

Proposed reforms to Spain's securities clearing, settlement and registry system

28th February 2011

Consultation response from



The Depository Trust & Clearing Corporation



Euro CCP Ltd.

The Depository Trust & Clearing Corporation (DTCC) and EuroCCP thanks the Comisión Nacional del Mercado de Valores (CNMV) for the opportunity for industry participants and practitioners to provide direct input to the proposal to reform the Spanish securities clearing, settlement and registry system.

There is a great deal of projected market reform as the legislators and regulators seek to impose greater levels of security, integrity and transparency on markets and avoid repeat of the current financial crisis. It is critical that any reforms take note of and, where possible, satisfy requirements laid out in the various relevant texts including, but not limited to:

- European Market Infrastructure Regulation (EMIR),
- Market in Financial Instruments Directive (MiFID),
- Capital Requirements Directive (CRD IV),
- Central Securities Depositories (CSDs) and Securities Law consultation,
- BIS and CPSS-IOSCO recommendations.

In this response, DTCC has drawn on its almost 40 years of experience in operating CCPs and as a central securities depository and the feedback is restricted to those areas where comment is relevant based on this experience.

Summary

The following key points from the response are highlighted:

- **Harmonisation:** It is critical that reform of the Spanish market takes into account the broader reform landscape and harmonisation initiatives within the EU.
- **CCP governance:** As per the draft European Market Infrastructure Regulation, independence of management of a CCP should be addressed through appropriate governance rules.
- **Scope:** This reform initiative should apply to all cash equities and fixed income markets.
- **CCP risk management:** For systemic integrity, it is critical that CCPs maintain control over the contracts cleared and the participants accepted as direct members.
- **Central bank liquidity:** As per Commission's EMIR draft (15 September 2010), we believe central bank liquidity access should not be mandatory for the day to day requirements of a CCP.
- **Interoperability:** In order to promote reduction of cost in the provision of clearing services, it is vital that market participants are able to select a preferred clearing venue. We therefore believe that access to trade feeds and Interoperability between cash equity CCPs should be a mandatory characteristic of the market.

Q1 – What do you think of curtailing the assignment process?

EuroCCP supports the curtailing of the current assignment process. The current process of technical references and registrations restricts the netting benefits that a CCP can introduce to the market because the highest level of netting is only available after registrations are disclosed.

In other European markets, the removal of the registration name allows the CCP to net transactions by ISIN and therefore reduces the settlement risk by reducing the volume of settlement obligations at the CSD.

Technical references also restrict the movement of securities and can be used to introduce unnecessary settlement discipline. The required matching criteria are far beyond any other European market and we do not believe this additional information improves market efficiency

Q2 – Do you think the aggrieved party should receive the penalty imposed, eventually, to the party in breach?

EuroCCP supports the introduction of a fail regime if the settlement ratio is low or in decline. The fail regime must be monitored and actioned by the CCP on the defaulting party, and should not be imposed by the CSD on all parties.

Q3 Do you consider that the elements described above are sufficient to enable CCPs to be managed professionally, independently or their ownership structure? Do you consider additional factors that should be added?

As a general principle, the correct structuring of governance of a CCP is more important than the ownership structure. The position is amplified in Question 7.

With regard to a reference in paragraph 42 that points to the need for a ‘high level of competition’, this would only be possible through the adoption of interoperability between the CCPs supporting a particular trading venue. This is in reference to Title V of the

proposed EMIR regulation which specifically outlines the relevant right of operability, and also refers to Article 21 (1) of the MiFID which states:

'Member states shall require that investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, cost, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.'

As originally proposed, this article makes no specific reference for clearing to be included in this requirement. In light of the EMIR proposals around mandatory clearing, it appears that this is an omission that should be corrected in the review of MiFID. Clearing should be identified as a condition necessary to *'obtaining the best possible result for their clients'*. The MiFID legislation does not ensure that when clearing is mandated under the EMIR legislation, the investment firms and their clients are be offered clearing via venues that take into account *'price, cost, speed, likelihood of execution and settlement, size nature or any other consideration relevant to the execution of the order.'* This requirement implies that the investment firms and their clients should have choice in the selection of clearing venues most appropriate to their requirement.

Q4 – Do you think it should be legally binding to channel multilateral trades in equities listed in the stock exchange via a CCP?

It is not common practice for a CCP to clear all securities listed on a stock exchange. As recommended in the draft of EMIR, a CCP should have the option to clear only the transactions for which, based on its own risk management analysis, it feels it is able to clear. This is the so called 'bottom up' approach as defined in EMIR.

Q5 – Do you think the reform should be addressed on a joint basis so that the CCP handles both equities and fixed-income securities?

