London Stock Exchange Group Response to ESMA consultation on "Guidelines for participant default procedures under CSDR"

Introduction

London Stock Exchange Group (LSEG) is a diversified international market infrastructure and capital markets business sitting at the heart of the world's financial community. The Group can trace its history back to 1698.

The Group operates a broad range of international equity, bond and derivatives markets, including London Stock Exchange; Borsa Italiana; MTS, Europe's leading fixed income market; and Turquoise, a pan-European equities MTF.

Post trade and risk management services are a significant part of the Group's business operations. In addition to majority ownership of multi-asset global CCP operator, LCH Group, LSEG operates CC&G, providing clearing services for a range of European securities as well as exchange traded equity and commodities derivatives; Monte Titoli, a CSD successfully migrated in Target 2 – Securities settlement platform; and globeSettle, the Group's newly established CSD based in Luxembourg.

In this context we welcome the opportunity to respond to ESMA consultaion on ***"Guidelines for participant default procedures under CSDR"***.

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Part A. General Remarks

- We welcome ESMA's initiative to issue guidelines on participant default rules and procedures under Regulation (EU) No 909/2014 of the European Parliament and of the Council on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation No 236/2012 ("CSDR"). We fully support this initiative, which is in line with the objectives we highlighted in our response to the European Commission's Consultation on Capital Markets Union, more specifically in relation to the harmonisation of insolvency procedures.

- In this regard, we would welcome an **extension of the scope of this harmonisation exercise.** Indeed, the proposed guideline will only cover CSD participant default procedures, whereas **we believe it would be greatly beneficial if ESMA could issue guidance to all systems covered by the Settlement Finality Directive ("SFD"),** and therefore include payment system operators, and CCPs. This is necessary to ensure a smooth management of a default at all level of the post-trading environment.

- While we understand that ESMA's choice is to stay close to SFD definition of default (i.e. a situation where insolvency proceedings are opened against a CSD participant), we believe that part of the guidelines should also be dedicated to other events of contractual "default", and the corresponding interactions between CSD and CCPs. This way, the guidelines will cover the full "chain" from trading to clearing and settlement, thus reducing the possibility of a lack of harmonisation and potential systemic issues.

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Part B. Responses to Questions

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?

1. As mentioned in the general remarks, ESMA guidelines should address all systems covered under SFD. To this end, the list of stakeholders that, we believe, should be involved in the definition of the procedure should **include the operator of the relevant payment system** which manages the cash component of the settlement for CSDs and which do not hold a banking licence. In this case, there should be a close coordination between the procedure applied by the payment system operator (i.e. NCBs) and the CSD, to ensure smooth management of delivery versus payment ("DVP") transactions pertaining to the insolvent participant.

   Concerning the level of involvement of the different stakeholders, we recognise that market infrastructures and other CSD participants will be directly impacted by the CSD default rules, and therefore, should be consulted on the definition of the procedures. In this context, it should be recognised that the role of market infrastructures (including trading venues, CCPs, operators of the payment system, and in some cases other CSDs) is different from the one of other CSD participants.

   For instance, the interactions between CCPs and CSDs are crucial for managing the risks of all markets participants. Hence the guidelines should recognise the specific role of CCPs, and adequately enable CCPs to manage risks on behalf of their participants.

   However, the level of involvement of market infrastructures in developing a CSD participant default rules and procedures also depends on the operational models adopted between these market infrastructures and the CSD operating the relevant SSS.

   According to our experience, the operational aspects that might be of relevance are:

   - the role assigned to the market infrastructures by domestic regulation dealing with the insolvency of a market/clearing/settlement participant;
   - for CCPs and trading venues, the set up chosen by the market infrastructure to input the settlement instructions;
   - for other CSDs, operational differences deriving from link set-up, in particular standard vs. inter-operable links.

   Whilst we believe that ESMA guidelines should recognise the specific role played by market infrastructures in the context of the default rules and procedures, we don not recommend thatthe level of involvement of those stakeholders is specified in detail
   in order to accommodate the variety of operational models that exist int he industry..

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?

1. We welcome ESMA's initiative to provide guidelines on the "acknowledgment process". Since the SFD does not fully address this topic, further harmonisation would be helpful in this regard.

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However, we suggest that ESMA considers whether the inclusion of a detailed mechanism in the guidelines, as proposed in this consultation, is an appropriate solution. Indeed, the "acknowledgement process" might have already been specified **by national regulation implementing SFD.** A survey conducted among CSDs in T2S showed that national regulations adopted different approaches in this regard. For instance, some CSDs only activate their default procedure upon notification by their own competent authority, while other CSDs can decide to trigger it when they are made aware by a third party, without official notification.

For instance, according to the Italian SFD implementing provisions, the CSD is notified by its home designated competent authority about the default. However, in the case where the CSD receives the information from other sources, it can decide to trigger the default procedures **without further controls,** and is only required to inform its competent authority about **when and how** it has been informed of the default.

After the implementation of T2S, all CSDs agreed on a procedure for the dissemination of the information in case of a participant default. This procedure also covers the minimum information that should be transmitted, including among others:

- Identification of the sender;
- Identification of the insolvent participant: legal name / BIC code (if and when possible);
- Identification of the insolvency proceeding;
- Date of the opening of the insolvency proceedings;

As a result, Monte Titoli's activates its default procedure when: (i) it is made aware of insolvency according to the operational procedure agreed within T2S (i.e. a call among CSDs after which the information is broadcasted); or (ii) it is notified in writing by a third party (including by a participant, a central counterparty, a trading venue or the operator of a payment system) which is liable for the accuracy of the information provided.

