



European Securities and
Markets Authority

Consultation Paper

Guidelines on participant default rules and procedures under CSDR



Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **30 June 2016**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

The collection of confidential responses is without prejudice to the scope of Regulation (EC) No 1049/2001¹. Possible requests for access to documents will be dealt in compliance with the requirements and obligations laid down in Regulation (EC) No 1049/2001.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading [Legal Notice](#).

¹ Regulation (EC) No 1049/2001 of the European Parliament and of the Council of 30 May 2001 regarding public access to European Parliament, Council and Commission documents, OJ L 145, 31.5.2001, p. 43–48, ESMA • CS 60747 – 103 rue de Grenelle • 75345 Paris Cedex 07 • France • Tel. +33 (0) 1 58 36 43 21 • www.esma.europa.eu

Who should read this paper

All interested stakeholders are invited to respond to this consultation. In particular, this paper may be specifically of interest to central securities depositories (CSDs) and their participants.

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Acronyms used

CSDR	Regulation (EU) No 909/2014 of the European Parliament and of the Council on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation No 236/2012
CP	Consultation paper
EC	European Commission
ESMA	European Securities and Markets Authority
EU	European Union
OJ	The Official Journal of the European Union
RTS	Regulatory technical standards
SFD	Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems

1 Executive Summary

Reasons for publication

Article 41(4) of Regulation (EU) No 909/2014 of the European Parliament and of the Council on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation No 236/2012 (CSDR) provides that ESMA may issue guidelines in accordance with Article 16 of Regulation (EU) No 1095/2010 in order to ensure consistent application of Article 41 of CSDR relating to participant default rules and procedures.

Contents

Section 2 contains information on the background and mandate, Section 3 contains an analysis of the scope and content of the proposed guidelines, while Section 4 contains the proposed guidelines.

Annex I sets out a summary of the questions contained in this paper and Annex II includes a high level cost-benefit analysis for the guidelines.

Next Steps

ESMA will consider the feedback it will receive to this consultation with a view to finalising the guidelines by Q4 2016.

2 Background and mandate

1. Article 41 of CSDR on participant default rules and procedures provides that:
 - “1. For each securities settlement system it operates, a CSD shall have effective and clearly defined rules and procedures to manage the default of one or more of its participants ensuring that the CSD can take timely action to contain losses and liquidity pressures and continue to meet its obligations.*
 - 2. A CSD shall make its default rules and relevant procedures available to the public.*
 - 3. A CSD shall undertake with its participants and other relevant stakeholders periodic testing and review of its default procedures to ensure that they are practical and effective.”*
2. Under Article 41(4) of CSDR, ESMA may issue Guidelines *“in order to ensure consistent application of [Article 41]”*. In preparing these Guidelines, ESMA is required to closely cooperate with members of the ESCB.

3 Analysis

3.1 Scope of the guidelines

3. The mandate for the Guidelines under CSDR is thus limited to the subject-matter and scope of Article 41 of CSDR, which relates to rules and procedures for the management of the default of one or more of its participants.
4. The concept of *“default”* itself is already defined under CSDR in relation to a participant as *“a situation where insolvency proceedings (...) are opened against a participant”*.
5. SFD defines *“insolvency proceedings”* as *“any collective measure provided for in the law of a Member State, or a third country, either to wind up the participant or to reorganise it, where such measure involves the suspending of, or imposing limitations on, transfers or payments”* (Article 2(j)) and the moment of opening of an insolvency proceeding against a participant as the moment when the relevant judicial or administrative authority handed down its decision (Article 6(1)). SFD also provides that such authority shall in such case immediately notify its decision to the appropriate authority chosen by its Member State and that the Member State shall immediately notify the European Systemic Risk Board, other Member States and ESMA (Article 6(2) and(3)).
6. The purpose of these Guidelines is therefore not to specify further the concept of *“default”* in relation to a participant, but only to provide guidance on the steps a CSD should set up and follow in case such default occurs.
7. In this respect, one might note that the scope of the PFMI is wider than that of these guidelines as it provides that *“an FMI should provide in its rules and procedures what circumstances constitute a participant default, addressing both financial and operational*

defaults”, specifying that “*an operational default occurs when a participant is not able to meet its obligations due to an operational problem, such as a failure in information technology systems*”.

8. It is important to note that, although CSDR uses a rather narrow definition of the “default” of a participant, this does not prevent CSDs from providing in their rules for procedures to address events affecting their participants (such as resolution) other than the opening of formal insolvency proceedings against them. However, the scope of this consultation paper and contemplated guidelines is limited to the definition of “default” given in CSDR.

