

Notice No.: RISK-2019-033

Issue Date: 23 August, 2019

Subject: Consultation on Default Management

Notice to all Members,

Subject: Consultation on Proposed Enhancements to Default Management Capabilities of DCCC

1. Summary

- 1.1 Clearing Members will be aware that the DCCC Clearing Rules (“the Rules”) affords DCCC certain powers, amongst other things, in the event of the default of a Clearing Member. DCCC now wishes to consult with its Clearing Members on proposals to introduce new powers with respect to the management of Clearing Member defaults.
- 1.2 This Consultation Notice (“the Notice”) details the background to the proposals together with associated changes to the Rules, if adopted. This Notice should be read against the backdrop of the introduction of the Default Fund and the announced changes with regard to segregation of assets, both of which are designed to protect DCCC, its Clearing Members, the market and those who trade, through the implementation of practices and standards that have been internationally-recognised as being prudent and appropriate for Central Clearing Counterparties (“CCPs”) to adopt.
- 1.3 However, it is important to note that CCPs cannot, on their own, remove completely the risk of a Clearing Member default, and that it is the responsibility of all involved to ensure that appropriate and effective risk management practices and procedures are in place to reduce the risk of such an event taking place.
- 1.4 This consultation shall remain open until the close of business on **Friday 27 September 2019**, and responses should be sent via email to: risk@dccc.co.ae .

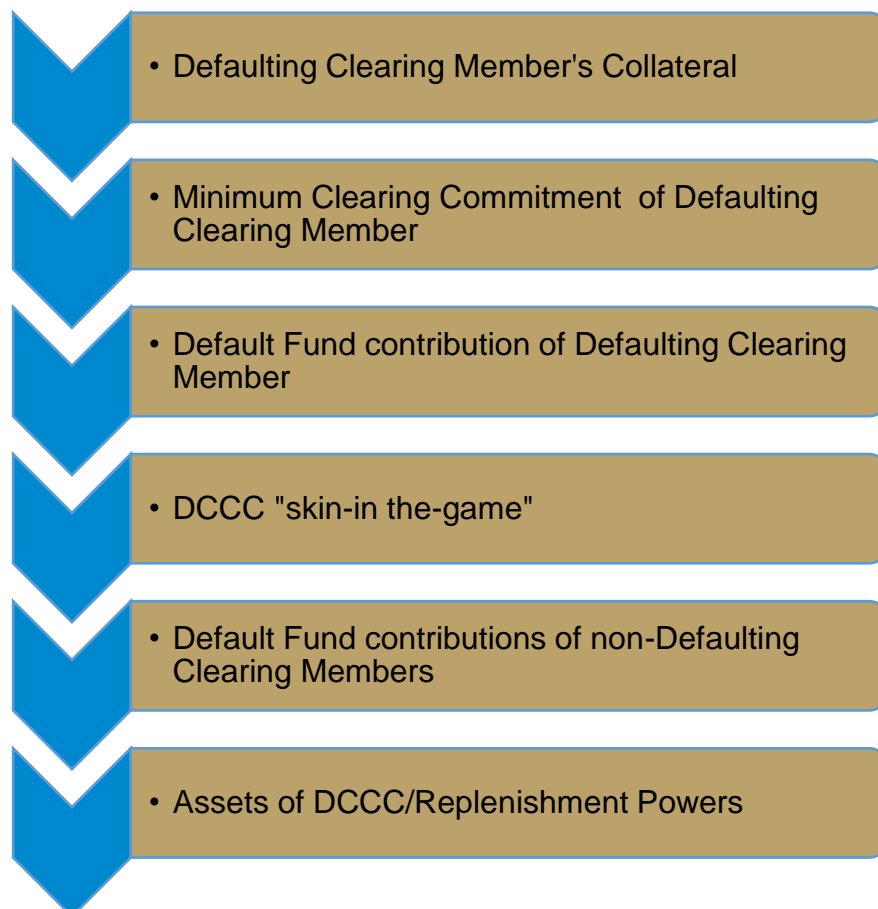
2. Background

- 2.1 Part H of the Rules details the procedures to be followed in the event of a default of a Clearing Member which, for the purposes of this Notice, shall be considered to be solely the failure to pay margins as required by DCCC. When an event of default has been declared by DCCC then all of the open positions held by the defaulting Clearing Member, both those on behalf of clients (which shall include any Exchange members for whom the Clearing Member provides clearing services), and any proprietary positions become the responsibility of DCCC.
- 2.2 With regard to client positions the aim of any default management procedure is to insulate clients from the impact of a Clearing Member default. Therefore, CCPs look to either transfer open client positions to other Clearing Members or to have them closed-out in the market without delay, depending upon the instructions of each relevant client. However, it should be noted that CCPs will not generally return

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collateral associated with open client positions until the CCP has satisfied itself that it can do so without adversely impacting any remaining collateral held by the defaulting Clearing Member. What this means in practice is that those clients who wish to transfer open positions to another Clearing Member, will be required to post additional collateral to support the holding of the positions at the other Clearing Member.

