ECSDA
European Central Securities Depositories Association

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Guidelines on CSD participant default rules and procedures

This paper constitutes ECSDA's response to the Consultation paper issued by ESMA on 31 May 2016 on "Guidelines on participant default rules and procedures under CSDR".

Executive Summary

1. **The upcoming ESMA guidelines should not result in CSDs implementing different rules on participant defaults than other operators of payment or clearing systems**

Participant default rules and procedures are closely related to existing rules on finality and insolvency. In principle, these rules all apply equally to all operators of payment, clearing and settlement systems. It is therefore important that the adoption of guidelines on CSD participant default rules and procedures by ESMA does not result in a situation where CSDs would have to apply different rules from other market infrastructure operators.

In order to avoid the risk of discrepancies, ECSDA recommends that the guidelines should take into account existing rules and procedures such as the collective agreement between central banks operating a TARGET2 component and CSD participants[1].

2. **The ESMA guidelines should distinguish more clearly between non-bank CSDs and CSDs authorised to provide banking type ancillary services**

Unlike CCPs and commercial banks, CSDs are not expected to use their own financial resources in relation to the management of a participant default. The ESMA guidelines should be redrafted to more clearly reflect this fact, and should clearly specify when certain actions or procedures are expected to be used by CSDs authorised to provide banking type ancillary services.

[1] In its article 2, this agreement describes the rights and obligations of all parties with respect to the insolvency of a participant.

3. The ESMA guidelines should be redrafted to avoid potential conflicts with national law

ECSDA is concerned that some of the "minimum requirements" specified in the guidelines may occasionally conflict with national law. This could be the case with insolvency law, local law implementing the Settlement Finality Directive (SFD), and/or legal provisions on professional secrecy duties. Despite steps taken by Council Regulation 1346/2000 on insolvency proceedings, insolvency law is not harmonised across EU jurisdictions and national rules typically impose strong restrictions on the possibility for counterparties of the defaulting entity to take unilateral decisions. ESMA should thus be aware that, in cases where there is a potential conflict between national law and the proposed guidelines, CSDs may be prevented from implementing the guidelines in full. In some countries for instance, a CSD risks infringing the law if it terminates a participation agreement solely on the basis of a default declaration.

1. 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?

ECSDA 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*".

Some CSDs may also include operators of relevant payment systems in their list of stakeholders. As regards the involvement of CSD participants, ECSDA expects that CSDs will often rely on existing fora such as user committees.

2. 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?

- **The acknowledgement process**

ECSDA does not agree with paragraphs 14 to 17 (p. 11) of the proposed guidelines describing the "acknowledgement process".

Today, in several markets (e.g. ES, PL), the insolvency judge transmits the default notice to the supervisor of the defaulting entity, which in turn informs all operators of payment, clearing and settlement systems, in which the defaulting entity participates. This channel of communication is well established as part of domestic law implementing the SFD. However, the information flow only or primarily works at domestic level and foreign CSDs are often not notified of the insolvency by the relevant authorities.

In other jurisdictions, a CSD is required to take actions based on its reasonable assessment of the defaulting participant's situation and on the reliability of the source(s) without the need for a prior notification to the competent authority, a verification or an acknowledgment. This is especially important for insolvent CSD participants established outside the European Union. In many jurisdictions, requiring a CSD to wait for an official confirmation/verification from the relevant authority(ies) could expose the CSD to high risks by preventing the default rules and procedures to be implemented in a timely manner, which could result in a breach of insolvency law and SFD requirements.

ECSDA thus recommends deleting paragraphs 14 to 17 of the guidelines.

- **The contents of the default notice**

Although this falls outside the scope of the proposed guidelines, a harmonised list of information items to be provided in the notification of default could helpfully include the following items:

- Identification of the sender via a Legal Entity Identifier (LEI) and a signature of the legal or contract representative of the sender;
- Identification of the insolvent participant with its legal name, LEI and/ or BIC code;
- Identification of the insolvency administrator, i.e. the authority designated under art.6(2) of the SFD;
- The date of opening of the insolvency proceedings.

