

ESMA
103 rue de Grenelle
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22 May 2014

LCH.Clearnet Group Limited response to the ESMA discussion paper on the Draft Technical Standards for the Regulation on improving securities settlement in the European Union and on central securities depositories (CSD).

Dear Sir, Madam

This letter provides the response of LCH.Clearnet Group Limited¹ ("LCH.Clearnet") to the ESMA discussion paper on the draft technical standards of the CSD Regulation issued in March 2014.

The LCH.Clearnet is the leading multi-asset class and multi-national clearinghouse, serving major international exchanges and platforms as well as a range of OTC markets. It clears a broad range of asset classes, including: securities, exchange-traded derivatives, commodities, energy, freight, foreign exchange derivatives, interest rate swaps, credit default swaps and euro, sterling and US\$ denominated bonds and repos. LCH.Clearnet works closely with market participants and exchanges to continually identify and develop innovative clearing services for new asset classes. LCH.Clearnet Group Ltd is majority owned by the London Stock Exchange Group² ("LSEG"), a diversified international exchange group that sits at the heart of the world's financial community.

LCH.Clearnet appreciates the opportunity to respond to the discussion paper and provide input into the development of the relevant technical standards. We would like to clarify that the response is based on the CSD Regulation text adopted by the European Parliament in its 15 April 2014 plenary session.

LCH.Clearnet focuses its response on section *III.1 Settlement Discipline* of the discussion paper.

¹ The Group consists of three operating subsidiaries: LCH.Clearnet Limited, incorporated in the UK, LCH.Clearnet SA, incorporated in France, and LCH.Clearnet LLC, domiciled in the United States.

² LSEG is headquartered in London, UK, with significant operations in Europe, North America and Asia, and operates a broad range of international equity, fixed income and derivatives markets, including: London Stock Exchange; Borsa Italiana; MTS, and Turquoise; post trade and risk management, including CC&G, the Rome headquartered CCP and Monte Titoli, the European settlement business; and is majority owner of the leading multi-asset global CCP, LCH.Clearnet Group. LSEG operates also the EMIR authorised trade repository, UnaVista.

General remarks on the CSDR buy-in regime

We agree that settlement rigour is important and that the industry should maintain vigilance on ensuring that fails do not become a problem. However, we do not believe that there is a problem with settlement fails in respect to fixed income securities and are very concerned that the buy-in regime designed by the CSD Regulation could create genuine new issues for the repo market.

The CSD Regulation's approach of applying different buy-in procedures and timeframes depending on the asset type and the liquidity of financial instruments is welcome. We believe ESMA should calibrate a buy-in process and timeframes for illiquid cleared shares that mitigate the incentives set in the level 1 text for market participants to move away from central clearing.

Finally, we would like to emphasise that mandatory buy-ins should only apply after the last wave to the T2S project, because, until then, some fails are likely to occur because of settlement infrastructure's issues, not intentionally (e.g. based on a decision by a dealer to not make a delivery).

Overarching remarks on ESMA's discussion paper

- We support an extension period of 7 business days, from the intended settlement date, before the buy-in procedures are triggered for ETFs, both cleared and non-cleared, and fixed income securities.
- We encourage ESMA to take into account trading volume, available free-float and number of liquidity providers when defining the liquidity of an instrument.
- We urge ESMA to clarify that repurchase transactions in triparty environments are excluded from the scope of the settlement discipline regime.
- We would like to point out that reference to the original trade price and original trade source cannot be applied to compensation calculation performed by the CCP, because a single failed settlement instruction may be the net of many trades from many trade sources.
- We encourage ESMA to clarify that the circumstances under which a buy-in is considered not possible should be pre-determined and pre-agreed between the CCP and its competent authority in respect of a specific set of instruments. The CCP should not be required to seek approval from the competent authority on a case by case basis, because it would slow down the decision-making process of the CCP and add unnecessary risk to the buy-in procedure.
- We invite ESMA to clarify that the exemption for the repurchase transactions included in the level 1 text of the CSD Regulation applies to both the opening leg and the closing leg. We agree with ESMA's view that for repurchase transactions, buy-ins will be ineffective where the intended settlement date of the opening leg of the repo plus the extension period and execution period of the buy-in is equal to or later than the intended settlement date of the return leg of the repo transaction.
- We believe that it is not appropriate to introduce disincentives if settlement instructions are not received by the CSD by the end of ISD-2. On the basis of the T+2 settlement cycle, ISD-2 corresponds to the trade date; it can be very difficult for all settlements to be matched on the trade date. In addition, fixed income securities typically settle on T+1 or T+0; therefore in many cases a trade that settles on ISD has not yet been executed on ISD-2.

