedge.

The CDC is a sole decision making authority for all decisions concerning default events and close-out handling in Nasdaq Clearing’s default management process.

2.5 **What are the options for close-out?**

Nasdaq Clearing can close down or hedge a portfolio in several different ways. Under certain circumstances, the defaulting counterparty may be allowed to close down or hedge the portfolio under strict supervision from RM. If this is not an option, Nasdaq Clearing can choose to close down or hedge the portfolio through the exchange, brokers or through proxy trading.

Alternatively, the portfolio can be closed down through an auction, where either the whole portfolio is sold to one participant or divided and sold by parts. In this case, it is important that Nasdaq Clearing has close-out agreements with market makers or other members. Nasdaq Clearing has such agreements with 6 clearing members in the Commodities market, based on the level of activity in the market.

For some contracts, Nasdaq Clearing may also execute forced termination. Members that hold opposite positions in certain option contracts may be subject to forced termination, where buyer(s) or seller(s) in
the relevant contracts are randomly selected for termination of their contracts. The forced termination may be applied to all or parts of the positions at a forced termination contract price calculated by the Clearinghouse. The basis for the calculation will be market prices of the contract for the underlying as set by the Clearinghouse at the time of the forced termination adjusted up or down within the risk interval to the disadvantage of the defaulter.

2.6 What are the stated objectives of the default management process?

The objective of the default management process is to close out and/or mitigate the market risk of the defaulted counterparty’s portfolio, minimize the costs and thereby the expenses of the defaulted counterparty, participants to default funds and Nasdaq Clearing in the process.

2.7 How is valuation performed?

The clearing system’s ordinary calculations of market values and margins will be used to monitor the progress of the close-out process. A margin simulation tool will also be used to simulate the effect of close-out and hedge trades as well as changes in prices and volatility.

Margin runs are scheduled hourly in the clearing system throughout the course of a normal business day. RM also has the possibility to manually trigger additional margin runs if deemed necessary.

2.8 Who are the members of the CDC?

The Nasdaq Clearing Default Committee is the single decision-making authority within Nasdaq Clearing for evaluating default situations and events and deciding which—if any—actions will be taken as permitted under its Rules and Regulations as well as any applicable legal agreements. The Default Committee has the mandate to act in every possible way to reduce the risk in the portfolio. This means that Default Committee is authorized by the Boards to choose whatever solution adequate to reduce or eliminate the risk exposure.

The CDC consists of the following members:

(i) the President of Nasdaq Clearing AB;
(ii) Chief Risk Officer (CRO);
(iii) Head of Risk Operations;
(iv) Chief Technology Officer;
(v) Representative from Legal;
(vi) Representative from Treasury;
(vii) Representative(s) from Group Risk Management (observer – no quorum);
(viii) Representative from Communications (observer – no quorum); and
(ix) any other person(s) deemed appropriate by the CDC during a default situation.
The CRO acts as Chairman of the CDC and together with the President makes the decisions in the Committee. If the Chairman and the President disagree on which action to take, the Chairman should address the issue to the Board of Directors of Nasdaq Clearing.

2.9 The auction process

One or more members may participate in an auction and the portfolio is allocated based on the best bid and ask quotes or the best bid for the entire portfolio.

Members that have signed close-out agreements will be contacted first if the portfolio of the defaulting member is auctioned. The close-out agreement is non-binding, based on voluntary contribution.

According to the agreement, the member undertakes to use its best endeavours to offer Nasdaq Clearing binding bid and ask quotes (two-way spread) of the applicable products in the volume requested by Nasdaq Clearing. The member may fulfil the requested volume in whole or part.

Nasdaq Clearing may choose to disclose detailed information about the portfolio to one or more members, in order to enable such members to consider a bid on the portfolio pursuant to a “Close-Out Volume Provider” agreement with Nasdaq Clearing.

In some situations, it might be considered beneficial by Nasdaq Clearing to divide the portfolio into sub-portfolios. Where some participants explicitly state their inability to provide prices on certain markets or instruments, a sub-portfolio without these instruments may be created for all to be able to participate.