- 2.3 For House/proprietary positions held by the defaulting Clearing Member the position is very different, in that these positions represent a real and tangible risk to both the CCP and its Clearing Members. At the point at which a Clearing Member has been declared to be in default the CCP is no longer managing a balanced book of short/long positions, and hence is automatically exposed to market risk. Therefore, a CCP must take such steps as are necessary to balance their book, and to do so without delay. The steps taken will crystallise any loss inherent in the open positions, and it is this loss that will be met through the application of the “default waterfall”, as shown below:



- 2.4 Whilst a CCP will make every effort to minimise the loss incurred in managing an event of default, the default waterfall exists because of the very real risk that the losses will exceed the resources of both the defaulting Clearing Member and the

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CCP's own "skin-in-the-game" ("SKITG"). On this latter point it should be noted that DCCC's own SKITG amounts to US\$ 2.75 million, or approximately 27% of the total Default Fund, and this is far larger than many other CCPs' contributions in percentage terms. However, even with this greater contribution it is by no means assured that the resources would be sufficient to meet the losses incurred. By way of example, the default of a clearing member on the Norwegian Nasdaq Clearing AB market in September 2018, resulted in losses of €113 million, which was the entirety of its default fund, and the defaulting clearing member was a sole trader – i.e. not a firm/company.

- 2.5 Therefore, it is in the interests of all Clearing Members that a CCP, and DCCC in particular, has the relevant powers that will enable it to effect a swift response to an event of default.
- 2.6 Currently the Rules provide for DCCC to liquidate open positions in the market, and it will do so by using those Clearing Members with whom it has client agreements in place – i.e. DCCC will not itself enter orders into the market, but will instruct brokers to do so on its behalf. However, it should be recognised that in the event of a Clearing Member default the markets are most likely going to be more volatile than usual; either it was the volatility itself that caused the Clearing Member to default; or the fact that the market is having to digest the fact that a Clearing Member has defaulted. In a volatile market, with prices potentially gapping, trying to liquidate positions becomes more difficult, and although DCCC will make every effort through its brokers to liquidate positions it may simply be unable to do so, either at acceptable prices or even at all, if there is no willing buyer/seller for certain contracts.
- 2.7 In such a scenario DCCC does have the power to force compulsory settlement of contracts, but this would require the identification of equal opposite positions to settle against the open positions of the defaulting Clearing Member. Although sanctioned by the Rules, this arbitrary identification of positions, either Client or proprietary, and subsequent settlement is likely to lead to a loss of confidence in the market. Further, if the aim of DCCC in managing an event of default is to limit the impact to the wider market then, arguably, the compulsory settlement of contracts is in direct contradiction of this objective.
- 2.8 Therefore, DCCC needs to be able to find an alternative solution for managing open positions in a way that does not damage market confidence. Once such method, which is employed by a number of global CCPs in US, Europe and Asia, is to hold an auction for the open positions. Broadly speaking, the bid that represents the lowest cost to the CCP, and hence to the market as a whole, would be the one chosen by the CCP, with the positions transferred to the Clearing Member who submitted that bid.