3.2 Content of the guidelines

9. These guidelines further specify paragraphs (1) and (3) of Article 41 of CSDR regarding the definition by a CSD of its participant default rules and procedures, including by specifying a non-exhaustive list of actions a CSD may take in order to manage the default of a participant, and set minimal requirements in respect of the testing and review of such rules and procedures. The fact that a particular type of action does not appear on the list does not mean that it cannot be carried out. In respect of the public disclosure of such default rules and procedures, it has been considered that there was no need at this stage to specify further the provisions of paragraph (2) of article 41 of CSDR.
10. As mentioned in recital 6 of the CSDR, ESMA should ensure consistency with the CPSS-IOSCO Principles for financial market infrastructures² (PFMIs). In this respect it should be considered that Article 41 of CSDR already incorporates Principle 13 of the PFMIs on participant default rules and procedures. Therefore ESMA in developing its guidelines under Article 41 would need to ensure consistency with the purpose of Principle 13 of the PFMIs and its relevant key considerations.
11. In order to elaborate these guidelines, ESMA has also reviewed regulations issued in respect of other market infrastructures, in particular CCPs, and actual rules published by CSDs.

² The Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO), *CPSS-IOSCO Principles for financial market infrastructures*, April 2012



4 Proposed guidelines

1 Scope

Who?

1. These guidelines are addressed to CSDs (as defined under article 2(1) of CSDR) and their competent authorities.

What?

2. These guidelines apply in relation to the rules and procedures the CSD shall set up to address a participant default pursuant to Article 41 of CSDR.

When?

3. These guidelines apply from the latest of the date of entry into force of Regulation (EU) No... [RTS on CSD Requirements] and the date of entry into force of Regulation (EU) No...[RTS on Prudential Requirements].

2 Definitions

4. Unless otherwise specified, terms used in these guidelines have the same meaning as in CSDR, SFD and the RTS.
5. In addition, the following definitions apply:

CSDR	Regulation (EU) No 909/2014 of the European Parliament and of the Council on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation No 236/2012
CP	Consultation paper
EC	European Commission
ESMA	European Securities and Markets Authority
EU	European Union
RTS	Regulatory technical standards
SFD	Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems



3 Purpose

6. The purpose of these guidelines is to ensure common, uniform and consistent application of the provisions in Article 41 of CSDR. In particular, they aim at ensuring CSDs define and apply clear and effective rules and procedures to manage the default of one or more of their participants.

4 Compliance and reporting obligations

4.1 Status of the guidelines

7. This document contains guidelines issued under Article 16 of the ESMA Regulation. In accordance with Article 16(3) of the ESMA Regulation competent authorities and financial market participants must make every effort to comply with guidelines and recommendations.
8. Competent authorities to whom the guidelines apply should comply by incorporating them into their supervisory practices and monitor whether CSDs comply with them.

4.2 Reporting requirements

9. Competent authorities to whom these guidelines are addressed must notify ESMA whether they comply or intend to comply with the guidelines, with reasons for non-compliance, within two months of the date of publication by ESMA to [email address]. In the absence of a response by this deadline, competent authorities will be considered as non-compliant. A template for notifications is available from the ESMA website.
10. Financial market participants are not required to report whether they comply with these guidelines.

5 Draft Guidelines

5.1 Definition of the participant default rules and procedures

5.1.1 Procedure for establishing participant default rules and procedures

12. A CSD should involve its participants and other relevant market infrastructures (CSDs, CCPs and trading venues) in developing its participant default rules and procedures.
13. The participant default rules and procedures of a CSD should be:



- (a) approved by the management body;
- (b) subject to periodic testing and review, as specified under section 5.2 below.

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?

5.1.2 Acknowledgement of a participant's default

14. A CSD may be informed of the default of one or more of its participants by the participant itself, the authority designated according to Article 6(2) of the SFD in the Member State of the participant, the CSD's competent authority, a defaulting participant's competent authority or any other relevant sources, such as a CCP, a trading venue or a linked CSD.
15. To this end a CSD should request its participants to notify their default to it as soon as possible and should specify through which channels such notification should be made.
16. As soon as it is informed of such default, the CSD should transmit such information to its competent authority and should verify it with the authority designated according to Article 6(2) of the SFD in the Member State of the participant, if received from another source than the respective authority.
17. The application of a default procedure by a CSD is activated following the confirmation to the CSD of the occurrence of a default in respect of that participant by the relevant authority designated according to Article 6(2) of the SFD.
18. The CSD should, as soon as possible, identify and transmit to its competent authority at least the following information:
 - the type of participant in respect of which the default has occurred,
 - 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,
 - the type of transactions and financial instruments those instructions relate to,
 - the number of clients concerned, as well as
 - information on any risks such default might entail.

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?