Regarding the list of information items which a CSD should transmit to its competent authority "*as soon as possible*" once a participant default is confirmed, as described in paragraph 18 of the proposed guidelines (p. 11), ECSDA wishes to make the following comments:

- We assume that such information is to be provided to the competent authority in written.
- *"- 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,"*
  ECSDA 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 among the pending settlements. In fact, all pending settlement instructions may fail to settle if, for example, the defaulting participant is suspended.
- *"- the type of transactions and financial instruments those instructions relate to,"*
  ECSDA assumes that the information will have to be provided based on the categories defined in the CSDR for transaction types and financial instruments.

- *"- the number of clients concerned,"*

  ECSDA believes that the word "clients" should be replaced by "participants", in line with the CSDR terminology and the title of the guidelines. Indeed, in many EU markets operating on the basis of omnibus accounts, CSDs do not have access to details on clients of CSD participants, and will thus only be in a position to assess the number of impacted participants. Whereas the insolvent participant will typically be expected to disclose the number and name of impacted clients to its regulators, this will not be the case for non-defaulting CSD participants acting as counterparties to the defaulting participant.

  This is without prejudice to those markets (so-called "direct holding markets") where CSDs maintain beneficial owner accounts and where domestic regulators may request the CSD to provide information on beneficial owners (indirect participants) affected by a CSD participant default.

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

  ECSDA believes that in most cases, the main risk, i.e. settlement risk, 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, CSDs should not be expected 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. ECSDA thus 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.

3. 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?

CSD default rules and procedures should apply equally to all types of participants. In order to clearly define the scope of the guidelines and the notion of "default", ECSDA recommends incorporating paragraphs 4 and 6 of Section 3.1 (p. 7) into Section 1 the guidelines (p. 9).

Paragraph 19 (p. 12) foresees that, at a minimum, participant default rules and procedures should include:
(a) the suspension of the defaulting participant's access to CSD's services; and
(b) termination of the defaulting participant's access to CSD's services.
In this respect, ECSDA remarks that, although the opening of insolvency proceedings typically affects the ability of a defaulting entity to enter additional transfer orders, an insolvent CSD participant is still obliged to comply with the requirements applying to transfer orders that have reached final status according to the SFD. If a CSD suspends or terminates the defaulting participant's access to CSD services (in particular to custody and settlement services), it may not be possible to protect "final"

transfer orders, as foreseen in the SFD. Moreover, the administrator needs 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, it should be possible for a CSD to suspend or terminate a participant's access to CSD services at a later stage and based on additional grounds (e.g. breach of contract, change in regulatory status).

ECSDA recommends deleting the phrase "at least" in the second sentence of paragraph 19 and replacing it by "where appropriate" to clarify that the confirmation of the insolvency of a participation does not automatically trigger its suspension and/or termination. Alternatively, the guidelines could state explicitly that the CSD should have some discretion as regards the timing of the suspension/termination, and that a suspension should not prevent a participant from complying with the requirements arising from instructions already introduced into the settlement system.

Generally speaking, ECSDA supports ESMA's approach of specifying a non-mandatory and non-exhaustive list of actions to be included in CSD participant default rules and procedures. However, we believe that some of the actions to be included "where relevant" in the default rules and procedures should be amended or clarified. More specifically:

- *"(c) changes to the normal settlement practices;"*
  ECSDA wonders whether ESMA may wish to include some concrete examples of what these "changes to normal practices" could entail. For example, could the recycling functionality or other functionalities described in the CSDR regulatory technical standards on settlement discipline be restricted in relation to the processing of settlement instructions of the insolvent participant?

- *"(d) changes to the treatment of proprietary and customer settlement instructions and accounts, also considering the type of accounts (omnibus or individual client segregation);"*
  ECSDA wonders in what way CSDs could be expected to change the way they treat proprietary versus customer instructions, or proprietary versus customer accounts. Today, only some CSDs are able to identify whether a given settlement instruction is made on behalf of a participant's own account or on behalf of clients. Even if, in the future, CSDR Level 2 legislation requires all CSDs to operate such a distinction on all securities accounts of participants, it is not clear in what circumstances a CSD could have valid reasons to treat instructions on securities accounts differently based on the type of account, especially when instructions related to both client and proprietary accounts originate from the insolvency administrator. Is ESMA implying that CSDs could be allowed to use a defaulting participant's proprietary assets to process the settlement of instructions in client accounts, in case there are insufficient assets on client accounts? Such an interpretation could raise some problems, e.g. undermining existing rules on the prioritisation of settlement instructions, and is in principle unnecessary since client assets should be clearly recognisable and ring-fenced from the participant's own assets (and thus from the risk of liquidation).

