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Feedback document to the consultations on the “draft ESCB-CESR recommendations for securities clearing and settlement systems and central counterparties in the EU” and the “draft recommendations for central counterparties as amended for OTC derivatives” by the European System of Central Banks and the Committee of European Securities Regulators

The ESCB-CESR Working Group (WG) received many useful comments as a response to the two public consultations. A large number of these comments were taken on board in the final text of the recommendations.

In an effort to be transparent this feedback document to the public consultation on the “draft ESCB-CESR recommendations for securities clearing and settlement systems and central counterparties in the European Union” and the “draft recommendations for central counterparties as amended for OTC derivatives” highlights a number of comments which were not taken on board and provides the reasoning for this decision. It does not constitute a complete overview of all the opinions expressed by respondents and not included in the final text. It has been drafted on a “best efforts basis” and only highlights some of the more significant points made by the respondents and not included in the final text.

Twenty-seven respondents provided comments on the public consultation on the draft recommendations for CSDs and CCPs. The respondents included replies from 15 national, European and international industry associations of banks, clearing houses, exchanges, CCPs, dealers, CSDs and repo market and responses from two ICSDs, two CSDs and CCPs, one bank, advisory firm, trading platform owner, provider of trade confirmation systems, securities exchange and SWIFT

Eighteen respondents provided answers to the public consultation concerning the recommendations on CCPs, as revised to cover CCPs clearing OTC derivatives. The respondents included nine industry associations of banks, clearing houses, exchanges, brokers, dealers, asset management and electricity industry, a clearing house, an international securities depository, several market participants, including those involved in energy trading.

All submissions to both public consultations, except one where consent for publication was not given, have been published on the websites of the ECB and CESR.

1. PUBLIC CONSULTATION ON THE DRAFT ESCB-CESR RECOMMENDATIONS FOR SSSs AND CCPs IN THE EU (23 OCT 08 – 23 JAN 09)

On a more general issue, some respondents took the view that these recommendations cannot be considered a mutual recognition process and compliance with these recommendations by a European infrastructure cannot be leveraged by it as a “European passport”, voicing concerns that this could lead to a regulatory arbitrage.

Feedback: Taking into account that the current regulatory situation is fragmented by national jurisdictions this set of Recommendations cannot and is not intended to provide a basis for implementing EU legal concepts such as ‘passporting’ and/or ‘mutual recognition’, but rather serves as a further step towards further convergence among the various jurisdictions.

1.1 Recommendations for securities clearing and settlement systems

Recommendation 1: Legal Framework

One respondent did not agree with the statement in the explanatory memorandum of RSSS 1 according to which only one legal system should govern proprietary aspects and only one legal system should govern the relationship between the systems. In their view, the text should refer instead to the law governing the account and the law governing other services.

In the same paragraph another respondent proposes to replace "proprietary aspects of securities" with "rights of securities held on a participant's account with the system".

Feedback: The paragraph explains how to minimise the legal risk introduced by the potential conflict(s) amongst the different laws governing the various legal relationships within a given system. In this respect, RSSS 1 suggests minimising the choices of applicable laws to two following the rules set out in the European legal framework (e.g. Settlement Finality Directive).

The current wording “proprietary aspects of securities” is maintained because there is a need to cover, in particular, rights to use collateral and transfer property interests notwithstanding the bankruptcy of an individual participant. Similar wording exists in the CPSS-IOSCO RSSS 1.

Recommendation 2: Trade confirmation and settlement matching

Some respondents proposed further encouragement of the use of electronic trading systems further. A number of respondents proposed to delete the exception of matching requirement for FOP transactions.

Feedback:

The advantage of using electronic trading systems is mentioned in an explanatory paragraph. The Group considered that encouraging all the players to use automated procedures could introduce some undue costs to those (small) players with very limited number of transactions. Though the WG agrees that having matching requirements for all transactions would reduce settlement

failures, the risks associated with FOP transactions are less and therefore a strict matching requirement for all FOP transactions was not considered necessary.

Recommendation 3: Settlement cycles and operating times

A number of respondents addressed issues with regard to settlement fails. Some respondents viewed fines for failed trades as counterproductive, others proposed to introduce a benchmark of one percent (instead of 5) of settlement fails value or propose making public statistics of fails and efficiency ratios.

