The Impending EU CCP Recovery and Resolution Regime and its Impact on EU and Non-EU Firms

24 September 2020

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Agenda

A. EU CCP Recovery and Resolution Regime

1. The EU CCP Recovery and Resolution (R&R) Regime and why is it relevant to EU **and non-EU** clearing members and their clients

2. Key elements of the EU CCP R&R regime with a focus on tools and powers impacting clearing members

B. US resolution regime for CCPs

1. Brief overview of the US CCP resolution regimes

2. Key points of comparison *vis-à-vis* the EU regime

The EU CCP R&R Regime

Background to the EU CCP R&R Framework

The G20 leaders agree at the 2009 Pittsburgh summit that all standardised OTC derivative contracts should be cleared through a CCP as a method of mitigating counterparty credit risk

The crucial role that central counterparties (CCPs) have played in the overall safety and soundness of the international financial system in the years following the 2008 financial crisis has led to concerns of a new category of entity that is “too big to fail”

Too big to fail?

UK introduced a domestic CCP recovery and resolution framework on 1 January 2015 based on the existing bank recovery and resolution framework

Now the EU has agreed a framework for CCP recovery and resolution

The EU CCP R&R Regime – relevance to EU and non-EU firms

Regime has implications for:

Regulators

- Provides relevant authorities with broad tools and powers and sets out detailed requirements on how authorities may utilise such powers and how they are to coordinate with other regulators

Clearing members and clients of clearing members

- Affects CCP rulebooks and CCP interactions with clearing members
- Broad jurisdictional nexus: will apply to all clearing members of an in scope CCP – whether they are an EU firm or non-EU firm

CCPs and owners of CCPs

- Affects CCP rulebooks, requirements for capital and CCP interactions with clearing members

Where are we now? Development of International and EU CCP R&R Frameworks

Global

16 April 2012
- CPMI-IOSCO publish 'Principles for financial market infrastructures' (PFMI)

15 October 2014
- **CPMI-IOSCO** report on the recovery of financial market infrastructure (FMI)
- **FSB Key Attributes** of Effective Resolution Regimes for Financial Institutions

5 July 2017
- The **FSB** publishes guidance on CCP R&R, building on the Key Attributes
- **CPMI-IOSCO** publishes revised report on Recovery of financial market infrastructures (2017)

4 May 2020
- The FSB publishes consultative document on Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution

EU

5 October 2012
- The European Commission publishes consultation paper on R&R planning for non-banks

28 November 2016
- The European Commission publishes legislative proposal for the Regulation establishing the CCP R&R framework

July 2020
- The European Parliament and Council agree the text of Regulation for the CCP R&R framework – *__subject to legal linguist revision__*

?? 2022
- The entry into force of the CCP R&R Regulation – 18 months after its entry into force

Key elements of the EU CCP R&R regime

Key elements of the EU CCP R&R Framework

Planning

Recovery planning *– led by the operators of the CCP*

Resolution planning *– led by resolution authorities*

Early intervention

Allows national competent authorities to intervene on a limited basis before conditions for resolution are met

Such measures include:

- implementing recovery plans, changes to business strategies, legal and operation structures requiring CCPs to replenish financial resources in a timely manner
- **requiring CCPs to instruct clearing members to invite their clients to participate directly in auctions**
- total or partial removal of the senior management or board of the CCP

Resolution

Provides resolution authorities with the tools to intervene and fundamentally restructure a CCP where a CCP is failing or is likely to fail (and other conditions and objectives for resolution are met) in order to preserve the critical functions of the CCP

