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ESMA consultation ESMA/2016/732 -

Guidelines on participant default rules and procedures under CSDR

Euroclear Group response

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We welcome the opportunity provided by ESMA to provide our input on the proposed Guidelines on Participant default rules and procedures under CSDR.

General comments

We find the clarifications of the scope of the Guidelines and the definition of "default" in in the introductory part of the consultation document (paragraphs 4 and 6 on page 7) very helpful. We propose to incorporate them in the Guidelines themselves.

Although we believe ESMA should try to minimize the cases where application of the Guidelines could be in violation of local insolvency law, SFD implementation or other obligations like confidentiality, we nevertheless recommend including a general clarification in the introduction that the requirements in the Guideline are subject to such laws.

Procedure for establishing participant default rules

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?

Euroclear takes note of ESMA's proposal, in paragraph 12, that *"a CSD should involve its participants and other relevant market infrastructures (CSDs, CCPs and trading venues) in developing its participant default rules and procedures".* As regards the involvement of CSD participants, this can take various forms and CSDs may rely on existing fora such as user committees.

Generally, other financial market infrastructures are standard participants and will be treated like other participants when the CSD manages an insolvency event. Therefore, a special dialogue with other FMIs might not be required.

Acknowledgement of a participant's default

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?

Euroclear does not agree with the acknowledgement process in paragraphs 14 to 17 of the proposed guidelines and believe they must be deleted.

The proposed system which is solely based on the exchange of notifications between national competent authorities designated in accordance with the SFD is in contradiction with the requirements of the SFD. In the SFD, the time at which there is awareness of the CSD as the operator of a designated system regarding the opening of the insolvency proceeding is relevant to determine whether or not transfer orders are legally enforceable and binding on third parties.

Indeed, in the jurisdictions we are familiar with, the CSD is required to take actions based on information available to it, its reasonable assessment of the defaulting participant's situation and on the reliability of any source(s) of information. Where a CSD has actual notice of an insolvency, it must be able to take action, in the interests of financial stability and minimising the impact of a participant insolvency immediately and without delaying pending confirmation by the competent authority (which from experience will not be sufficiently timely). Requiring a CSD to wait for an official confirmation or verification from the relevant authority could expose the CSD and other participants to high risks by preventing it from implementing its default rules and procedures in a timely manner, thereby being in breach of national insolvency and SFD legislation.

In addition, we believe that the requirements in paragraphs 16 and 17 may create unnecessary delays in the handling of the insolvency event and, where relevant, undue risk for the CSD, including if the CSD if authorised to provide banking type ancillary services.

In order to reflect the close link of this issue to insolvency law and local SFD implementation, we firmly believe it must be left to national law how a CSD should obtain information about an insolvency event. Harmonisation in this area would require amendments to the SFD and could not be achieved via an ESMA guideline.

Euroclear has the following comments regarding the list of information items set out in paragraph 18 which a CSD should transmit to its competent authority *"as soon as possible"* once a participant default is confirmed:

- The requirement to transmit the information *"as soon as possible"* might put undue pressure on the CSD whose first priority should be to manage the default event and limit its impacts on the market. We do not object to providing the proposed information, but propose to change *"as soon as possible"* into *"in due course".*

- *"The value and volume of the defaulting participant's settlement instructions that are pending settlement and if possible of those that may fail to settle,"*
  Euroclear welcomes the use of the phrase "if possible" by ESMA because it will often not be possible for a CSD to distinguish those instructions that "may fail" from other instructions among the pending settlements. Also, all pending settlement instructions may fail to settle if, for example, the defaulting participant is suspended.

- *"the number of clients concerned*,"

Euroclear believes that the word "clients" should be replaced by "participants" as the relevant consideration is those counterparties to transactions which may no longer settle. Indeed, CSDs should only be required to provide information about entities (or individuals) with whom they have a contractual relationship.

This is without prejudice to so-called "direct holding markets" where CSDs maintain end investor accounts and where domestic regulators may request the CSD to provide information on those investor accounts affected by a CSD participant default.

- *"information on any risks such default might entail."*

Euroclear believes that in most cases, the main risk, i.e. risk of settlement failures, will be both obvious and already known to the competent authority. The specific details of settlement failures will be assessed by providing the information listed above on the number of pending transactions and impacted participants. We also think that, in case of a participant's insolvency, it is not the role of CSDs to provide a "qualitative" risk analysis. They should only be expected to provide quantitative information to regulators, allowing regulators to assess risks with their own methods and criteria. Therefore, Euroclear recommends deleting this point from the list. The priority of regulators should be to receive timely and objective information on a default, rather than a detailed risk analysis which is beyond the scope of a CSD.

Although the question has not been raised by ESMA, we would like to encourage authorities, in close coordination with FMIs, to work on developing a standard form of notification template for use in a default scenario. It should would contain information essential for FMIs in different jurisdictions. Use of a harmonised template would minimise the need for FMIs and their participants to reach out to other sources to obtain basic information.[1]

Actions a CSD may take in case of default

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?

It is essential for a CSD to be able to manage a default event within the limits of applicable insolvency legislation, local legislation implementing the SFD and the contractual rules of the CSD. As a consequence, we do not believe any of the actions listed in the Guidelines should be mandatory.

More specifically, the proposed Guidelines foresee that participant default rules and procedures should include at least:

(a) suspension of the defaulting participant's access to all or part of the CSD's services and functionalities; and

(b) termination of the defaulting participant's access to all or part of the CSD's services and functionalities.

