

**Communication of the Association of Global Custodians  
European Focus Committee  
Subject to Supplemental Commentary**

30th June 2016

**By electronic submission**

European Securities and Markets Authority  
[www.esma.europa.eu](http://www.esma.europa.eu)

**Re: AGC Response to ESMA's Consultation Paper on Guidelines on participant default rules and procedures under CSDR**

Dear Sir/Madam:

The members of the Association of Global Custodians' European Focus Committee (the "Committee")<sup>1</sup> are grateful for the opportunity to provide comments in response to the above-captioned Consultation Paper issued by ESMA.

As a general, preliminary point, the Committee notes that this consultation is very tightly focused on CSD rules and procedures in the event of a default/insolvency of a direct participant in the CSD. This is clearly an important and relevant focus. However, it is also important to note that a CSD, as a central safe-keeper, and as the operator of a settlement system, is impacted by the insolvency of any trading party in the issuance and custody chains (i.e. by the insolvency of issuers, and of trading parties/investors that use an intermediary to access the CSD). CSD rules and procedures relating to insolvency procedures as well as (more broadly) to settlement discipline must take into account the possibility that an issuer or investor, or indeed another intermediary in the issuance and custody chains, may themselves enter into insolvency, and, furthermore, that intermediaries (issuer agents, custodians) may also have to manage the insolvencies of *their* clients.

**Q1: Do you consider other stakeholders should be involved in the definition of the default rules and procedures of a CSD? If so, which ones, and what should be the level of their involvement?**

A1: We believe it is essential to involve all CSD participants (including other CSDs, CCPs and their respective general clearing members, Recovery and Resolution Authorities, T2S Community, Central Banks and Supervisors of CSDs) in the preparation of such procedures.

The respective recovery & resolution authorities must in our view be part of this discussion. Any plan for a default procedure will have to be dealt with by the respective resolution authority responsible for the defaulting CSD participant: planning for any change of responsibility needs to take this into consideration. In the event of a default of a bank (direct/ indirect CSD participant depending on local legislation as outlined under Settlement Finality Directive ("SFD")), the respective authority will take over the administration of that entity and can decide to run the bank as a going concern for the time being.

In this connection, the role of payment banks and their relationships to CSD participants need to be considered. If a CSD participant utilizes a payment bank to gain access to central bank money, the default of the payment bank could impact the CSD participant's ability to settle its RvP instructions. In this situation, a switch to another payment bank is necessary to enable the CSD participant to fulfil its obligations.

In addition to CSDs, we believe it essential to include the T2S community as a whole in this review. We note that CSDs migrating to T2S have signed the so-called "Collective Agreement", which addresses among other things the legal requirements stemming from the SFD and operational requirements for relevant scenarios of the insolvency of CSD and NCB participants. This aspect is especially important to consider in the context of

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<sup>1</sup> The members of the Association of Global Custodians are: BNP Paribas Securities Services, BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor & Treasury Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and Trust Company.

cross-CSD settlement where non-harmonized default rules and procedures on cross-CSD transactions can impede the recovery & resolution process. We believe it is important that the ESMA Guidelines in relation to the application of CSDR Article 41 and the operational approach established under the T2S Collective Agreement are applied consistently.

Finally, we suggest that ESMA clarify in the final guidelines that the default procedures also cover situations where the defaulting participant is another CSD or a CCP.

**Q2: Do you think that such acknowledgement process is appropriate? In particular, do you consider it necessary for the CSD to verify the information regarding the default with the designated authority under the SFD before the CSD can take any action, or should the CSD be able to start taking actions based on its reasonable assessment of the participant's situation and on the reliability of the source that informed the CSD in the first place?**

A2: We believe that existing approaches should be considered in order to develop the right process.

The Committee believes that the management of a participant's default must be closely aligned with the recovery & resolution requirements and mechanisms applying to Banks and / or FMI. Entering into resolution is not a decision undertaken by a respective participant but rather by the responsible resolution authority or, if the participant is not a bank, a court. As a result, the responsible authority should be required to notify the CSD of the commencement of resolution.

The T2S Collective Agreement describes situations under which local legislation already forces CSDs to take action in response to a default. In principle, CSDs can only take action if they have "reliable" information about the default of a CSD participant (whether that participant is direct or indirect). The definition of reliable information differs across jurisdictions currently. A common approach to this would be beneficial by harmonising expectations.

In a real-time settlement engine, the precise time of the receipt of the default notification should be recorded: there may be a time-gap between the time the court/resolution authority declares the default and when the CSD receives notification. Due to settlement finality practices, transactions may have settled between the time the default is declared and the time a CSD receives the default notification.