Focus on tools and powers impacting clearing members and their clients

Recovery plans

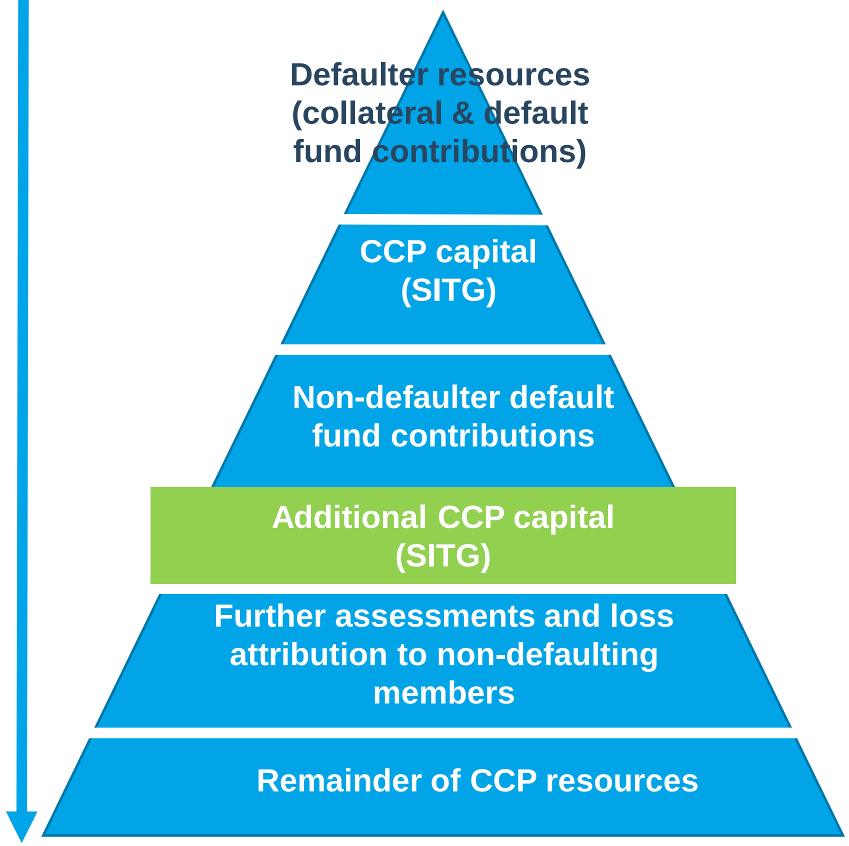
CCPs required to draw up and maintain recovery plans (*measures that create financial or contractual obligations on clearing members and other 3rd parties to form part of the CCP's rulebook to ensure enforceability*)

Arrangements and measures to be taken by the CCP should include:

- actions to restore the CCP's matched book and capital, and replenish pre-funded resources
- capital, loss allocation and liquidity actions to maintain or restore the viability and financial position

Requirement for an **additional amount of CCP "*prefunded dedicated own resources*"** between 10-25% of its EMIR risk-based capital requirements

Illustrative Default Waterfall



Proposed CCP Resolution objectives and conditions

Resolution objectives

- Ensure the continuity of the CCP's critical functions
- Ensure the continuity of the links with other FMIs (which if disrupted would have a material negative impact on financial stability or the timely completion of payment, clearing, settlement and record-keeping functions)
- Avoid a significant adverse effect on the financial system
- Protect public funds
- Minimise the cost of resolution on all affected stakeholders and avoid destruction of the CCP's value

When can **resolution** tools be used?

Resolution conditions

A resolution authority is required to take resolution action when:

- CCP is failing or is likely to fail
- no reasonable prospect of alternative private sector measures or supervisory action within a reasonable time frame
- resolution action is necessary in the public interest where the winding down of the CCP under normal insolvency proceedings would not meet the objectives of resolution

Outside a circumstance where all of these factors are present, resolution authority may only take resolution action where the CCP has applied, or intends to apply, recovery measures which could prevent the CCP's failure but cause significant adverse effects to a financial system in the EU

Resolution tools

Position and loss allocation tools	**Position allocation tool:** Allows resolution authority to tear-up (terminate), in full or in part certain contracts of (a) clearing member in default, (b) the affected service, and (c) the CCP **Loss allocation tool:** Allows resolution authority to (a) apply **VMGH** and (b) require additional **cash calls** so that non-defaulting clearing members are to contribute cash to the CCP up to **twice** the amount equivalent to their contribution to the CCP's default fund
Write-down and conversion (bail-in) tool	Write-down (but not conversion) of a CCP's instruments of ownership, or write-down and conversion of a CCP's debt instruments or other unsecured liabilities
Sale of business tool	Transfer of instruments of ownership issued by a CCP or any assets, rights, obligations or liabilities of a CCP to a private purchaser
Bridge CCP tool	Transfer of instruments of ownership issued by a CCP or any assets, rights, obligations or liabilities of a CCP to a legal person (a) controlled or partially owned by a resolution authority or public authorities and (b) created for the purposes of receiving CCP in resolution shares or assets

Position allocation tool

Allows resolution authority to tear-up (terminate), in full or in part certain contracts (a) with clearing member in default, (b) of the affected service, and (c) of the CCP. **The tool can apply to both client and house contracts, and so impacts can flow to clearing member clients.**

Partial Tear-Up (**PTU**) terminates the positions opposite the defaulter for a price determined by the CCP in accordance with its rules, so a matched book can be achieved.

Full Tear-Up is the complete termination of all contracts within a particular product or clearing service.