- We do not support the inclusion of the “trade date” as a mandatory matching field because it is not a piece of data which can be accurately provided at a settlement instruction level following a netting process.

Detailed comments on ESMA’s discussion paper

Measures to prevent settlement fails (Article 6(4))

Comment on para 18

ESMA proposes that the “trade date” should be one of the standardised matching fields for the settlement instructions. We would like to highlight that it is not possible to identify a single trade date for each settlement instruction; settlements which are generated as a result of the netting of several transactions within a CCP (particularly, but not exclusively, in relation to repo transactions) do not necessarily relate to a single trade date; thus “trade date” is not a piece of data which can be accurately provided at a settlement instruction level following a netting process.

Comment on para. 23

ESMA proposes that settlement instructions which are not received by the CSD by the end of ISD-2 should be subject to disincentives by the CSD. We would like to highlight the reasons why this proposal is not appropriate.

After 6 October 2014 most T2S markets will migrate to the T+2 settlement cycle, therefore ISD-2 will correspond to the trade date; we would like to point out that not all matching instructions will always be sent to the CSD on the trade date. While a high majority of trades are automated through STP processes, in the participant chain from *client - executing broker - Clearing Member* there are multiple steps and mechanisms of confirmation which make it very difficult for all settlements to be matched on the trade date. This is especially the case with bilateral OTC transactions and for buy-side clients, some of whom may be offshore in a different timezone (US or Asia), and therefore match the following day. It is important to note that these issues are not unique to the European market. Therefore, applying disincentives could create high frictional costs, particularly in the equity markets.

In addition, ESMA’s proposal would create issues for CCPs operating the methodology CNS (Continuous Net Settlement), such as LCH.Clearnet SA, because this methodology will not allow sending instructions to the CSD on the trade date, after the migration to T+2. Effectively the CCPs would send the CNS instruction at ISD-1, which equals to the end of T+1.

In respect of Fixed Income settlement, the settlement convention varies by market but instruction takes place on either ISD-1 or on ISD itself, corresponding respectively to either a T+1 or T+0 settlement convention. The settlement instruction timetables utilised by LCH.Clearnet correspond to these market conventions. Therefore, in many cases a trade which is to be settled on ISD has not yet been executed on ISD-2.

Details of operations of the appropriate buy-in mechanism: extension period (Article 7(14)(d))

Q13: CSDR provides that the extension period shall be based on asset type and liquidity. How would you propose those to be considered? Notably, what asset types should be taken into consideration?

We would like to highlight a mis-quote in para. 48 of the discussion paper, before responding to the question. The wording in para 3 of article 7 is not consistent with the wording in the CSD Regulation text adopted by the European Parliament in its 15 April 2014 plenary session. We based the response to the question on the wording of the aforementioned text; this prescribes that *on ISD+4 a buy in process shall be initiated* against the failing participant, not that *the failing participant shall be subject to the buy in on ISD+4*. This wording ensures that the buy-in process starts on ISD+4, reflecting the intended flexibility in respect to the beginning of the effective execution period of the buy-in.

We agree with ESMA's recommendation that ETFs should be subject to a longer extension period up to ISD+7 given the significant number of underlying financial instruments that need to be bought in on several markets; in addition, ETFs have a structural disadvantage in meeting a tight deadline for settlement where they access physical underlying securities in foreign markets. Such characteristics are not dependent on whether ETFs are cleared or not cleared, therefore we invite ESMA to clarify in the draft RTS that such flexibility in the extension period is valid for both cleared and not cleared ETFs. On ETFs there are already cross-border settlement issues due to the high proportion of OTC trading (60% of ETFs are traded OTC vs 40% cleared) and multiple listings on exchanges (and therefore settlement through at least 5 CSDs), which means that the length of settlement delivery is longer; hence the statistically higher fail rates on these markets. Having a buy-in procedure triggered at ISD+4 only exacerbates the problem and decreases liquidity; ultimately this drives ETF trades out of clearing and away from transparency. For the above reasons, we believe that the appropriate extension period for ETFs is ISD+7.

We further agree with ESMA's recommendation that a longer buy-in period for Fixed Income securities is appropriate and suggest an ISD+7 extension period be adopted.

We appreciate that ESMA will refer to MiFIR's definition of liquidity to assess whether a security is not sufficiently liquid and therefore may be subject to an extension period of ISD+7 maximum. However, we would like to highlight that i) trading volume, ii) available free-float and iii) number of liquidity providers (e.g. market makers) are all important factors to measure liquidity.