The close-out or hedges will be executed at the best prices provided. Nasdaq Clearing has absolute discretion to decide whether to call on quotes, and may choose to accept or reject any or all quotes. Nasdaq Clearing will consider whether any combinations of bids for sub-portfolios would result in a more beneficial bid for the total portfolio than what has been received.

2.10 Distribution of losses

In the event that the default process results in losses which are greater than the defaulting counterparty’s pledged collateral, the excessive losses will be covered by the default fund.

The default fund waterfall starts from the bottom and works its way through the capital resources towards the top of each pillar. The proceedings for distributing the losses are covered by the documentation covering the default fund.

The waterfall is illustrated by the following diagram:
3. **HOW DO NASDAQ CLEARING’S RULES COMPARE TO THE ICE CLEAR CREDIT RULES?**

The ICE Clear Credit rules (the **ICE Rules**) are very detailed and cover a variety of different scenarios that are not contemplated in Nasdaq Clearing’s default strategy. Set out below are some key differences between the ICE Rules and Nasdaq Clearing. ICE Clear Credit (ICE) clears only swaps and security based swaps.

- ICE employs reduced gains distributions (variation margin haircutting) for up to 5 days.
- Governance and consultation requirements for use of default tools
- ICE may break the portfolio into one or more lots, each of which will be auctioned separately.
- Participants have an obligation to bid for each lot in a minimum amount determined by ICE.
- The auction for each lot is conducted as a modified Dutch auction, with all winning bidders paying or receiving the auction clearing price.
- Guaranty fund and assessment contributions of non-defaulting Participants are subject to “juniorization” and are applied using a defined default auction priority based on the competitiveness of their bids.
- A secondary auction for a lot will be deemed successful if it results in a price for the lot that is within ICE’s remaining default resources, which will be allocated to each lot for this purpose based on the initial margin requirements for the lot.
- Proceed to partial tear-up after a max of five days of VM haircutting
ICE will consult with its CDS Default Committee, to the extent practicable, with respect to establishing the terms for default auctions and secondary auctions, including defining different lots for default auctions.

In the context of an initial auction, ICE will also consult with the CDS Default Committee as to whether to hold additional such auctions and/or to accept a partial fill of any lot in such an auction.

Seconded committee members are required to act in the best interests of ICE (rather than in the interests of their firm).

ICE will consult with its Risk Committee, to the extent practicable, with respect to key decisions, including whether to hold a secondary auction, invoke reduced gains distribution, implement a partial tear-up and/or terminate the clearing service.

Rules set out notice and similar procedures for Risk Committee consultation, and address circumstances in which such consultation is impracticable (in which case ICE may act without prior consultation but must generally consult as soon as is practicable).

Secondary default management actions (like other actions) rest with the ICE Board. In practice, ICE management and the ICE Board have worked collaboratively with the Risk Committee.

Certain key decisions including whether to hold a secondary auction, invoke reduced gains distribution, implement a partial tear-up and/or terminate the clearing service involving secondary default management actions must be made by majority vote of the ICE Board (and may not be delegated to an officer).

ICE can defer the use of certain default tools if, in its discretion in consultation with the CDS Default Committee, it determines that at such time such actions would not be in the best interests of ICE Clear Credit or other CDS Participants, taking into account the size and nature of the positions in question, market conditions prevailing at the time, the potential market effects of such liquidating transactions as might be directed by ICE Clear Credit, and such other circumstances as it deems relevant.

In effecting Standard Default Management Actions (other than a Default Auction), ICE Clear Credit shall use only resources provided by the Defaulting CDS Participant and, if needed and in consultation with the Risk Committee pursuant to Rule 20-605(l)(iv) below, Initial Phase Default Resources.