3. Proposal

- 3.1 DCCC considers that it would be beneficial to include within the Rules specific provisions that would allow it to conduct an auction of open positions in the event of a Clearing Member default. However, it should be noted that the holding of an auction would not be mandatory, but would instead be viewed as one method for managing open positions in a default scenario, alongside the existing powers of liquidating positions in the market, and compulsory settlement of contracts.
- 3.2 As to participation in any auction DCCC has considered whether it would be appropriate to either mandate participation or to make it voluntary, and also whether non-Clearing Members – i.e. Exchange Members and/or Clients – should be able to participate as well. It should be noted that arranging to schedule any auction will take time, and participants of whatever type will need time to undertake their own assessment of the positions which are to be auctioned. This time period represents risk to DCCC, and all other Clearing Members, as the positions will be subject to market price movements, and so any resulting loss may increase during this period.
- 3.3 Therefore, there is an obvious tension between securing as many auction participants as possible so as to allow for competitive bids to be submitted, and for holding and completing the auction process in as short a time as possible.
- 3.4 **DCCC proposes that participation be mandatory for all Clearing Members.** In reaching this decision DCCC is mindful of the fact that none of its contracts, with the exception of the Shari’ah Spot Gold contract requires physical delivery of a commodity, and therefore the operational ability of Clearing Members to manage the positions of a defaulting Clearing Member is not subject to question. In the event that the defaulting Clearing Member’s positions did include the Shari’ah Spot Gold contract then, but its very nature, the position will already have undergone the delivery process or will have been cash-settled at the time the Clearing Member was declared in default under the Rules.
- 3.5 Further, DCCC would be concerned that if, by allowing non-Clearing Members to participate in the auction there would be greater opportunity for information leakage in terms of the positions that would be auctioned, and that this would lead to potential abusive behavior in the market.
- 3.6 Notwithstanding the proposal that participation in an auction would be mandatory for all Clearing Members, DCCC considers that it would also be appropriate to incentivise Clearing Members to submit competitive bids. A review of other CCPs which have auction procedures in place has identified that such incentivisation takes the form of “juniorisation” of Clearing Member Default Fund contributions.
- 3.7 What this means is that in the event that the losses incurred in managing the default exceeded the resources of both the defaulting Clearing Member and the CCP, then

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the allocation of loss would firstly be to the Clearing Member who had submitted the least competitive bid in the auction. Once that Clearing Member's Default Fund contribution had been exhausted, so the allocation would move to the Clearing Member with second-least competitive bid, and so on, until such time as the losses had been met through the application of the Default Fund¹.

Example

Assume there are 10 Clearing Members that are not in default, and they have all submitted bids in the auction, and below are the rankings in terms of competitiveness and Default Fund contributions:

Clearing Member	Ranking of Bid	Default Fund Contribution
A	1	US\$ 150,000
C	2	US\$ 150,000
D	3	US\$ 100,000
G	4	US\$ 50,000
H	5	US\$ 50,000
B	6	US\$ 100,000
J	7	US\$ 150,000
I	8	US\$ 100,000
E	9	US\$ 50,000
F	10	US\$ 100,000

The size of the Default Fund, including the resources of both the defaulting Clearing Member and the CCP is US\$1.3 million.

The total losses incurred by the CCP in managing the default are US\$ 1.1 million, and after the resources of the defaulting Clearing Member and the CCP have been used, this has left losses of US\$ 0.8 million. This would be apportioned as follows:

Clearing Member	DF Contribution	Loss Allocated	Balance
F	US\$ 100,000	US\$ 100,000	US\$ 700,000

¹ For the purposes of this Notice it is assumed that the size of the Default Fund is sufficient to cover the losses incurred in managing the default.

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E	US\$ 50,000	US\$ 50,000	US\$ 650,000
I	US\$ 100,000	US\$ 100,000	US\$ 550,000
J	US\$ 150,000	US\$ 150,000	US\$ 400,000
B	US\$ 100,000	US\$ 100,000	US\$ 300,000
H	US\$ 50,000	US\$ 50,000	US\$ 250,000
G	US\$ 50,000	US\$ 50,000	US\$ 200,000
D	US\$100,000	US\$100,000	US\$ 100,000
C	US\$150,000	US\$100,000	Nil
A	US\$150,000	Nil	

In this example, Clearing Member C would only contribute US\$ 100,000 out of their total contribution of US\$ 150,000, and Clearing Member A would not have to make any contribution in recognition that their bid in the auction had been the most competitive.

- 3.8 In summary, DCCC proposes to introduce specific powers that would enable it to undertake an auction of positions held by a defaulting Clearing Member if DCCC considered it appropriate to do so. In such cases, participation in any auction would be mandatory for all Clearing Members, with the allocation of losses being distributed to those Clearing Members that submitted either no bid or the least competitive bids, in ascending order until such time as either the losses have been met in full or the resources of the “default waterfall” have been exhausted.
- 3.9 The proposed changes to the Rules can be found at Appendix I to this Notice.
- 3.10 In addition to the proposed introduction of an auction process, DCCC is also taking this opportunity to clarify the procedure that would be adopted if Compulsory Settlement, as detailed in Part I of the Rules was to be invoked as part of the management of a Clearing Member default.
- 3.11 Compulsory Settlement, as defined in the Rules is the process whereby open positions held by the defaulting Clearing Member are closed out against opposite positions held by non-defaulting Clearing Members. However, the process for identifying such opposite positions is not defined within the Rules.
- 3.12 Clearly the invocation of Compulsory Settlement is an extreme, but foreseeable course of action and one which has the potential to be far-reaching in terms of market impact. DCCC proposes that the identification of opposite positions be undertaken on a pro-rata basis at Clearing Member account level – i.e. positions held in a Clearing Member’s House/Proprietary Position Keeping Account (“PKA”) would be considered separate to any positions held in individual Client PKAs.