We fully support ESMA's arguments in favour of a longer extension period for less liquid instruments in para.51. Indeed, ISD+4 may be an appropriate timeframe to trigger the buy-in procedures for liquid securities, but it does not work for less liquid securities. This is consistent with the recital 16 of the CSD Regulation, which notes that the settlement discipline should be scaled *'in such a way that maintains and protects liquidity of the relevant financial instruments. In particular, market making activities play a crucial role in providing liquidity to markets within the Union, particularly to less liquid securities'*. However, article 7(5) of the CSD Regulation contradicts the recital and, indeed, ESMA' arguments, because it prevents illiquid shares cleared by CCPs to avail of the prolonged extension period of ISD+7. We would like to highlight such inconsistency to ESMA and the adverse impact that it could have, by creating incentives for market participants to trade in non-cleared shares. Please note our comment in the answer to question 14 on the need for ESMA to calibrate a buy-in process and timeframes that mitigate such incentives for market participants to move away from central clearing.

Details of operation of the appropriate buy-in mechanism (Article 7(14)(c))

Q14. Do you see the need to specify other minimum requirements for the buy-in mechanism? With regard to the length of the buy-in mechanism, do you have specific suggestions as to the different timelines and in particular would you find a buy-in execution period of 4 business days acceptable for liquid products?

We believe there is no need to specify other minimum requirements for the buy-in mechanism and we agree with ESMA that a buy-in execution period of 4 business days is acceptable for liquid products. However we would like ESMA to take into account the following points when drafting the RTS: the role of CCPs in the calculation of the cash compensation and the execution of the deferral period; the ability of CCPs to attempt buy-ins repeatedly during the execution and deferral periods; and the need to calibrate an execution period for illiquid cleared shares that mitigates incentives to move away from central clearing.

Para 10(a) of the level 1 text states that *'For transactions cleared by a CCP, the CCP shall be the entity that executes the buy-in procedure according to paragraphs 3 to 4a'*; this excludes the paragraphs of the article which deal with cash compensation and deferral period. We assume that the intention is that the CCP will also be in charge of the calculation of the cash compensation and the execution of the deferral period, and that this will be clarified in the final text to be published in the Official Journal.

We encourage ESMA to clarify in the draft RTS that the buy-in can be attempted repeatedly by the execution party in case it fails, both during the execution period and the deferral period, provided that it is done within the timeframes to be determined in the RTS for a given instrument. Similarly, in the case the buy-in is only partially settled, as noted under para. 55, we believe ESMA should also clarify that there would be the option for the executing party to attempt the buy-in before the cash compensation, provided it is done within the given timeframes for the execution period.

As noted in the answer to question 13, the CSD Regulation prescribes that the participants trading in shares cleared via CCPs are subject to ISD+4 extension period, even in the case of illiquid shares. This is in contrast with the prolonged extension period of up to ISD+7 for less liquid shares which are not cleared. The result is an unlevel playing field between cleared and non-cleared shares and an incentive for participants to move away from central clearing. As part of the RTS, it is vital that ESMA calibrates an execution period for illiquid cleared shares that mitigates such incentive. Our risk management analysis on illiquid shares shows that, even in normal markets, illiquid shares require a longer theoretical holding period for liquidation which takes into account the average daily volume traded and free float of the shares on offer. Setting a one-size fits all buy-in approach for both liquid and not liquid cleared shares will only trigger further inefficiencies in the market, as CCPs will be obliged to buy-in on shares that have no liquidity and the buy-in itself will lead to a further fail, thereby exacerbating the problems of failed settlement. This adds unnecessary delays and increased costs of trading in illiquid shares and deters potential trading or investment interests, thereby further increasing the illiquidity of the securities. While we appreciate that there may be issues around the practicability of applying different buy-ins approaches depending on the liquidity of the products, we fully support it for the above reasons.

Q15: Under what circumstances can a buy-in be considered not possible? Would you consider beneficial if the technical standards envisaged a coordination of multiple buy-ins on the same financial instruments? How should this take place?

We agree with ESMA's view that the executing party should decide whether the buy-in is feasible or not. However, ESMA also proposes that the decision should be preceded by the approval of the competent authorities *'and therefore sent for the CSD supervisors in advance'*.

Firstly, we believe that the need to get the competent authorities' approval on a business as usual matter would unnecessarily slow down the decision-making process of the CCPs, as executing party for cleared trades, which need to act promptly. It also seems contrary to the intention to leave the CCPs in charge of the decision. We strongly encourage ESMA to clarify in the final rules that such approval is not required on a case by case basis but should be pre-determined and pre-agreed between the CCP and its competent authority in respect of a specific set of instruments (e.g. illiquid instruments) and/or under specific scenarios (e.g. the security ceases to exist). This will ensure certainty for both the CCP and the market participants as to the cases where the buy-in '*fails or is not possible*' and it may be cash compensated or deferred as a result. Moreover, it will avoid the CCP and the competent authority having to deal with such issues on a case by case basis, adding unnecessary risk to the buy-in procedure.