Feedback: Fines for failed trades are only mentioned as one alternative tool among others, the same applies to the possibility for an operator to set a maximum size. The WG has, following some comments, extended the list of possible measures and feels that fines should remain as one option out of many. The WG encourages transparency with regard to fails statistics or efficiency ratios; however, it is aware that due to non-harmonised methodology such statistics, at this stage, are only limitedly comparable across systems and therefore could not be sufficient to significantly improve transparency. It has therefore listed this proposal as a follow-up item, that would include aiming at developing with ECSDA a harmonised methodology that would allow for a better comparability of figures. With regard to a the benchmark for settlement fails the WG would like to point out that the CSD may also be dependant on banks in order to reduce settlement fails that originate at that level. Furthermore, in some segments, especially cross-border settlement a benchmark of one per cent appears too ambitious and therefore the WG prefers, at this stage, to maintain the current failure rate, which is equivalent to the CPSS-IOSCO methodology.

Recommendation 5: Securities lending

Some respondents doubted that from a risk perspective a CSD should be allowed to engage in securities lending activities.

Feedback: The WG considers that irrespective of whether a CSD or another entity offers such services, adequate risk management and mitigation measures in line with recommendation 9 would need to be implemented.

Recommendation 6: Central Securities Depositories (CSDs)

Some respondents proposed that only full dematerialization (i.e. elimination of physical securities) should be recommended and pursued by all CSDs. One respondent proposed to make compulsory omnibus account structures. Another considered the requirement to separate CCP service into a distinct legal entity as inappropriate. Finally, some respondents considered it unhelpful or unnecessary to distinguish between core and non-core activities of a CSD or that CSDs uniquely combine the provision of final settlement with the recording of changes in legal title.

Feedback: The recommendation takes into account the different legal frameworks for clearing and settlement that exist in different EU Member States. The advantages of dematerialization are listed in an explanatory memorandum.

The different holding structure of securities and the steps to be taken to protect customers' securities are addressed in RSSS 12. In addition, it is foreseeable that the introduction of T2S will lead to further harmonization in this respect. Furthermore, the risks associated with owning and trading securities are already considerably reduced by means of immobilisation, which allows for most of the benefits of dematerialisation.

As a result of the nature of its business a CCP concentrates risks and responsibilities or risk management. The adequacy of financial resources and risk management are key aspects of the post trading infrastructure and therefore CCPs are considered to be of systemic relevance to the market they serve. Given their importance, the WG considers the requirement for a separate legal entity as appropriate.

The WG is of the opinion that there are services provided to the financial market that are unique to CSDs and are hence core services of a CSD. To this end the WG considers it appropriate to distinguish between core and non-core activities, specifically from a risk management point of view.

Recommendation 7: Delivery versus payment (DVP)

Respondents proposed that the recommendation was extended to require CSD transactions to be settled on a DVP basis. One respondent believed it was inappropriate that the methodology states that 95% of transactions should be settled on DVP basis, as a CSD should and cannot control the share of DVP transactions.

Feedback: The requirement to settle cash transactions between CSDs on DVP basis is listed in recommendation 19. The requirement for settling at least 95% of transaction on a DVP basis is also observed in the assessment methodology of CPSS-IOSCO, which is considered the 'minimum requirement' by these recommendations.

Recommendation 8: Timing of settlement finality

Some respondents suggested that unilateral revocation of instructions should not be allowed in any event once they have been matched. Other comments highlighted the importance of the timing of settlement finality, which should be harmonised throughout a currency union. Other respondents would like to be offered a hold and release functionality also for matched transactions.

Feedback: In order to address the liquidity risk the recommendation requires systems to prohibit unilateral revocation late in the settlement day. With regard to matched instructions, the rules of the system may allow, for example a CCP to unilaterally withdraw a settlement instruction as part of the exercising of the CCP's default rules. With regard to settlement finality the WG would like to point that the Commission is currently reviewing the Settlement Finality Directive, also taking into

account experiences from the current financial crisis. The outcome of this exercise will be taken into account in a future review of the recommendations. The WG is of the view that the current wording does allow for a hold and release functionality.