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3.13 In addition to the identification of opposite positions, DCCC is also proposing that the price used to settle such positions under the Compulsory Settlement provisions of the Rules, be the relevant daily settlement price of the day on which such settlement occurs.

4. Consultation

4.1 Clearing Members are asked to respond to the following questions:

- A. Do you consider it appropriate for DCCC to have express powers to conduct an auction when managing a Clearing Member default? Yes/No (if No, why not?)
- B. Do you consider that DCCC must always hold an auction when managing a Clearing Member default, regardless of the scenario? Yes/No (If Yes, why?)
- C. Do you believe that participation in an auction must be mandatory for Clearing Members? Yes/No (If No, why not?)
- D. Do you believe that non-Clearing Members should be permitted to participate in an auction? Yes/No (If Yes, why?)
- E. Do you believe that auction participants should be incentivised to participate in an auction? Yes/No (If No, why not?)
- F. Do you consider that the incentivisation proposed is appropriate? Yes/No (If No, why not?)
- G. Do you consider that the pro-rata basis for identification of opposite positions in the case of Compulsory Settlement is appropriate? Yes/No (If No, why not and what other basis should be used?)
- H. Do you agree that the daily settlement price should be used to settle positions under the Compulsory Settlement provisions of the Rules? Yes/No (If No, why not and what other price should be used?)
- I. Are there any other powers that you believe DCCC should have to manage Clearing Member defaults? Yes/No (If Yes, what?)

For Dubai Commodities Clearing Corporation

Andrew Dodsworth
Director – Operations and Risk

Appendix I

Proposed Amendments to DCCC Clearing Rules

H.2.3 The Auction Process and Subsequent Allocation of Loss

- (a) Notwithstanding the provisions of Rule H.2.1. the Clearing Corporation may determine in its absolute discretion to undertake an auction process with regard to Open Contracts of the Clearing Member in Default. This auction process shall apply on a per-Defaulting Clearing Member basis, so that in the event that more than one Clearing Member has been declared in default under the Rules, the auction process shall be applied separately in respect of each such Clearing Member in Default.
- (b) In the event that the Clearing Corporation decides to undertake an auction then it shall advise all Clearing Members of the timetable for the auction, and all Clearing Members will be required to participate in the auction. Any Clearing Member that does not participate in the auction will be deemed to be in breach of these Rules and may be subject to disciplinary action.
- (c) The Clearing Corporation shall provide each Clearing Member with sufficient information as to the Open Contracts that will allow Clearing Members to undertake their own assessment as to the value of the Open Contracts.
- (d) The Clearing Corporation shall not specify a minimum bid price for the auction, but shall assess the bids received and select the winning bid. The decision of the Clearing Corporation shall be final and binding and not be subject to appeal by any Clearing Member.
- (e) The Clearing Corporation may accept the best price that it believes accurately reflects the risk of the Open Contracts. If two or more Clearing Members submit a bid of the same value, then the winning bid will be that which was received first by the Clearing Corporation.
- (f) Prior to commencing an auction the Clearing Corporation shall determine the juniorisation approach that shall be applied in the event that the losses incurred by the Clearing Corporation require the use of the Default Fund.
- (g) The Clearing Corporation shall rank all bids received, and in the event that a Clearing Member does not submit a bid then they shall be ranked last, preceded by the least competitive bid received and ending with the bid that was closest to the successful bid.
- (h) The Clearing Corporation shall use the ranking performed in (g) to allocate losses as appropriate.
- (i) In the event that the Clearing Corporation determines that none of the bids received during an auction are reflective of the risk of the Open Contracts, then it shall declare

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the auction to be closed. In such an event the Clearing Corporation may carry out a further auction if it considers that such action would be appropriate.

- (j) If the Clearing Corporation determines that it would not be appropriate to carry out a further auction, then it may resort to seeking to close out the Open Contracts in the market in accordance with Rule H.2.1, or to perform compulsory settlement in accordance with Rule I.5.