4. **FIA\(^1\) PAPER RECOMMENDATIONS**

Effective initial margin is the foremost risk mitigation technique in a CM default scenario to prevent wider loss allocation or, ultimately, recovery and resolution. CCPs should prioritize the “defaulter pays” approach, where the defaulting CM’s initial margin is the primary source of funds to meet the CCP’s loss upon a default with respect to the relevant clearing service. In addition to greater transparency with respect to CCP initial margin requirement methodologies as discussed above, FIA Global advocates for higher levels of initial margin (where such initial margin is currently inadequate) as a means to reduce

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\(^1\) FIA Global CCP Risk Position Paper (April 2015)
contingent liabilities. If a CCP calculates and calls for sufficient initial margin, the likelihood of needing to utilize the default fund or enter into a recovery scenario is greatly reduced.

With respect to default fund contributions, CCPs should be required to have sufficient capital and the ability to replenish CCP contributions for at least two defaults per clearing service within a defined period.

While no loss allocation tools are ideal, FIA Global believes that gains haircutting is preferable over other loss allocation tools such as initial margin haircutting or additional assessments. Gains Haircutting across all participants is effective and comprehensive in meeting any and all mark-to-market-related losses arising from a CM default, and is supportive of the goal of clearing service continuity, in part because it incentivizes CMs (and indirectly all Participants) to more fully participate in a post-default auction process.

FIA Global believes that a CCP should only be permitted to clear a product if it has a well-articulated and highly credible default management strategy to effectively neutralize the risk in respect of that product. Such default management strategy must be able to specify the hedging requirements for any portfolio of cleared contracts with respect to such product, including the cost and timing of such hedges as would be available in stressed market conditions within the default management timeframe (recognizing that for some products in times of stress the market capacity to absorb the risk of such products may be strictly limited).

5. SELECTED EMIR REQUIREMENTS


Cover 2

EMIR, Art. 43: At all times, a CCP shall maintain sufficient prefunded available financial resources to enable the CCP to withstand the default of at least the two clearing members to which it has the largest exposure under extreme but plausible market conditions. Such prefunded financial resources shall include dedicated resources of the CCP, shall be freely available to the CCP, and shall not be used to meet the CCP’s capital requirements.

RTS–CCP, Art. 51(2) and 53(1): On a regular basis, a CCP shall conduct stress tests designed to ensure that its combination of margin, default fund contributions, and other financial resources are sufficient to cover the default of at least the two clearing members to which the CCP has the largest exposures under extreme but plausible market conditions. As part of its stress testing, the CCP also shall examine potential losses resulting from the default of entities in the same corporate group as the two clearing members to which it has the largest exposure under extreme but plausible market conditions.

Framework for defining market conditions

RTS–CCP, Art. 30(2) and 59(5): A CCP shall develop a framework for defining the types of extreme but plausible market conditions based on a range of (1) historical scenarios that could expose it to the greatest risk; and (2) potential future scenarios founded on consistent assumptions regarding market volatility and price correlation across markets and financial instruments, drawing on both quantitative
and qualitative assessments of potential market conditions. If a CCP decides that recurrence of a historical instance of large price movements is not plausible, the CCP shall justify to the competent authority its omission from the framework. A CCP shall analyze and monitor its financial resources coverage in the event of defaults by conducting at least daily stress testing using standard and predetermined parameters and assumptions.

**Containing losses**

EMIR, Art. 48(2): A CCP shall take prompt action to contain losses and liquidity pressures resulting from defaults and shall ensure that the closing out of any clearing member’s positions does not disrupt its operations or expose non-defaulting clearing members to losses that they cannot anticipate or control.

**Setting margin requirements**

EMIR, Art. 41(2), 49(1): A CCP shall adopt models and parameters for setting margin requirements that capture the risk characteristics of the products and swaps cleared and take into account the interval between margin collections, market liquidity, and the possibility of changes over the duration of the transaction. The models shall be validated by the competent authority. A CCP regularly shall review its models and parameters for setting margin requirements and shall subject the models to rigorous and frequent stress tests. A CCP also shall obtain independent validations of its models and parameters.

RTS–CCP, Art. 24(2)(b): In determining the adequate confidence interval for each class of product that it clears, a CCP shall consider, among other factors, the risk characteristics of the class of product, which can include, but are not limited to, volatility, duration, liquidity, non-linear price characteristics, jump-to-default risk and wrong-way risk.

