ISDA/FIA Response to ESMA's Consultation Paper
"ESMA's Guidelines on CCP conflicts of interest management"

Introduction and executive summary

ISDA, FIA and their members welcome ESMA's work on aligning practices in Europe around best practice in conflict of interest management and equally welcome the opportunity to provide their comments on the proposed guidelines. Whilst being broadly supportive of ESMA's proposals, we recommend further enhancement of the guidelines, as set out below.

CCPs are organisations that have to manage conflicts from their role as systemically important market utilities, which are commercial enterprises, often (part of) public companies that have to balance marketing new business, risk management and regulating their members.

Clearing participants support robust rules for managing conflicts of interest in the context of CCPs. We note that these guidelines see conflicts as the result of the breach of rules by stakeholders that need to be controlled and sanctioned. In the context of banking institutions however, front line staff is routinely confronted with (potential) conflicts of interest, for instance between executing orders by two different clients in the illiquid same security. Banks have established their own rules and procedures to identify and manage such conflicts of interest. In the environment of CCPs such dynamic conflicts may arise for instance in the process of default management (DMP), when CCP personnel or seconded clearing member staff have to balance the allocation of a defaulting clearing member's initial margin against the position of the remaining, non-defaulting, clearing members.

Protecting confidential information is paramount. Clearing participants often experience however that confidentiality considerations are used as a reason for CCPs to restrict transparency. As a general principle, clearing participants' information about size, composition, risk of their portfolio and trading activities needs to be protected at all time.

However, as long as the above information is properly protected, outside the default management process confidentiality should not be used as a reason to restrict disclosure of relevant information to market participants, as long as the information is aggregated to an extent such that no individual portfolios, transactions or risk profiles can be deduced or identified.

Responses to the questions consulted on

Q1. Do you agree with the definition and with the scope here above described?

Paragraph 19 includes the relationship between clearing broker and clearing client, or clients amongst each other in the scope of these guidelines. We note that at least conflicts in the relationship between clearing brokers and their clients will also be covered by regulation applicable to the bank or clearing broker. We therefore propose to remove the last bullet point from the list of sources of conflicts of

interest. As a minimum ESMA should therefore ensure their proposed guidelines do not contradict banking regulation.

Paragraph 20 proposes to define the length of time a conflict of interest is presumed to have effect after the conflict ceases to exist. We believe this very much depends on the situation. There may be merit in standardizing such length of time for members of the default management group (DMG) across CCPs. Ideally the DMP is designed in such a way that conflicts of interest are minimized and the traders on the DMG do not have information that would stand in the way of them returning to their work after the DMP has been concluded. Should there be reason to believe that the effect of conflicts of interest continue after completion of the DMG, the cut-off time of such continuation should be standardised across CCPs.

Q2. Do you think that the CCPs should implement such organisational arrangements to avoid an inappropriate use of confidential information?

Paragraph (23) states that "*In this framework, staff members and clearing members involved in the risk committee and in the default management groups should be subject to strict confidentiality obligations and should sign a specific confidentiality agreement. This should also apply to subcontractors or consultants if in their functions they access confidential information*."

These rules should not be used to stop risk committee members from consulting specialists in their organizations when, for example, opining on risk models or Stress Testing frameworks, provided that there are appropriate confidentiality procedures in place within that organization. In general, membership of a Risk Committee or DMG should not confer a commercial competitive advantage on the institution which has appointed/employed the committee member.

This information sharing should however be on a "*need to know*" basis only and not indiscriminately, and sharing of such information should not trigger conflicts of interest scenarios for those who receive such information.

In addition, ESMA should ensure that CCPs have the obligation not to unduly expose a clearing member's representative to a conflict of interest at the clearing member level. For instance, CCPs should ensure that the information shared within the Default Management Group is restricted and relates only to the defaulting clearing member's positions. Our expectation is that a trader seconded to a CCP as part of a Default Management Group should be able to return to his/her normal duties once the positions of the defaulting clearing member are closed out. Every effort should be made by the CCP to ensure that exposure to confidential information does not impede a clearing member's representative from doing so.

Q3. Do you consider that the proposed rules of conduct as appropriate to limit the risks of conflicts of interest?

Yes

Q4. Do you believe that the CCPs should apply such rules concerning the gifts?

Yes, this is in line with common practice at banks.

Q5. Are you in favour that CCPs should adopt the above clear rules on the ownership of the financial instruments?

Yes, this is in line with common practice at banks. We propose however to bring these rules even more in line with best practice and to require prior approval of CCP staff's financial investments by CCP management.

We also note that the proposed guidelines state that a CCP may consider to exclude fully delegated investments (discretionary accounts) from the restrictions. Discretionary accounts should always be excluded from the restrictions.

Q6. Do you consider that the CPP staff should be trained on the applicable law and policies concerning the conflicts of interest as above described

Yes, similar to required compliance trainings for staff at banks.

Q7. Do you agree on the above-proposed rules?

We note that board members are not only addressees of information about conflicts at the CCP, but can potentially be subject to conflicts of interest as a result of additional external appointments or positions. Such conflicts need to be managed too.

Q8. Do you agree on the above specific organisational arrangements a CCP pertaining to a group should adopt to avoid and mitigate the risk of conflicts of interest?

Yes in general.

Q9. Do you think that the above-described procedure is appropriate to investigate, to solve, to monitor and to record the conflicts of interest?

This section pictures conflicts of interests as one-off, negative events that need to be escalated to the Chief Compliance Officer (CCO). The proposed measures are reasonable for exceptional conflicts of interests that come from ignoring mitigation rules laid out in previous sections (e.g. not disclosing financial interests etc).

In banks, conflicts of interest can arise in the normal course of business and can be part of the daily routine of front-line staff, for instance when dealing with two orders for the same illiquid security. Such conflicts need to be managed, not sanctioned.

CCPs are intrinsically conflicted organisations. The conflicts arise from various sources, including but not limited to:

- CCP being commercial enterprises, in some cases, (part of) public companies. That means they engage in marketing and solicitation of new business, and are incentivized to compete in their markets
- CCPs being utilities that provide a service – a service that in many cases is 'systemically important', and which is therefore in tension with their role as profit-making enterprises
- CCPs being organisations with broad powers to regulate and discipline their members and participants, a function that needs to be separated from the commercial role of the CCP.

An example in a CCP context would be hedging of a defaulter's portfolio, where the DMG member always has to manage a conflict between the duty to the defaulter to manage the default in a reasonable fashion and minimize the cost of the default and the use of margin, and the duty to the CCP and other members to minimize risk.

Another example might between clearing members and providers of critical services. A CCP having several liquidity providers should for instance have fair criteria for selecting the liquidity provider it would use during a liquidity shortfall, or whether to use a liquidity provider versus member resources.

The guidelines should also include a section on conflicts of interest during default management (see above) and recovery, where the whole CCP management is likely to be conflicted: In recovery the CCP is inflicting losses on clearing participants while safeguarding their own equity.

There may also be situations where disclosure to relevant persons or bodies with the CCP may be appropriate, but direct disclosure to the chief compliance officer (required under Paragraph 50) may be inappropriate, if it involves a very minor potential conflict that is part of daily routine business.

We hope these comments are useful. ISDA and FIA would be glad to discuss these comments further.