In a default event, the main urgency for the CSD will be to minimise the disruption to the system and its other participants caused by an insolvency and to take the necessary steps to ensure that the defaulting participant can no longer enter new instructions into the system without the approval of the insolvency administrator. This can be achieved by temporarily blocking the Participant's technical ability to enter new instructions and, in our experience, is generally what is done. Some CSDs will refer to this as a suspension. The CSD must be able to lift the suspension when an arrangement has been found with the administrator for communicating new instructions. In any event, the

[1] A harmonised notification template would also be beneficial in the area of resolution given the complexities of such events.

administrator will need to be able to deal with and dispose of assets held in the CSD as part of the winding up of the insolvent entity. Therefore, suspension must be part of the CSD's tool kit, but the CSD will need discretion as to when, to what extent and for how long to use it.

While termination can be part of the default management tool kit, it might not always be relevant or possible. Indeed, there is no reason to terminate the relationship with a participant merely on grounds of insolvency. In some countries, a CSD risks infringing the law if it terminates a participation agreement solely on the basis of a default declaration.

However, the CSD must have the right to terminate a participant's access to some or all CSD services if the circumstances change and the defaulting participant no longer meets the participation criteria (e.g. change in regulatory status) or breaches its contractual obligations (e.g. unpaid fees).

We propose to address the above concerns by amending the introductory sentence in paragraph 19 to say: *"The default rules and procedures of a CSD should at least provide that the CSD has the right to take the following actions:"*

We also believe that some of the actions to be included "where relevant" in the default rules and procedures should be amended or clarified. More specifically:

- *"(d) changes to the treatment of proprietary and customer settlement instructions and accounts, also considering the type of accounts (omnibus or individual client segregation);"*

  Omnibus client accounts and individually segregated accounts are both accounts opened by the Participant in the name of that participant. Only the participant or, in case the participant becomes insolvent, the insolvency administrator can instruct on these accounts. The CSD has no valid reasons to treat instructions on these accounts differently in a default scenario. Thus, the reference to omnibus or individual client segregation should be deleted.

  This differs from the business model in some CSDs where participant act as account operators for end investor accounts and where the operation of these end investor accounts could be transferred to another participant in case of a participant insolvency situation.

- *"(e) use of financial resources;"*

  We wonder whether this is a reference to SFD article 4 which provides that available resources and credit facility may be used to settle transactions on the day of insolvency. If so, ESMA might want to clarify this.

Implementation of the default procedures

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

We have no comments on this section of the ESMA document.

Communication on the implementation of the default procedures

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?

Euroclear recommends the following amendments to paragraph 24 of the guidelines:

- *"(a) The maximum time for the CSD to notify the defaulting participant of the actions*

taken or to be taken by the CSD following the default;"

Determining a "maximum time" could prove difficult for a CSDs given that some cases may be more complicated than others (e.g. if the information is hard to obtain from foreign jurisdictions). While the CSD can do its best to ensure swift communication, it would not be able to commit to a predefined deadline.

Therefore, we recommend rephrasing as follows: *"The CSD should notify the defaulting participant as soon as possible of the actions taken…".*

- *"(b) The timing and the mechanisms followed by the CSD to inform: i. its competent authority; ii. its relevant authorities; iii. its non-defaulting participants; iv. the trading venues and CCPs served by the CSD; v. the linked CSDs; vi. ESMA."*

  Relevant authorities should be informed by the competent authority of the CSD. This would be in line with the information flows foreseen in CSDR and it would ensure better coordination among regulators. Likewise, the competent authority should notify ESMA. Requiring all CSDs separately to notify all competent authorities, relevant authorities and ESMA will lead to a confusing web of duplicative notifications.

  Moreover, we urge ESMA to give consideration to the unintended consequences of obliging CSDs to inform non-defaulting participants, trading venues, CCPs and linked CSDs. Some market players may start relying on CSDs to provide information on the insolvency of other market players. This should not be the role and responsibility of CSDs.

For CSDs with private individuals as participants, it will be impossible to comply with paragraph 25 on the protection of personal data (participant information by definition will include information regarding individuals).

According to paragraph 26, *"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."* We are concerned that this sentence could be interpreted in a problematic way so we suggest to either delete it or to clarify that:

- Such a request by a competent authority should only relate to specific steps in specific default cases and should not apply every time the default procedure is applied. For purposes of providing the competent authority with more general information about insolvency events, some CSDs already have existing procedures in place to notify the competent authority of crisis meetings.

- Prior information should not be understood as prior approval on the part of the authority and it should be clarified that such information provision should in no way fetter the ability of the CSD to take timely action, for example when it has actual knowledge of a default event (for the reasons noted above). Indeed, time is of essence in the handling of insolvency events and there is a risk that a validation by the competent authority would result in delays in the application of the default rules and procedures, potentially exposing the CSD and its participants to unnecessary risks.

Periodic testing and review of participant default procedures

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

Paragraph 28 states that a CSD should perform tests on its participant default rules and procedures *"at least annually"*. We do not believe this frequency is required. In the absence of substantive changes to the default rules and procedures, we believe that it should be possible for a CSD to perform tests every 2 or 3 years, in agreement with the competent authority.

Furthermore, we believe that paragraph 28 should refer to *"the entity settling the cash leg of transactions in the systems"* rather than *"payment systems",* to take into account the fact that CSDs do not always settle the cash leg of securities instruction in a payment system.

As regards paragraph 29, ESMA should acknowledge that regular tests should be proportionate to the specific circumstances of a CSD, and that a CSD should be able to limit the scope of the tests to the most relevant actions for its circumstances. Moreover, if a CSD has handled one or more real insolvency events during the testing period, this should be counted as a test and the CSD should be given discretion to determine whether further testing is necessary.

Finally, we recommend clarifying the reference to *"participants holding different types of accounts (omnibus and segregated)"* in paragraph 29. Indeed, the type of account opened by a Participant is not a relevant criterion for the purpose of testing default scenarios (see also our response to question 3).

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