Recommendation 9: CSD risk controls to address participants' failures to settle

As explained in the Introduction to the ESCB-CESR Recommendations, given the lack of common EU legislation for CSDs, the Group agreed to adopt for recommendation 9 the same text as the CPSS-IOSCO RSSS 9.

Recommendation 10: Cash settlement assets

Whereas some respondents suggested further strengthening the requirements for settlement in central bank money, others considered the current wording with regard to the use of commercial bank money too restrictive.

Feedback: The WG believes that the current wording is well-balanced, taking into account that in some cases, e.g. multi currency systems, settlement in central bank money may not always be possible. In addition it provides for safeguards to address the risks if settlement does not take place in central bank money.

Recommendation 11: Operational risk

One respondent suggested that information systems should be audited by independent external auditor, whereas others argued that the requirement for frequent and independent audits of risk control systems and related functions adds a significant administrative and cost burden. One respondent proposed limiting the approval/notification requirements with respect to outsourcing to “material” outsourcing.

Feedback: The recommendation sets out a minimum qualification for internal auditors. The public authority would need to assess whether the internal auditor has a sufficient degree of independence within its organisation and also on a case-by-case basis whether the internal review is considered sufficient. However, the WG is of the opinion that the requirement to always employ an external auditor is not warranted in all cases. The risk control systems are important safeguards within an organization. The WG is aware that that such audits required additional resources, but deems them necessary in order to ensure safety and soundness of the infrastructure. With respect to outsourcing the WG is of the opinion that the concept of materiality is subjective and should be assessed by the public authority.

Recommendation 12: Protection of customers' securities

Two respondents proposed deletion of "investor CSD" in the examples of entities in a custody chain which are obliged to periodically reconcile their records to ensure that customer claims can be satisfied (see RSSS 12, key issue B2).

Feedback: The relevant recommendation of CPSS-IOSCO provides for a broader wording that captures all layers of the custody chain and it neither specifically refers to nor excludes investor CSDs. The group acknowledged on one hand that reconciliation with the records of the issuer CSD is of outmost importance. It also acknowledged that an investor CSD may not be held liable to ensure the integrity of the whole issue. On the other hand, the Group considers crucial that in longer custody chains involving many CSDs and custodians, all entities involved in maintaining securities accounts should reconcile their records to keep them current and accurate with the immediate upper custody level.

Recommendation 13: Governance

In the view of one respondent the use of the term "market participants" in this recommendation is too broad in scope and it could be conceivable that there are (competing) market participants with converging objectives. Therefore, the recommendation should refer to the objectives of "users" rather than of "market participants".

Feedback: The Group considered that referring to the objectives of participants only may be too narrowly defined, as valid interests not only of participants but also of other users, such as for instance the customers of the participants. Furthermore, the recommendation addresses the situation where the objectives of participants in the systems are not compatible, either amongst themselves or between them and the operator of the system.

Recommendation 14: Access

Some respondents proposed deletion of the sentence "Some CSDs may establish more stringent criteria for members that act as a custodian". Another respondent argues that this recommendation should equally be applicable to MTFs.

Feedback: This recommendation is in line with CPSS-IOSCO equivalent recommendations. . The access rules should reflect the role the participant plays in the system and the different risks they may add to the system. Requirements on MTFs would go beyond the scope of the ESCB-CESR Recommendations that only address (refer to) CSDs and CCPs.

Recommendation 16: Communication procedures, messaging standards and straight-through processing (STP)

One respondent argued that all processes should be harmonized using ISO-standards, not only between the CSD and their participants but in the whole chain of Issuers, CSDs and participants.

Furthermore, one respondent suggested that this recommendation explicitly requires Giovannini Protocol compliance by March 2011.

Feedback: Though the WG agrees in general with this remark, the scope of the recommendations is limited to CSDs.

The WG support Giovannini Protocol compliance. However, in these recommendations the Group has refrained from inserting deadlines/target dates for initiatives that are monitored by other bodies.

Recommendation 17: Transparency

One respondent proposed to add explicit reference to compliance with the Basel II/CRD framework (and to risk disclosures under Pillar 3 in particular), for those CSDs which are banks.

Feedback: References to the CRD are not introduced as CSDs that are banks are expected to comply with the CRD in any case.