5.1.3 Actions a CSD may take in case of default

19. A CSD should indicate in its default rules and procedures which actions it may take when a default occurs in respect of one or more of its participants. Such actions should include, at least:
 - (a) to the fullest extent permitted under applicable law, suspension of the defaulting participant's access to all or part of the CSD's services and functionalities; and
 - (b) to the fullest extent permitted under applicable law, termination of the defaulting participant's access to all or part of the CSD's services and functionalities;and, where relevant:
 - (c) changes to the normal settlement practices;
 - (d) changes to the treatment of proprietary and customer settlement instructions and accounts, also considering the type of accounts (omnibus or individual client segregation);
 - (e) use of financial resources;
 - (f) any other mechanisms that may be activated to contain the impact of a participant default.
20. The participant default rules and procedures of a CSD should specify the consequences of the actions it takes in respect of a defaulting participant, in particular, where relevant, the measures it will take to contain losses and liquidity pressures, at and after the point of participant 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?

5.1.4 Implementation of the default procedures

21. The CSD should specify the criteria for applying each of the actions listed in its default rules and procedures to address a participant's default.
22. The management body should ensure that the CSD has the operational capacity, including sufficiently well-trained personnel, to implement its default rules and procedures in a timely manner.
23. The CSD should have internal plans that clearly delineate the roles, obligations and responsibilities of the various parties, including non-defaulting participants, as appropriate, for addressing a participant default and provide training and guidance to its personnel on how the default rules and procedures should be implemented. These plans should address



communications, documentation, and information needs, and coordination including when more than one market infrastructure is involved.

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

5.1.5 Communication on the implementation of the default procedures

24. The participant default rules of a CSD should indicate:
- (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;
 - (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.
25. Information provided under points iii. to v. of letter (b) of paragraph 24 above should not contain personal data within the meaning of point (a) of Article 2 of Directive 95/46/EC.
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.

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?

5.2 Periodic testing and review of participant default procedures

27. The default rules of a CSD should specify the mechanisms and timing to test the effectiveness and practicality of its default procedures.
28. A CSD should perform such tests at least annually and, in any case, following any substantive changes to the CSD default rules and procedures or upon request from its competent authority, with a relevant sample of its participants, payment systems, other relevant market infrastructures and any other entities (such as common settlement infrastructures, third parties to which the provisions of services has been outsourced, etc.),



as appropriate, for each of the securities settlement systems it operates. The competent authority of the CSD may request to take part in such tests.

29. Prior to each test, a CSD should define the parameters according to which such test should be run, taking into account different types of participants (in terms of volume, activity, etc.), participants located in different countries or time zones, participants holding different types of accounts (omnibus and segregated), relevant market infrastructures, as appropriate. Such test should include a simulation exercise and a test of the communication plan. A CSD may submit the parameters it intends to use to its competent authority prior to each test, if requested so by the competent authority.
30. Where a test reveals any uncertainty on the application of its default procedures, the CSD should modify them accordingly. Where the simulation exercise reveals the lack of knowledge or readiness to apply the default procedures by its participants or other market infrastructures, the CSD should make sure that these entities are duly informed and take actions to fill the gaps.
31. The results of these tests should be shared with the CSD's management body, risk committee, competent authority and relevant authorities.

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

5 Annexes

5.1 Annex I – Summary of questions

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?

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?

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?

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

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?

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

5.2 Annex II – Preliminary high level cost-benefit analysis

1. Article 16 of the ESMA Regulation requires ESMA, where appropriate, to analyse the potential costs and benefits relating to proposed guidelines. It also states that cost-benefit analyses must be proportionate in relation to the scope, nature and impact of the proposed guidelines.
2. The objective of performing a cost-benefit analysis is to assess the costs and benefits of the various policy or technical options which were analysed during the process of drafting the guidelines.
3. The guidelines included in this CP are of an optional nature, i.e. they are not envisaged in any Regulation, but are issued in line with Article 16 of ESMA Regulation in order to ensure uniform, consistent and coherent application of Union Law.
4. The choices or options envisaged by ESMA while drafting these guidelines were therefore limited to whether to issue these guidelines and ensure a consistent application of CSDR within the Union (which is one of ESMA's tasks) or not issuing them.
5. There are directly applicable provisions in CSDR that would not apply in a uniform, consistent and coherent way within the Union in the absence of a clarification from ESMA on participant default rule and procedures.
6. The costs implied by these guidelines can be summarised as the cost of changing current market practices, where necessary.
7. As proved by the impact assessment of the EC on CSDR, the benefits brought by the proposal significantly outweigh the costs. These guidelines aim at ensuring the uniform, consistent and coherent application of CSDR across the Union, which is an essential component of an EU Regulation that by its nature is directly applicable in all Member States. In particular these guidelines should help bringing more homogeneity in the content and presentation of rules and procedures established by the various CSDs, thus giving more clarity to the participants and their clients as to the consequences of the default of a participant on the client accounts it holds.
8. On the basis of the analysis above, ESMA concludes that the benefits of issuing guidelines on the participant default rule and procedures outweigh the costs.