The reform should address the use of CCP facilities in both equity and fixed-income securities markets. However, there should be no requirement that a CCP must clear both equity and fixed-income securities.

Q6 –Do you think the use of the CCP should be optional in markets where trading is not multilateral (e.g. fixed-income outside the electronic platforms, block trades, OTC trades in equities)

As above, the choice of a CCP to clear off-exchange transactions should remain the decision of the CCP. The use of such a service by participants should be optional.

Today, EuroCCP supports the clearing of off-exchange transactions and OTC equity trades matched on OTC Matching Engines, introducing the benefits of CCP clearing to a wider financial community. This offering is a service option.

Q7 – Do you consider that the conditions set out above about the CCPs corporate governance are sufficient?

EuroCCP is fully supportive of the need to establish independence of governance from ownership and believe that the guidelines identified in the consultation document have considerable merit.

EuroCCP's governance policy is closely aligned with these guidelines. However, while supporting the principle of independent directors, the impact of their Board presence will be more valuable if they hold relevant skills and experience. Simply having a prescribed minimum number of independent directors on a Board will not in itself provide appropriate oversight and governance control.

For a CCP to have robust governance arrangements, the following elements are essential, as laid out in EMIR:

- A clear organisational structure.
- Adequate policies and procedures.
- A business continuity policy and disaster recovery plan.
- A clear separation between the reporting lines for risk management and those for other operations of the CCP.
- A remuneration policy which is consistent with and promotes sound and effective risk management and which does not create incentives to relax risk standards.

- Information technology systems adequate to the complexity, variety and type of services and activities performed.
- Record keeping of all the services and activity provided and all the transactions processed.
- Persons who effectively direct the business should be of sufficiently good repute and experience so as to ensure the sound and prudent management of the CCP.
- At least three board members should be independent both from other board members and from clearing members and the management of the CCP should be represented by not more than two board members.

EuroCCP supports the principle of establishing an independently chaired Risk Committee and would add the following specific comments:

- The Risk Committee should not be involved in the day to day running of the CCP, its role being that of policy advisor.
- The Risk Committee should be 'independent from any ability of the management of the CCP to override a decision of the Risk Committee', but it is also appropriate to permit a representative from the management of the CCP on the Risk Committee to provide relevant subject matter expertise.
- The Risk Committee should be composed only of representatives of the direct clearing member community of the CCP and independent Board members ('administrators'), plus possibly a representative of the CCP management as identified above. Whilst the case for direct clearing member involvement supported by independent Board members is of clear value, the case for membership of the Risk Committee by clients of clearing members (Non Clearing Firms or NCFs) is less clear given their contractual agreement is with the clearing member, not the CCP. Consequently, their input is more appropriately sourced through the establishment of consultation mechanisms such as advisory groups.
- Where possible, one or more members of the Risk Committee should have relevant risk management expertise.

The principle of 'comply or explain' in relation to the ultimate responsibility for managing the business must remain with the Board of the CCP. If the Board chooses to ignore the

advice of the Risk Committee, it should be able to explain why if asked to do so by the competent authority.

Q8 – Do you think it is necessary that the CCP have access to overnight liquidity from the Eurosystem?

Access to central bank funds should not be necessary during the normal operation of a CCP.

The European Commission's EMIR draft published on 15 September 2010 which suggests that "such liquidity could result from access to central bank liquidity or to creditworthy and reliable commercial bank liquidity or a combination of both" should be supported.

Q9 – Do you consider the proposal mechanisms for managing failed transactions to be appropriate?

EuroCCP maintains nine different buy-in regimes and would support the introduction of a harmonised pan-European process. EuroCCP is actively involved in working group discussions in Brussels to support a harmonised buy-in process, and has suggested a deadline of SD+5. The various timelines and schedules are dictated by the primary stock exchange, primary CCP or primary CSD.

Following an investigation of the possibility of introducing stock borrowing, in the form of CCP auto-borrowing, our analysis has indicated that this will not be cost effective and will introduce an increase of risk in the operational processes of the CCP. There is a further concern that a CCP may not be able to borrow the full coverage of any failed position, resulting in uncertainty as to whether the market will be bought in or borrowed against.

EuroCCP supports the introduction of a CCP controlled buy-in regime. A failed transaction should be able to be settled the next business day, as long as it is prior to a set deadline.

Q10 – Do you consider appropriate the proposed model of settlement by balances and the elimination of the RR?

The continued use of Registration names will not support T2S, nor create a harmonised settlement approach when compared to other CSDs in Europe today.

It would appear that the proposed model of the settlement of balances is to maintain the use of registration names and omnibus third party accounts, even though the consultation also states the proposed changes to the settlement system would be similar to pan-European projects such as T2S.