- *"(e) use of financial resources;"*
  Point (e) is misleading. We assume it refers to the CSD's own financial resources, rather than to the insolvent participant's financial resources. The guidelines should clearly specify that non-bank CSDs are not expected to ever use of their own financial resources in the context of CSD participant default rules and procedures. This point is potentially only relevant for CSDs allowed to providing banking type of ancillary services. In fact, even among those CSDs authorised to provide banking services, some will not allow the CSD's own financial resources to be used in relation to the management of a participant default.

- *"(f) any other mechanisms that may be activated to contain the impact of a participant default."*
  We would welcome further clarifications from ESMA on what "other mechanisms" could be used to containing the impact of a participant default.

4. Implementation of the default procedures

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

Paragraph 22 (p. 12) is unnecessary and should be deleted. The CSD Regulation already requires a CSD to have sufficient operational capacity and competent personnel to support all its activities, and ECSDA understands that this includes default rules and procedures.

As regards paragraph 23 (p. 12-13), ECSDA is not in favour of requiring an a "internal plan" in addition to the default rules and procedures. There is no need for a separate document. The CSD default rules and procedures should include a delineation of the roles, obligations and responsibilities of the various parties, including non-defaulting participants. In fact, it would seem a bit of a paradox to define the responsibilities of external parties in the "internal plan" of a CSD.

5. 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?

ECSDA recommends the following amendments to paragraph 24 (p. 13) 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). We thus 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(ies) of the CSD. This would be in line with the flow of information foreseen in the CSDR and it would ensure better coordination among regulators. It would avoid that CSDs issue separate notifications to each domestic and foreign authority involved in their supervision.

  Likewise, the competent authority(ies) should notify ESMA.

  Moreover, the obligation for CSDs to inform non-defaulting participants, trading venues, CCPs and linked CSDs may have unintended consequences. Other 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.

ECSDA agrees with paragraph 25 (p. 13) on the protection of personal data provided that "impacted clients" is replaced by "CSD participants". Indeed, in indirect holding markets, there may be confidentiality issues with the data of underlying clients if CSDs are expected to provide information beyond their direct participants. In direct holding markets, complying with this requirement will also be challenging if details on securities accounts maintained on behalf of private individuals have to be disclosed.

According to paragraph 26 (p. 13), *"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.*" ECSDA believes that this sentence could be interpreted in a problematic way and suggests deleting it, or at least including the following clarifications in the guidelines:

- Such a request by a competent authority should only relate to specific default cases and should not apply to each and every insolvency proceeding. For instance, some CSDs already have existing procedures in place to notify the competent authority of crisis meetings at a certain crisis level.
- The notion of "prior notification" does not involve a prior approval on the part of the authority. Indeed, 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.

6. Periodic testing and review of participant default procedures

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

Paragraph 28 (p. 13) states that a CSD should perform tests on its participant default rules and procedures "*at least annually*". For several ECSDA members, the annual frequency of the tests is disproportionately burdensome. In the absence of substantive changes to the default rules and procedures, ECSDA believes 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 entities settling the cash leg of securities transactions rather than "payment systems", to take into account the fact that CSDs do not always settle the cash leg of securities instructions in a payment system.

As regards paragraph 29 (p. 14), 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, ECSDA recommends deleting the terms *"participants holding different types of accounts (omnibus and segregated)"* in paragraph 29. Indeed, the type of client account is not a relevant criterion for the purpose of testing default scenarios (see also our response to question 3).

About ECSDA

The European Central Securities Depositories Association (ECSDA) is a member of the EU Transparency Register under number 92773882668-44. The association represents 41 central securities depositories (CSDs) across 37 European countries. As regulated financial market infrastructures, CSDs play a vital role in supporting safe and efficient securities transactions, whether domestic or cross-border. If you have any questions on this paper, please contact Soraya Belghazi, Secretary General, at info@ecsda.eu or +32 2 230 99 01.