Different considerations may arise if a resolution decision is made by an authority outside the context of the EU BRRD. However, practically speaking, this scenario currently should arise only in situations where CSDs recognise indirect participants. Because invocation of insolvency procedure can have far-reaching consequences, particularly if done incorrectly, we believe the CSD should only rely on public information to the extent that it comes from a regulatory authority responsible for the insolvency or recovery of the relevant participant(s). In the case of non-EU participants, the regulatory authority for the CSD could be expected to enter into cooperation agreements or MOUs with the third-country participants' regulators to obtain the information.

**Q3: Do you consider that the actions listed are appropriate, or that other actions should be listed? Should certain actions be mandatory, depending for instance on the type or size of default, the characteristics of the participant or the CSD or any other criteria?**

A3: We disagree with the suggested guideline. In principle it might be prudent to suspend a CSD participant for a short period to fully understand the consequences of the participant's default. However, we believe that such a decision can only be made in cooperation with the resolution authority handling the respective default.

We believe that a suspension might interfere with or disrupt an otherwise orderly restructuring or wind-down process if the movement of assets pursuant to pending trading contracts could no longer be completed or settled (especially if under the supervision of an administrator), especially when used for risk-divesting purposes. At a transaction level, the guidelines should take into consideration the different steps in the settlement finality process that any transaction goes through from the moment it is entered into the settlement system (SF1) over the binding matching of the transaction (SF2) to the final and irrevocable

settlement of the transaction (SF3). While transactions in SF1 could still be cancelled unilaterally, a transaction at SF2 could only be cancelled bilaterally and would hence require the agreement of the trading party.

When considering the status of transactions, we encourage supervisors to apply a common approach especially in cases of cross-CSD settlement. In particular, an insolvency procedure should provide clarity on the insolvency regime applicable in situations where (for example) French securities are to be settled between a German and Italian Counterpart through their respective CSD accounts in the CSDs of their respective home-countries (i.e., Germany & Italy).

With regard to client-facing business undertaken by a defaulting CSD participant (e.g., custody business/non-proprietary account), it is important that the impact of a termination or suspension of that participant's access to the CSD be minimised. From a systemic perspective, and to minimise market disruption, and taking into account the safeguards in place under MiFID/ CSDR which ensure that client assets are clearly differentiated from proprietary assets, efforts should be made in collaboration with the resolution authority to maximise the possibility for continued settlement of client activity. A suspension or termination of client activity would prevent the defaulting participant from earning additional income in order to pay potential claims and, even worse, it would significantly damage the defaulting participant's client business by no longer being able to deliver/receive traded securities. This in turn would render it subject to buy-in and penalty procedures under the CSDR. We therefore believe it is of utmost importance that transactions resulting from a participant's client portfolio can continue to move to non-defaulting participants.

An immediate "termination" of access by a CSD participant might undermine the granting of relief by a court (e.g., an order permitting the ongoing performance of activities). The Committee believes that the guidelines should take this possibility into account. In addition, the rules of CSD should avoid 'cherry-picking': blocking liquid securities or cash movements may inappropriately harm the fulfilment of liabilities of a participant in favour of its counterparts.

Finally, the guidelines should take into consideration that in some countries CSDs may also require specific procedures for so called "indirect participants", i.e., a client of a custodian which is expressly identified or identifiable by the CSD (in general, a segregated client). We believe that such recognition is of utmost importance to ensure that the regular custody business of a custodian can continue to be processed if one of its clients is in default. We reiterate that to invoke the insolvency procedure, the CSD should use reliable information stemming from the relevant regulatory authority managing the process.

#### **Q4: Do you think other items should be included in the internal plans?**

A4: We believe that the suggested items are reasonable and that they should be part of the licensing process. Moreover, we believe that such plans should be reviewed periodically, as the legal framework may change over time.

#### **Q5: Do you think that information on the implementation of the default rules and procedures should be transmitted to other stakeholders? If so, which other stakeholders?**

A5: We believe the list in principle is acceptable, but we encourage ESMA to include central infrastructures to which CSDs may have outsourced the processing of their business. In particular, we refer to T2S where an alignment process between participating CSDs would be desirable (see recommendations of the T2S Ad-Hoc Task Force). Also, as CSDs may be involved in the central bank accounts of participants, we believe Central Banks should participate in this discussion. Finally, the relevant supervising authorities and resolution authorities of participants should be included.

#### **Q6: Do you think that such testing and reviewing processes are appropriate?**

A6: In principle, testing may be useful, but it should also involve custodians/settlement agents in order to ensure identification of concerns that may arise in connection with the default of a "client of a CSD participant"; in any case, these testing activities should be done in close cooperation with the relevant authorities managing the default.

We are grateful for the opportunity to provide our contributions in response to ESMA's consultation. Please do not hesitate to contact the undersigned should you wish to discuss any of the above.



John Siena

Chair, European Focus Committee  
Association of Global Custodians