Q11 – No comment

Q12 – No comment

Q13 – Do you consider that the proposed failed transaction management mechanisms are appropriate?

The above proposals are appropriate and we agree with the need for a buy-in and subsequent cash compensation regime, where necessary, operated by the CCP.

EuroCCP also supports the introduction of partial settlements which can either be operated automatically by the CSD (currently implemented at Euroclear UK & Ireland and VP Securities Denmark) or be operated manually by the CCP (currently operated by EuroCCP where 'CSD auto-partialing' is not present and where the CSD allows the bilateral input of new transactions for same day settlement).

Q14 – Do you consider that there should be a mechanism of alternative compensation?

If penalties are introduced, any fines received should be used to compensate the non-failing party.

Q15 – Do you consider it appropriate to establish a penalty system so as to discourage settlement failures?

EuroCCP does not operate a ‘fines’ regime due to the high success rate of settlements processing through the CCP. However the decision not to adopt a settlement fines regime may change if the settlement success rate decreases significantly and there is a concern that the place of execution, place of clearing and place of settlement have become a “cheap place to fail”.

An alternative would be to fine participants that do not meet a required settlement efficiency level over a set period as currently implemented by both Euroclear UK & Ireland and Monte Titoli.

Q16 – Do you think that the CSD should publish information on trades where settlement failed? If so, in what degree and how often?

EuroCCP does not publish in-depth information on settlement failures although participants are informed of high level settlement rates on a monthly basis. Similar data published by CSDs, with a harmonized definition of what constitutes a “settlement fail”, would be useful for participants.

Q17 – No comment

Q18 – No comment

Q19 – No comment

Q20 – No comment

Q21 – No comment

Q22 – No comment

Q23 – Do you agree with the need for harmonised discipline that regulates the accounts and book-entries, and that variations used by participants should be valid vis a vis the system?

There is a clear need for harmonisation of key data elements relating to accounts, both regionally and globally, such as the Legal Entity/Client Identifier or LEI. The inability of the global regulatory community to quickly, consistently and confidently identify parties to transactions across all markets hinders their ability to evaluate systemic risk and take appropriate corrective steps.

Going forward, regulators will be charged with gathering data originating from markets and processing systems that are increasingly dispersed in order to assess the risks both to specific firms and financial markets.

The EU has already taken tangible steps towards the adoption of standard LEI. For example, the Committee of European Securities Regulators (CESR) - now upgraded to European Securities Markets Authority (ESMA) - has endorsed the usage of the BIC, a standard business identifier code approved by the International Organisation for Standardisation, for specific purposes, as have other European regulators such as the Hellenic Capital Markets Commission and the UK's Financial Services Authority.

That monitoring of systemic risk will be severely hampered if a global LEI scheme is not adopted. This view is supported by several regulators and government agencies in both the EU and US. Without a global standard, regulators will need to 'translate' the multiple market identifiers, commercial identifiers and counterparties' own internal identifiers in order to aggregate data relating to a single counterparty operating across multiple jurisdictions, markets and asset classes.

Q24 – No comment

Q25 – No comment

Q26 – No comment

Q27 – No comment

Q28 – No comment

Q29 – No comment

Q30 – *In your opinion, does any other aspect of finality need to be considered at this time?*

No, all options are covered.

Q31 – *Which of the three options for the time of finality at the CSD do you consider to be the most appropriate from the standpoint of protecting the system?*

Option 2 is the most appropriate solution as:

- Option 1 is too early in the settlement lifecycle for finality at the CSD. A matched trade does not guarantee settlement as it is still possible for either buy-ins to take place or for one of the counterparties to go into default.
- EuroCCP agrees with the issues raised in paragraph 180 in relation to option 3.

Q32 – *Do you think overall system costs will be lower than at present?*

Due to CCP netting, the overall number of transactions that the CSD will need to process will be lowered, reducing the cost of the overall process. Fewer transactions to process will reduce operational risk and its associated costs.

Q33 – *in your opinion, will eliminating RRs make settlement and registry processes cheaper?*

Yes, as any simplification to the matching and settlement process is likely to reduce costs.

Q34 – *Do you think the changes to be introduced by the reform will reduce the number of entities performing these activities?*

As part of its risk management defences, a CCP will have specific membership criteria. Not all trading counterparties will satisfy these criteria and will therefore not have direct access

to a CCP. However, CCP services can be accessed indirectly through the use of a General Clearing Member or GCM.

Q35– No comment

Q36 – *Do you consider the introduction of non-settling members to be a good idea?*

Yes. This solution makes clearing accessible to a greater number of players and has been shown to positively impact liquidity of the market.

Q37 – No comment