Secondly, ESMA proposes notifying the 'CSD supervisors' about the feasibility of the buy-in. Where the executing party of a buy-in is a CCP, we believe it is the CCP's supervisor that should be notified.

Finally, the buy-in procedure does not specifically address settlement in relation to repo transactions where settlement is to be achieved via triparty settlement systems such as those supported by Euroclear Bank, Clearstream International and Euroclear UK and Ireland (Delivery-by-value (DBV) and Term DBV). Settlement in a triparty environment has a number of characteristics which are different to that of standard Delivery-versus-payment (DVP) settlement. In particular, the term nature of the settlement (with collateral automatically being returned to the giver at the end of the term) and the ongoing obligation to support mark to market transactions initiated by the triparty provider are significant. In this context the buy-in of collateral would not, in itself, be sufficient to support the settlement transaction on an ongoing basis, particularly in relation to triparty mark-to-market transactions. We would like to confirm that the intention of the CSD Regulation and related RTS is that settlements relating to repurchase transactions in triparty environments are excluded from the scope of the settlement discipline regime.

Q16. In which circumstances would you deem a buy-in to be ineffective?

We invite ESMA to clarify in the RTS that the exemption for repurchase transactions from the buy-in under Article 7(4)(b) of the CSD Regulation applies to both the opening leg and the closing leg of the repo transaction.

We agree with ESMA's view that for repurchase transactions, buy-ins will be ineffective where the intended settlement date of the opening leg of the repo transaction, plus the extension period and execution period of the buy-in is equal to or later than the intended settlement date of the closing leg of the repo transaction.

Calculation of the cash compensation (Article 7(14)(f))

Q17. Do you agree on the proposed approach? How would you identify the reference price?

In relation to fixed income securities a single failed settlement instruction may include trades executed on an OTC, bilateral and voice brokered basis as a result of the settlement netting process. Thus, the CCP would need to establish the current security price at its discretion rather than rely on the original trade source for the current price.

Similarly, for cash equity instruments, a single failed settlement instruction may be the net of many trades from many trade sources. Due to multilateral netting by a CCP it is also likely that the net consideration of the selling party does not match that of the buying party – i.e. the equivalent 'trade price' is different on each side of the fail. Reference to original trade price and original trade source cannot therefore be applied

to CCP's multilateral net settlements and compensation calculation. The reference price is generally the last available closing price (as used in margin calculation) or any other price depending on specific circumstances at the discretion of the CCP for the reasons set out above.

Conditions under which a participant is deemed to consistently and systematically fail to deliver the financial instruments (Article 7(14)(g))

Q19. Please, indicate your views on the proposed quantitative thresholds (percentage/months?)

It is unclear how the quantitative thresholds would be applied in practice. For example, from a CCP's point of view, ESMA does not clarify if the overall value/number of the settlement instructions submitted by the failing participant over a period of certain months, on which the percentages will be based, refers only to the cleared portion or to the total value of settlement instructions across all venues (i.e. trading venues, CSDs, CCPs). We encourage ESMA to clarify this in the draft RTS.

Due to the large difference in the value of settlements for each clearing member across different asset classes within a CCP, we suggest CCPs calculate a separate fail percentage for each clearing member per clearing service. This will enable the CCP to suspend a participant in relation to its activity in a particular clearing service in which it fails consistently, without impacting the other clearing activity of that participant.

Necessary settlement information (Article 7(14)(h))

Q20. What is in your view the settlement information that CSDs need to provide to CCPs and trading venues for the execution of buy-ins? Do you agree with the approach outlined above? If not, please explain what alternative solutions might be used to achieve the same result.

In respect to transaction cleared by CCP, CSDs currently give access to CCPs to the information necessary to execute the buy-in. We therefore do not see the need to create segregated accounts for the clearing members at the CSD level. The provisions on the access between CSDs and other infrastructures in the CSD Regulation, should also ensure the necessary flow of information between CSDs and CCPs.

Article 7(10) is clear about the obligation of the CSD to provide the necessary settlement information to the CCPs, however we would like ESMA to clarify in the RTS that such information will be sent automatically by the CSD and not on request.

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We hope that the above response will assist ESMA in the development of the draft RTS under the CSD Regulation. We look forward to engaging further with ESMA on the topic, in particular in the context of the consultation paper which will follow. If you would like to discuss any aspect of the response please contact Valentina Cirigliano at Valentina.Cirigliano@lchclearnet.com or Perrine Herrenschiidt at Perrine.Herrenschiidt@lchclearnet.com.

Yours faithfully,



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