Recommendation 19: Risks in cross-system links or interoperable systems

One respondent proposed that credit extensions through cross-systems links should be ruled out completely. Another respondent was of the opinion that during conditions of acute market stress (e.g. 9/11) the recommendation should allow for uncollateralized credit extension.

Feedback: The current wording that credit extension should be fully secured and subject to limits addresses adequately the related risks and ensures consistency with the domestic situation. The events where uncollateralized credit extension may be acceptable are deemed to be rare and exceptional. In this case the public authority will have to take into account the special circumstances when conducting the assessment.

1.2 Recommendations for central counterparties

Recommendation 1: Legal risk

One respondent suggested adding that CCP's cash deposits with a bank should be protected from the bank's insolvency while acknowledging that this raises fundamental issues concerning insolvency and is of the view that it could be a long term goal.

Feedback: Due to its non-binding character and the addressees the ESCB-CESR recommendations cannot change existing insolvency laws. Furthermore, the WG believe that there are other ways to protect CCP's cash deposits within the current framework.

Recommendation 2: Participation requirements

Some respondents were of the view that all participants should be regulated entities. Furthermore, it was suggested to define what is understood under "third-party review". Finally, it was proposed to introduce an obligation put on regulators and supervisors to share relevant

information with a CCP in cases where those authorities have information concerning developments that may affect supervised entities' continuing ability to perform obligations.

Feedback: The WG acknowledges that different participants may introduce different risks to a CCP. However, in all cases the CCP will need to ensure that risks related to participation are adequately controlled. It will therefore analyze any specific risks that non-regulated entities may bring to the CCP and adopt appropriate risk controls.

Since there can be different types of third-party reviews that are acceptable the current generic wording is considered appropriate.

An obligation for regulators and supervisors to share information would be in contradiction of existing laws. However, in a future review with respect to the lessons learnt from the ongoing financial crisis the WG will also review information sharing in crisis situation.

Recommendation 3: Measurement and management of credit exposures

Comments (*Feedback*): A number of comments received on this recommendation fell within the scope of other recommendations, and the WG felt that the issues were sufficiently addressed elsewhere: the proposal to regular monitor the financial situation of participants (*covered in RCCP2*), establishing procedure that take into account consequences of a failing (*covered in RCCP6*), introducing the possibility of cross-margining (*covered in RCCP11*) or the requirement to disclose the model for assessing a reasonable daily settlement price in case of illiquidity of an instrument (*covered in RCCP14*).

Recommendation 4: Margin requirements

One respondent felt that approval by a CCP's senior management of the margin-setting process was not adequate and should rather be subject to review by an external entity (auditor, supervisor). Other respondents questioned the requirement to cover 99% of price movements.

Feedback: The WG is of the opinion that RCCP 13 adequately addresses the governance arrangements with regard to risk management of a CCP. The threshold of 99% in this context should be considered as a minimum industry standard. It has been tested with the industry association and other market participants and the WG considers it an appropriate minimum threshold.

Recommendation 5: Other risk controls

Comments (*Feedback*): A number of comments received on this recommendation fell within the scope of other recommendations and the WG felt that the issues were sufficiently addressed elsewhere: one comment suggested that linked or interoperable CCPs should not be excluded when identifying the largest residual exposure (*the WG considers that the relates risks are sufficiently addressed in RCCP5 in combination with RCCP11*); another respondent proposed to clearly segregate clearing activity from commercial activities conducted by CCPs' agents, in

particular with respect to the participants' contributions to financial resources (*sufficiently covered by RCCP7*).

Finally one respondent argued that a CCP should not be obliged to share stress testing assumptions with participants (*This is a CPSS-IOSCO requirement and, as a general rule, the ESCB-CESR recommendations are at least as stringent*).

Recommendation 6: Default procedures

One respondent proposes to specify and make prescriptive for all CCPs the exact order for the use of the different financial resources available to cover losses and that this order should be the same for all CCPs.

Feedback: As outlined in the recommendation, the financial resources available can take a variety of forms. The WG felt that specifying the order of use, in addition to the requirement to use resources of the defaulter first, would be too restrictive; however, the default procedures should be transparent to the participants of a CCP. In this respect the recommendation requires the CCP to clearly state the default procedure and make publicly available the key aspects thereof, including the order followed to make use of the different financial resources.