2. With regard to the information that a CSD should provide to its competent authority, we suggest the following amendments:

- **"number of clients concerned":** assuming that ESMA is referring to the clients of the defaulting participant, it should be recognised that CSDs do not commonly have access to this information, and are not able to obtain such information once the insolvency proceeding has been opened. Hence, this information should not be required, or at least it should be provided only **"when available".** By contrast, CSDs are able to provide the numbers of participants who are counterparty to the insolvent party which would constitute a more relevant information to assess systemic risk;

- **"information on any risk such default might entail":** we think CSDs should not be expected to provide a "qualitative" risk analysis of the default of a participant. We believe this objective should be achieved through the assessment by the regulators of the quantitative information that should be provided by the CSD, as per the proposed guidelines. This quantitative data should be considered a good proxy for the systemic impact of the default. **We, therefore, recommend removing this requirement from the list.**

3. As noted in the general remarks, a CCP can declare a default on basis that are different from insolvency proceedings, for instance, in the case where a member of the CCP has failed to comply with a contractual obligation under the CCP rules. Whilst not a "default" under CSDR, the effect of this event on the settlement side might need further guidance to ensure an appropriate treatment within the procedures of the CSDs.

   We also believe that CCPs and other market infrastructures should be very closely informed during the acknowledgment process to ensure that consistent and appropriate actions are taken across the market (e.g. suspension of trading access and clearing activity).

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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?

1. We support ESMA's proposal to specify a **non-mandatory and non-exhaustive** list of actions to be included in CSD participant default rules and procedures. Indeed, the actions a CSD needs to take in order to manage the default of a participant may vary depending on the domestic regulations it complies with.

   In our view, what matters most from a CSD participant perspective is that the procedure is clear and transparent regarding the type of actions that a CSD may take and the criteria established to trigger them. This approach will enable all CSD participants to assess the impact on their risk models of the CSD default management procedure.

2. We would welcome some clarifications on the following actions listed in the proposed guidelines: **"(c) changes to the normal settlement practices;"**

   We would find it helpful if ESMA could provide guidance on:

   - the scope of the changes to the normal settlement market practices, and particularly if changes to the minimum settlement functionalities prescribed under the RTS on CSDR settlement discipline are included. More precisely, further clarity would be beneficial on whether recycling, partial settlement, and hold & release should be applied in case of insolvency of a participant;
   - the coordination of the changes to the normal settlement practices with the buy-in procedure activated on transactions input by the insolvent participant before the insolvency procedure was opened. According to our understanding of the level 1 text, neither buy-in nor penalties shall be applied when an insolvency proceeding was opened for a participant. In light of the procedure set out in the RTS, it is not entirely clear to us what should happen if, for instance, the insolvency proceeding is opened in the middle of a buy-in execution period.

   To the extent possible, we would also like to point out that the impacts on the non-defaulting participants should be considered when taking actions toward pending settlement instructions or making changes to normal settlement practices under and in compliance with SFD rules.

3. Finally, although we recognise that harmonisation of actions taken under insolvency procedure may imply changes to national and European laws, we believe that further work in this regard should be undertaken by the relevant institutions to provide legal certainty to participants (i) on the status of their (pending) settlement instructions towards the defaulting participant. (ii) to stabilisation of the portfolio and subsequent "close out".

   For instance, from a CCP point of view, we would recommend that access of the defaulting participant is blocked indefinitely and/or instructions are removed from the platform[1].

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

1. Paragraph 23 requires all CSDs to have "internal plans" delineating the roles, obligations and responsibilities of the various parties. Whilst we believe that this requirement could be appropriate for CSDs which manage financial exposure of defaulting participants, we think it is not proportionate for the majority of non-bank CSDs, for which it would just duplicate the default procedure. Therefore, we suggest amending the guidelines to introduce a distinction between bank and non-bank CSDs for this requirement.

[1] Under the condition that settlement under SFD has been attempted with the defaulting member, but failed due to non-availability of cash or securities.

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In both cases, it should be a requirement that external impacts of the plan or procedure shall be disclosed to the CSD participants.

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?

1. For paragraph 24, we would welcome ESMA's clarification on the *"information on implementation of insolvency procedures"* , and whether it refers to the document describing the procedure itself, or to the actions taken when the CSD applies such procedure. In the first case, provide this information will not be an issueand will be publicly available. In the second case, we believe that the information needing to be shared with competent authorities would already be covered by the reporting requirements and cooperation arrangements provided both under SFD and CSDR.

   With reference to information flows towards participants, we think that the timing and degree of details should be calibrated to(i) the actions required by these stakeholders, (ii) the coordination needed across the market as a whole and (iii) the operational flexibity CSDs needs to deal with contingent insolvency issues on a case by case basis. Indeed, in case of insolvency, CSDs' priority is to undertake operational actions to contain the impact of insolvency on its system and on the other linked sytems. Information flows from CSD towards participant should be designed for this purpose. Priority should be given to market infrastructures in light of their particular role and their links with other participants (such as clearing members, trading venues, payment systems). Whilst we don't believe that CSDs shoud be subject to a mandatory timetable, we would, still recommend that CCPs, trading venues and market infrastructures are informed as soon as reasonably possible.

2. We would recommend that ESMA considers amending paragraph 26 of the proposed guidelines, whereby *"the competent authority may request to be informed by a CSD of any action the CSD intends to take with respect to the default of one or more of its participants prior to the implementation of such action."* Indeed, we believe it would be beneficial to clarify that such "prior notification" by the CSD does not mean a request for approval from the authority before the action is implemented.

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

1. No specific comment.

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