RTS–CCP, Art. 24(1): A CCP shall calculate the initial margins to cover the exposures arising from market movements for each financial instrument that is collateralized on a product basis, over an appropriate time horizon for the liquidation of the position, with a confidence level of 99.5% for over-the-counter derivatives and 99% for all other products.

EMIR, Art. 41(1) and (3): A CCP shall impose, call, and collect margins to limit its exposures from its clearing members, and where relevant, from CCPs with which it has interoperability arrangements. Such margins shall be sufficient to cover potential exposures that the CCP estimates will occur until the liquidation of the relevant positions. Such margins also shall be sufficient to cover losses that result from at least 99% of the exposures’ movements over an appropriate time horizon and they shall ensure that a CCP fully collateralizes its exposures with all its clearing members, and, where relevant, with CCPs with which it has interoperability arrangements, at least on a daily basis. A CCP shall regularly monitor and, if necessary, revise its margins to reflect current market conditions, taking into account any potential procyclical effects of such revisions. A CCP shall call and collect margins on an intraday basis, at a minimum when predefined thresholds are exceeded.

**Procedures upon default**

EMIR, Art. 48: A CCP shall have written procedures to be followed in the event of the default of a clearing member. The CCP shall take prompt action to contain losses and liquidity pressures resulting from defaults and shall ensure that the closing out of any clearing member’s positions does not disrupt its operations or expose the nondefaulting clearing members to losses that they cannot anticipate or control.
EMIR, Art. 37(6): A CCP may impose specific additional obligations on clearing members, including the participation in auctions of a defaulting member’s positions. Such obligations shall be proportional to the risk brought by the clearing member and shall not restrict participation to certain categories of clearing members.

EMIR, Art. 45: A CCP shall use a defaulting clearing member’s margins before using other financial resources to cover losses. Where the margins posted by the defaulting clearing member are insufficient to cover the losses covered by the CCP, the CCP shall use the default fund contribution of the defaulting member to cover the loss. A CCP shall use contributions to the default fund of the non-defaulting clearing members and any other financial resources only after having exhausted the defaulting clearing member’s contributions. A CCP further shall use its own dedicated financial resources before using the default fund contributions of non-defaulting clearing members. A CCP shall not use the margins posted by non-defaulting clearing members to cover losses resulting from the default of another clearing member.

RTS–CCP, Art. 61(2): A CCP shall make publicly available key aspects of its default procedures, including the circumstances in which action may be taken, who may take action, the scope of the actions that may be taken (including the treatment of both proprietary and client positions, funds and assets), and the mechanisms for addressing a CCP’s obligations to non-defaulting clearing members.

Skin in the game

Article 16 of EMIR includes requirements on the amount of capital that the CCP shall hold. EMIR also includes requirements on the amount of capital that the CCP shall have available in the “waterfall” (including the default fund). In accordance with these rules, the CCP shall contribute 25% of the Article 16 capital as “skin-in-the-game” in the waterfall. This corresponds to SEK 129 million for Nasdaq Clearing.

The total amount of capital set aside in the waterfall by Nasdaq Clearing amounts to SEK 145 million, i.e. SEK 16 million in addition to the regulatory requirement. This amount is allocated across the different clearing services, i.e. across the various asset classes. SEK 70 million (of the SEK 145 million) was allocated as Junior Capital to the Commodities waterfall. The Senior Capital is fixed to MSEK 200. The amount is calibrated to create an incentive for Nasdaq Clearing to minimize the risk for utilization of the Mutualized Default Fund.

Position Limits

The Norwegian FSA has set position limits for the relevant products, in accordance with MiFID II. The Norwegian FSA has confirmed, in a press release of September 14, that the position limits were not breached by the Relevant Clearing Member at the time of the default declaration.