Recommendation 7: Custody and investment risks

One respondent proposed to add a requirement for a CCP to only employ custodians incorporated in the European Union. Other comments requested that custodians have a 'Chinese wall' in place to shield this function from its brokerage activities.

Feedback: The WG considers it out of the scope of these recommendations to mandate a location policy in relation to custodians and that the recommended safeguards are sufficient to cover the associated risks without prescribing specific measures in detail. Custodian banks are outside the scope of the report as indicated in the introduction to the Recommendations..

Recommendation 8: Operational risks

One respondent suggests addressing more explicitly how risk contagion across markets could be mitigated when CCPs operate on multiple markets.

Feedback: The WG has identified the issue of interdependencies of payment and settlement systems, including cross border contagion, as one item for future follow-up.

Recommendation 9: Money settlements

One respondent suggests to only allowing settlement in central bank money.

Feedback: The WG believes that the current wording is well-balanced. (See also response to RSSS 10 above)

Recommendation 11: Risks in links between CCPs

One respondent proposed a set of criteria to be met before a link is established. Other respondents proposed to pay particular attention to the unwinding of transactions in the case of default.

Feedback: The industry (EACH) has established such criteria, which could be considered by public authorities when performing their assessment. Issues such as unwinding of transaction, are in principle covered in the RCCPs 3-6, addressing risk controls and in particular in RCCP 6 addressing default procedures.

Recommendation 13: Governance

One respondent proposed to make clear that the requirements cannot over-ride obligations on the managements and boards of CCPs that arise from statutory governance requirements, for example those applicable to listed companies, which apply to many European CCPs. One comment referred to competition issues that are outside the scope of these recommendations.

Feedback: The WG believes that the explanatory paragraph 2 already sufficiently clarifies that the recommendation intends to be consistent with national and EU law. Furthermore, these recommendations are in any case not intended to over-ride any statutory national/EU governance requirement.

Recommendation 14: Transparency

Some respondents proposed a broader application of transparency, in particular with reference to the current financial crisis.

Feedback: Additional requirements for transparency and disclosure of relevant information to users and providers have been introduced in various RCCPs, especially to cover risks of OTC derivatives.

2. CONSULTATION ON DRAFT RECOMMENDATIONS FOR CCPS, AS AMENDED FOR CLEARING OTC DERIVATIVES (31 MARCH – 17 APRIL 2009)

All respondents have strongly supported the revisions to the recommendations for CCPs to clarify issues related to CCPs clearing OTC derivatives. A number of the comments received supported issues already reflected in the current text of the ESCB-CESR RCCPs or described current developments initiated by the industry. Comments which required departing from the initial wording and spirit of the CPSS/IOSCO Recommendations for CCPs were not reflected in the RCCPs. Comments on parts other than the revisions concerning OTC derivatives and late comments were in principle not addressed, unless absolutely necessary.

The comments below required special attention by ESCB-CESR because they introduced elements which departed from the initial philosophy of the report, as it was drafted:

Introduction

Some respondents suggested replacing “participants” and “non clearing participants” in the RCCPs by “clearing members” or “customers of clearing members” respectively.

Feedback: The Group agreed with the general point and considered clarifying this point in the relevant part of the introduction explaining terminology, thus, retaining the language convention contained overall in the ESCB/CESR and CPSS-IOSCO Recommendations.

Recommendation 1: Legal risk

It was suggested to add a footnote with regard to rehypothecation of margin for obtaining central bank intraday liquidity.

Feedback: The Group considered that this point is more general and not specifically related to the OTC. Moreover, the Group considered that this point should be further analysed in the future.

One respondent expressed concerns that legal opinions cannot vouch for risk management techniques (see RCCP 1 C.12 point 8):

Feedback: The Group would like to point to the introductory sentence of this paragraph stating that CCPs should provide information about the matters listed and only “where appropriate and relevant” these matters should be supported by a legal opinion or external analysis. The Group deems this statement sufficient and adequate to address the concerns raised.

Some respondents further suggested that RCCP 1 (key issue B3) should consider the CCP’s default in the rules, procedures and contracts between the CCP and its participants.