Business as usual: Matched book

Clearing Member default

Partial tear-up

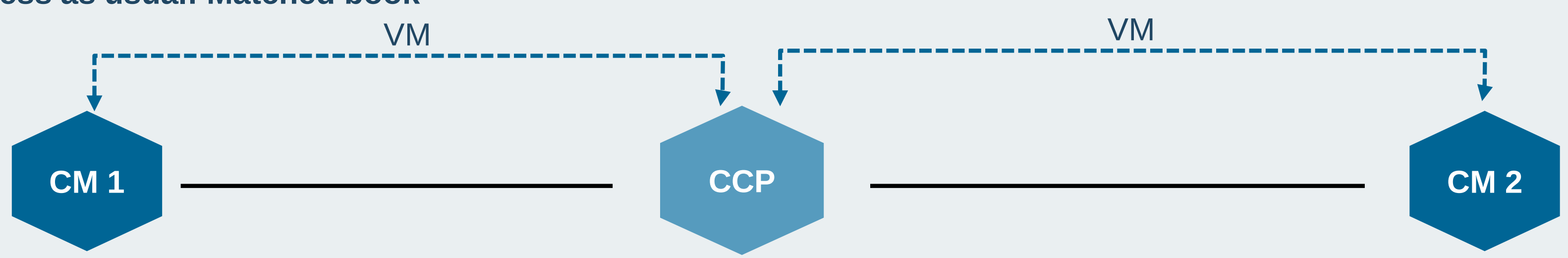
Loss allocation tool

***Allows resolution authority to (a) apply <u>VMGH</u> and (b) require <u>additional cash calls</u> so that non-defaulting clearing members are to contribute cash to the CCP up to <u>twice</u> the amount equivalent to their contribution to the CCP's default fund.* VMGH can apply to both client and house contracts, and so impacts can flow to clearing member clients.**

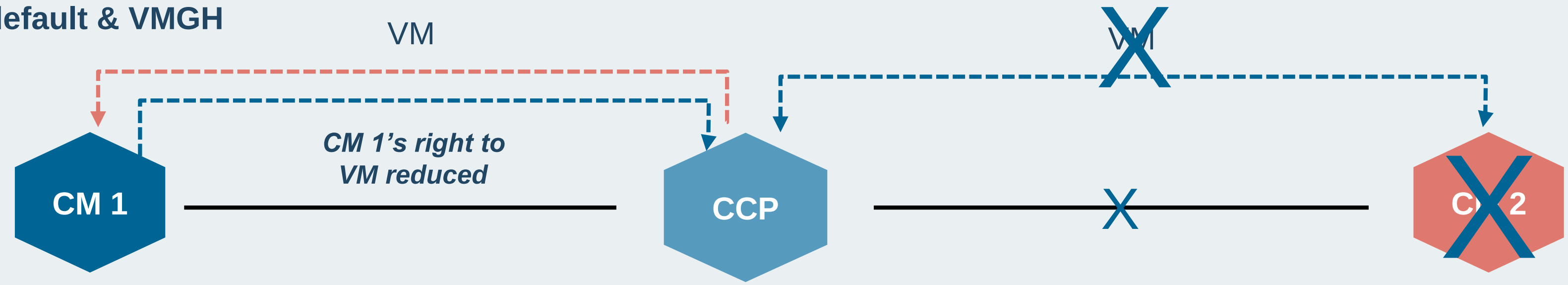
VMGH (variation margin gains haircutting) permits a CCP to reduce part of its liabilities to CMs and their customers with respect to positions that gained day-to-day and other mark-to-market amounts.

It is a liquidity tool for CCPs, but also a potential loss allocation tool. The appropriateness and length of any GH period is an topic of industry debate.

Business as usual: Matched book

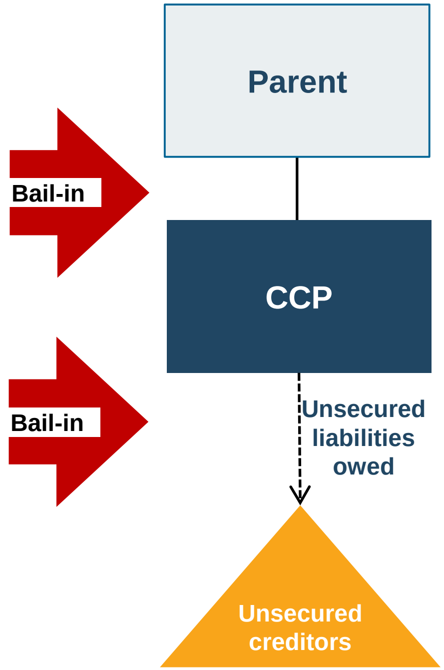


CM 2 default & VMGH



Write-down and conversion (bail-in) tool

Write-down (but not conversion) of a CCP's instruments of ownership, or write-down and conversion of a CCP's debt instruments or other unsecured liabilities