6. RECOMMENDATIONS DISCUSSED IN THE MARKET AND MEDIA

The Financial Stability Board released a discussion paper for public consultation on November 15, 2018\(^2\), seeking comment on financial resources to support CCP resolution and the treatment of equity in CCP resolution, which included some of the following areas of consideration:

understanding the availability of predefined and prefunded financial resources provided by the CCP to absorb losses as part of the default waterfall (skin in the game), and when it can be used;

understanding the availability of any additional loss absorbing equity beyond skin in the game (including from the CCP’s parent), the amount of such additional loss absorbing equity, and how it can be used to cover losses; and

where relevant, whether the parent (or other affiliated entity) or shareholders have a legal commitment e.g. a contractual agreement to provide, or would be likely to voluntarily contribute, further resources to cover losses or replenish equity (including skin in the game) and the amount of any such potential resources.

The Futures Industry Association released a paper in November 2018, including making the following recommendations:

- Participants who lack independent risk management capabilities must be intermediated by a clearing member capable of risk-managing the participant’s portfolio.

- CCP membership criteria should not be solely based on financial considerations but also objective assessment of specific capabilities (e.g. risk management, operational capability to monitor and control position, ability to participate in default management, if required, and have independent functions).

- CCPs who wish to include self-clearing members should develop more stringent provisions in their rulebook, risk framework and their governance to account for the nature of these members.

- CCPs should not rely exclusively on external credit ratings for monitoring membership but have a robust internally developed credit framework for reviewing creditworthiness of participants.

- Realistically determined margin periods of risk and liquidity add-ons are essential to prudent margin frameworks. Margin frameworks should consider position concentration relative to product liquidity in determining the amount of concentration related add-on that should be charged and should be justified using credible metrics.

- Regulators should regularly assess the resources of CCPs in relation to default scenarios utilizing the best practice developed at supra-national level.

- CCPs should establish an appropriate amount of skin in the game with the intention of calculating a skin in the game layer in a way that reflects the level of risk in the CCP’s system rather than maintaining a fixed amount. De minimis amounts of skin in the game which are justified on the basis of providing an incentive to employees of the CCP to be prudent are sub-optimal since they are not dynamic and reflective of the CCP’s level of activity and risk profile.

- CCPs should provide skin in the game at a level determined with regard to fairness towards non-defaulters and robustness of the CCP, not only to the minimum level currently required by regulation where it exists.

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3 https://fia.org/file/8326/download?token=arZLqCOp
Where a CCP allows self-clearing membership, the skin in the game amounts should realistically take into account the possibility of default by self-clearing members. Since for such self-clearing members the CCP must effectively act as a general clearing member or first line of defence, in terms of trading oversight and risk management for the self-clearing member, the CCP should be more stringent in ensuring it has sufficient financial resources available to cover defaults of self-clearing members.

The Commodity Futures Trading Commission’s (CFTC) Market Risk Advisory Committee (MRAC) held a public meeting on December 4, 2018 focused on clearinghouse risk and vendor risk management, including (1) clearinghouse governance structures and risk management; (2) management of non-default losses in recovery and resolution; and (3) recent reports, discussion papers and proposed rules involving global standard setting bodies and prudential regulators.

The media has also discussed potential areas to focus on in the aftermath of the default. For example, in a Risk.net article on October 30, 20184 the following points were discussed:

- Narrower segmentation of default funds as a remedy – either by membership type or by product. Currently, the biggest derivatives CCPs split guarantee funds by instrument type or asset class, as is the case for LCH’s UK business where service-level segregation exists for equity, foreign exchange, interest rates and repo. The ICE global clearing house network runs separate clearing houses for different product sets (e.g. ICE Clear US for agriculture, equity derivatives, forex and metals, ICE Clear Credit for credit, ICE NGX for energy), and ICE Clear Europe contains separate funds for over-the-counter and listed instruments. CME maintains twin default funds for exchange-traded products and interest rate swaps, within a single legal entity – an approach that came in for criticism from some members when it launched clearing for bitcoin futures and dropped the new product type into the existing structure.

- Fresh look at the process through which defaulting portfolios are auctioned off, and the amount of capital a clearing house is willing to put in harm’s way.

- Create a separate default fund for clearing members that are natural persons, or for clearing members that self-clear.

- Whether to apply a reserve to the auctioned position, which can create a disincentive in the market and distort market prices

- Higher levels of skin in the game

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