Feedback: The Group considered that this is a more general issue not specifically related to clearing of OTC instruments. The Group is of the view that any change to the key issues would depart from the philosophy followed so far that revisions related to CCPs clearing OTC derivatives should be clarifications and not revisions of existing recommendations and key issues.

Recommendation 2: Participation requirements

Some respondents disagreed with risk-related grounds for denying access because “significant legal, technical or operational reasons may justify restricting access to some participants”.

Feedback: The Group considered that the current wording “risk-related grounds” sufficiently addresses/covers risks such as legal, technical or operational risks. .

A respondent suggested adding participation requirements in CCPs clearing OTC derivatives.

Feedback: The Group considered that the wording of the relevant recommendation is adequate and balanced.

Recommendation 4: Margin requirements

One respondent suggested defining “highly liquid instruments” and deleting the words “to an appropriate extent” in RCCP 4 C4.

Feedback: The Group considers that this is a general issue which was already subject to the public consultation which ended on 23 January 2009 and, thus, outside the scope of the current public consultation. The Group further considered that the wording is balanced on grounds of preserving confidentiality and competition.

Recommendation 5: Other risk controls

It was further suggested to introduce the notion that the decision to set up multiple clearing funds should be user-driven.

Feedback: A clarification in this regard has been introduced in RCCP 13, C.4. The Group also wishes to highlight that the risk management policy is the responsibility of the CCP.

Some respondents suggested introducing a requirement for CCPs that credit lines should only be provided by central banks and that cash collateral should be held only at a central bank. Furthermore, these respondents would like to specify that collateral provided to the CCP should be limited to investments in secure assets such as government bonds.

Feedback: The above mentioned points are not related to the OTC derivatives clearing but are of general nature. The first point was already submitted during the previous public consultation. It was not reflected with the argument that if commercial bank money is used, the CCP has to put in place adequate safeguards. On the second point, the Group felt that the recommendations should remain open-ended to ensure adaptability to market conditions.

It was further suggested adding a requirement on the separation of funds for OTC clearing.

Feedback: The Group considered that the wording of the relevant recommendation is adequate and balanced in view of the various approaches taken by CCPs in Europe. The Group considered further that the decision to operate a separate clearing fund is a business decision of the CCP and that the decision to use the existing fund should be justified.

Recommendations 6 (Default procedures) and 7 (Custody and investment risk)

One respondent suggested further elaborating on default procedures for credit derivatives in RCCP 6, C.3 and on the rehypothecation wording in RCCP 7, C.2.

Feedback: The WG considered adding the example of auctions as mentioned in RCCP 2 C4. The notion of required participation in default processes is already included in the report and will not

be repeated in RCCP 6. As regards rehypothecation, the Group considered the reference in RCCP 1 as adequate and sufficient and does not intend to repeat this wording in RCCP 7.

Recommendation 8: Operational risk

A respondent suggested that multiple providers should be “seamlessly interchangeable” and that if all European CDS were stored in a European warehouse, the failure of that would impact European CCPs regardless of the existence of a US Warehouse.

Feedback: In view of the safety and efficiency of trade warehouses for OTC derivatives, the Group would like to highlight that paragraph 8 of the OTC introduction considers inter alia interoperability and fair access criteria in respect of trade warehouses and the possible need for future recommendations targeted to trade warehouses. This would address the concerns raised by this respondent. The Group would also like to stress that ECOFIN provided its unequivocal political support towards bolstering infrastructure in the EU. In any case, in Europe the respective entities are supervised and regulated and need to comply with business continuity requirements, in particular as regards recovery site and contingency measures.

Recommendation 15: Regulation, supervision and oversight

One respondent suggested specifying that the regulatory authority in charge of a CCP is the regulator of the country in the Euro-zone where the CCP is based (RCCP 15).

Feedback: The Group considered that such a principle would introduce a rule for the supervision of CCPs in the EU, for which there is currently no EU legislation comparable to the banking legislation. The competencies for supervision and oversight over a CCP are depending on the respective national law. Moreover, such a statement would not address the issue of a CCP outside the euro zone. Therefore, such a request would fall outside the scope of Recommendations.