Exclusions

Liabilities owed to:

– employees;
– commercial and trade creditors;
– tax and social security authorities;
– operators and participants in designated settlement systems, CCPs and central banks; and
– **initial margins.**

Business transfers: Sale of business tool and Bridge CCP tool

Sale of business tool *Transfer of instruments of ownership issued by a CCP or any assets, rights, obligations or liabilities of a CCP to a private purchaser*

Bridge CCP tool *Transfer of instruments of ownership issued by a CCP or any assets, rights, obligations or liabilities of a CCP to a legal person (a) controlled or partially owned by a resolution authority or public authorities and (b) created for the purposes of receiving CCP in resolution shares or assets*

A transfer of the CCP's *entire* business	A *partial transfer* of the CCP's business
Would not seem to cure any fundamental ills that may have triggered the CCP resolution: would not raise additional funds that may be required to return the CCP to a matched book	May provide benefits: allows flexibility to separate a failing silo of a CCP business from the other business lines of the CCP
However, provides an opportunity for revised branding and market faith in the CCP following the introduction of the new ownership/management of the CCP	**I.e. could be used to separate "good" (i.e. unaffected) from "bad" (i.e. affected) silos of CCP business**

Stays

Power to temporarily suspend or prevent:

- **Payment and delivery obligations -** any payment or delivery obligations of both counterparties to any contract entered into by a CCP under resolution;

- **Security interests** - secured creditors of a CCP under resolution from enforcing security interests in relation to any assets of that CCP under resolution;

- **Termination rights -** termination rights of any party to a contract with a CCP under resolution,

from publication of the notice until midnight the following working day.

General power to stay so long as substantive obligations under the contract continue to be performed.

Provisions expressly relating to 3rd countries

Contractual recognition

CCPs must include a contractual provision in their contracts or other agreements with clearing members, share holders and debt holders <u>located in **or** governed by the law of third countries</u> by which they agree to be bound by any action in respect of their assets, contracts, rights, obligations and liabilities taken by the resolution authority including:

- Position and loss allocation tools
- Bail-in powers
- Stay powers

Resolution colleges and resolution planning

(a) 3rd country authorities of clearing members established in third countries and the competent; and

(b) 3rd country authorities of 3rd country CCPs which have interoperable links with EU CCPs,

may be invited to participate in the resolution college as observers.

EU CCP resolution authorities may involve 3rd country authorities when drawing up and reviewing resolution plans

EU Safeguards and Compensation

Safeguards? Partial transfers protections

Protection for financial collateral, set off and netting agreements (however, the position allocation tool is carved out of this protection)

Protection for security arrangements

Protection for structured finance arrangements and covered bonds

Protection of trading, clearing and settlement systems

Safeguards? Compensation & NCWO

Compensation

- Compensation for those suffering **VMGH in recovery phase** in the event of non-default losses.

  Compensation to be provided in cash or instruments recognising a claim on the future profits and to be proportionate to loss in excess of contractual commitments.

- Compensation of non-defaulting clearing members that suffer financial loss following resolution authority use of **loss allocation tools in deviation from CCP rulebook**.

  Compensation to be provided in ownership instruments or debt instruments or instruments recognising a claim on the CCP's future profits. The amount should be proportionate and be deducted from any entitlement to a NCWO payment – provided that the non-defaulting clearing members would have been entitlement to a NCWO payment.

- Safeguards for clients/ indirect clearing members: if losses are passed down then the right to compensation should also.

No Creditor Worse Off (NCWO)

Counterfactual for default and non-default losses:

Shareholders, clearing members and other creditors should not incur greater losses than they would have incurred had the resolution authority not taken resolution action in relation to the CCP and the CCP had instead been wound up under normal insolvency proceedings, following the full application of the applicable contractual obligations and other arrangements in its operating rules

Some open questions remain – further detail to be set out under RTS

US Resolution Framework for US CCPs

US Regulation of CCPs Overview

- US CCPs fall into one or both of the following categories:
  - Derivatives Clearing Organizations (**DCOs**)
    - Principal Regulator: Commodity Futures Trading Commission (the **CFTC**)
    - Main Legal Framework: Commodity Exchange Act and CFTC rules
  - Clearing Agencies (**Clearing Agencies**)
    - Principal Regulator: Securities Exchange Commission (the **SEC**)
    - Main Legal Framework: Securities Exchange Act of 1934 and SEC rules
- CCPs designated as "systemically important financial market utilities" are also supervised by the Federal Reserve Board
- To different extents, DCOs and Clearing Agencies both maintain recovery and wind-down plans, financial resources, and risk management frameworks

US Regulation of CCPs Resolution and Risk Management

- The CFTC rules (Part 39) require a DCO to maintain:
  - Recovery and wind-down plans
  - Sufficient financial resources to implement recovery or wind-down plans
  - Various measures to deal with clearing member risk, including:
    - Default rules and procedures for clearing member defaults
    - Sufficient financial resources to deal with large clearing member defaults
    - Periodic stress tests to support the calculation of financial resource requirements
    - Risk management frameworks, including initial margin requirements
- The SEC rules (Rule 17Ad-22) are more principles-based and require Clearing Agencies to have "policies reasonably designed to":
  - Maintain a sound risk management framework, including recovery and orderly wind-down plans
  - Maintain sufficient financial resources to, among other things, ensure recovery or wind-down as contemplated by the plans
  - Manage general business risk

US Regulation of CCPS Regulatory Efforts

- The CFTC Market Risk Advisory Committee has also established a CCP Risk and Governance Subcommittee to provide reports and recommendations on clearinghouse risk management and governance issues.
  - Subcommittee members include representatives of major DCOs such as the OCC, ICE, CME, Eurex, and LCH and industry bodies such as FIA
  - Workstreams include:
    - Margin
    - Default Management
    - Governance and Transparency
    - Stress Testing and Liquidity Framework
    - Capital and Skin in the Game

US Insolvency Regimes
General

- US DCOs are subject to a special bankruptcy regime under Subchapter IV of Chapter 7 of the United States Bankruptcy Code (**Subchapter IV**), as supplemented by Part 190 bankruptcy rules of the CFTC (**Part 190**)
  - Liquidation regime that prioritizes the return of customer and member property under the supervision of a trustee

- US Clearing Agencies are not subject to a special bankruptcy regime and could theoretically be subject to proceedings under either Chapter 7 (liquidation) or Chapter 11 (reorganization) of the United States Bankruptcy Code

US Insolvency Regimes
Orderly Liquidation Authority

- A US CCP may also be subject to the Orderly Liquidation Authority (**OLA**).
  - Provides for the Federal Deposit Insurance Corporation to act as receiver (the **FDIC**)
  - Special regime for the resolution of large financial companies whose failure and resolution in ordinary insolvency proceedings would have serious adverse effects on US financial stability
    - Gives the FDIC various tools to maintain continuity of operations, such as ability to create bridge financial institutions, etc.
    - Aimed at preventing risks to the stability of financial markets
  - Non-OLA proceedings still establish the counterfactual that the FDIC must consider in various circumstances (e.g., what a claimant would be entitled to outside of OLA)
  - FDIC must apply provisions of Subchapter IV to the distribution of customer and member property of a DCO

US Insolvency Regimes DCOs - Subchapter IV and Part 190

- While Part 190 applies to DCOs, no DCO has ever filed for bankruptcy and Part 190 mainly focuses on the liquidation of futures commission merchants.
- Part 190 does not currently address all of the issues that would arise in a DCO insolvency. In the past, the CFTC has in the past taken the view that a DCO bankruptcy would be *sui generis*.
- On April 14, 2020, the CFTC published a proposed rule to overhaul and modernize Part 190 and, among other things, introduce detailed rules for DCO bankruptcy for the first time.
  - The CFTC expressly references OLA and its goal to clarify the counterfactual for purposes of OLA (as well as provide guidance for distribution of customer and member property under OLA)

US Insolvency Regimes for DCOs Subchapter IV and Part 190

- Proposed Part 190's general theme is that, given the complexity of DCOs and the need for prompt action in the event of a DCO bankruptcy, the bankruptcy trustee should defer to the existing default rules, procedures, and recovery and wind-down plans of a DCO. Trustee:
  - may not avoid or prohibit an action taken by a DCO in accordance with its recovery and wind-down plans;
  - to implement, in consultation with the CFTC, a DCO's existing default rules and procedures maintained in accordance with other CFTC rules, including any termination, close-out and liquidation provisions, subject to the reasonable discretion of the trustee and to the extent such implementation is practicable; and
  - in consultation with the CFTC, to take actions in accordance with any recovery and wind-down plans maintained by a DCO and filed with the CFTC to the extent reasonable and practicable
- The comment period for the proposal expired on July 13, 2020, and parties have commented on this aspect of the proposal in particular. The final iteration remains to be seen.

Questions?

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