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European Commission Public Consultation on Derivatives and Market Infrastructures

EUROCLEAR RESPONSE

Euroclear is pleased to be given the opportunity to offer its views on the consultation on Derivatives and Market Infrastructures that the European Commission is conducting in view of finalising draft legislative proposals for the regulation of Central Counterparties (CCPs) and Trade Repositories (TRs).

As a provider of securities settlement, custody and collateral management services[1] (and registered on the European Commission's register of interest representatives - ID number 88290282308-75), our comments relate to the general need to improve the infrastructure supporting OTC derivatives as well as to specific questions raised in the consultation document.

KEY POINTS

(i) Future legislation should recognise complementary risk management solutions which provide risk mitigation for bilaterally cleared, non-CCP eligible transactions

The regulation should take a balanced approach to risk mitigation, ensuring that existing bilateral risk mitigation techniques are actually recognised by regulators and are utilised by the market. Bilateral collateral management arrangements have proven their efficiency for repos, stock lending and related financing instruments. The use of the same tools and processes for collateral related to derivatives exposures provides the same efficiency and achieves comparable risk reduction. These solutions for non-CCP cleared activity should not be disproportionally discouraged by punitive capital requirements, but should be viewed as effective and complementary measures to achieve strengthened collateralisation of bi-laterally cleared transactions, contributing to the overall regulatory objective of reducing counterparty risk significantly. See section I.5. for additional specific comments.

(ii) There are alternative arrangements to the formal outsourcing of a CCP's functions, services or activities that are currently in successful operation in some markets and which should be recognised by the regulation to preserve market efficiency

Today some CCPs have entered into collaborative arrangements with some Securities Settlement Systems (SSS) which have proved their robustness, even in the most turbulent market conditions, and which have not affected the ability of the CCPs to keep strict control over their core risk functionality. See section II.4. for additional specific comments.

[1] Euroclear group comprises the international central securities depository Euroclear Bank, based in Brussels, as well as the national central securities depositories (CSDs) Euroclear Belgium, Euroclear France, Euroclear Nederland, Euroclear UK & Ireland and NCSD, the CSD for Finland and Sweden. Euroclear also owns EMXCo, the UK's leading provider of investment-fund order routing, and Xtrakter, which operates the TRAX trade matching system.

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(iii) Market Infrastructure legislation should be consistent with existing CPSS/IOSCO and ESCB/CESR recommendations

Considerable effort has already been invested across the EU (ESCB/CESR) and globally (CPSS/IOSCO) in delivering a regulatory environment which aims at efficient, safe and sound clearing and settlement arrangements. The final proposals from the Commission should be consistent with this already agreed Framework.

(iv) Market Infrastructures legislation must be consistent with any forthcoming CSD legislation and should appropriately reflect the provisions of the Code of Conduct

Whilst it is not yet clear what legal vehicle will define the future regulation of CSDs, the European Commission should ensure that any future CSD legislation is consistent with the proposed Market Infrastructures Regulation (for CCPs and TRs) and that both proposals take into account the 2006 Code of Conduct on clearing and settlement with regard to:

- access and interoperability,
- price transparency,
- unbundling of activities and accounting separation between trading, clearing and settlement layers, and
- access to CCP transaction feeds.

Specifically in relation to the last point, we believe CCPs should (subject to the provisions of the Code) be required to give a transaction feed to CSDs (for cash instruments).

(v) Market Infrastructures legislation must be consistent with MiFID provisions on access to clearing and settlement providers

Given that the proposed future legislation for CCPs – and the proposed CSD legislation – assigns clear responsibilities for authorisation to competent authorities and ESMA, we suggest that MiFID articles 34 §2 and 46 be reviewed. These articles (which were drafted when there was no authorisation framework for CCPs or CSDs) currently assign powers in relation to MiFID access rights to the regulators of the trading venues only.

(vi) Conflicts of interest in Trade Repositories (TRs) need to be avoided

We note that the proposed texts only include conflict of interest clauses in relation to CCPs, not in relation to TRs. We believe the legislation should anticipate situations where the operator of the TR is an entity that is competing in other areas with clients of the same TR, so appropriate segregation measures (e.g. Chinese walls, etc) should ensure the integrity of the systems and information held in those systems.

(vii) Trade Repositories should aim to develop common data standards

As the information specifications are still being discussed widely between market participants and newly formed (or still to be formed) TRs, we would recommend that the legislation mandates an open market consultation over common data standards. This would ensure that users of the TRs contribute to the development of these standards, that harmonisation of these standards is sought and efficiency of exchange and treatment of data is considered early in the process. The future European Securities Markets Authority (ESMA) may need to play a role in defining a Level 2 framework for such standard setting.

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SPECIFIC COMMENTS

I. Clearing and Risk Mitigation of OTC derivatives

- **I.5. Risk mitigation techniques for non-cleared contracts: Do stakeholders share the principle and requirements on the risk mitigation techniques for bilateral OTC derivative contracts?**

We support the European Commission's focus on counterparty risk reduction in the derivatives markets, but also appreciate that the European Commission recognises that innovation and developments in financial markets is likely to continue to result in non-standard, bespoke structures which may not be eligible for mandatory clearing.

While the G20 calls for differentiation in capital treatment of bilaterally cleared transactions, we believe that the related credit risk can be successfully mitigated through bilateral clearing arrangements (e.g. tri-party collateral management solutions). The earlier EC Communication recognised this and even promoted the strengthening of bilateral clearing arrangements. Bilateral collateral management arrangements have proven their efficiency for repos, stock lending and related financing instruments. The use of the same tools and process for collateral related to derivatives exposures provides the same efficiency and achieves similar risk reduction. We believe that the regulation should take a balanced approach to risk mitigation, ensuring that existing bilateral risk mitigation techniques are actually recognised by regulators and are utilised by the market.

Within this context, Euroclear Bank has developed a service for the OTC derivative markets, DerivManager, the main feature of which is to allow parties to a derivatives transaction to collateralise their counterparty exposure in a dynamic and efficient way for all classes of OTC derivatives trades. We are of the view that this offers an interesting complement to existing and future CCP services for OTC derivatives and fits within the generalised call for a structural risk management solution in this market.

We believe that solutions like these should not be disproportionally discouraged by punitive capital requirements on non-CCP cleared activity and should be viewed as worthwhile complementary measures to achieve strengthened collateralisation of bi-laterally cleared transactions which contributes to the overall regulatory objective of reducing counterparty risk significantly, which is also part of the G20 and EC's agenda.

II. Requirements for Central Counterparties

- **II.3. Conflicts of interest**

We believe that the requirements for CCPs should include some safeguards against potential conflicts of interest that could arise if CCPs belong to groups of companies that also provide other trade and post-trade services. This was an important issue covered by the 2006 Code of Conduct in its provisions on service and price unbundling between trading, clearing and settlement, accounting separation, and access requirements for receiving a CCP transaction feed. While the absence of such wording may suggest that the Commission has few concerns with vertical silos, this topic merits specific ex ante attention, as such structures could lead to anti-competitive behaviour towards other CCPs and CSDs, which could only be addressed by ex-post intervention based on EU competition law.

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- **II.4. Outsourcing**

The consultation paper wishes to retain "stringent principles and rules that ensure that a CCP continues to retain control over its functions and that they are not outsourced to third parties" and outlines three important principles and requirements which would meet those concerns. We understand these principles and agree that market infrastructures should at all times maintain control over their core functions and must be able to meet all regulatory and prudential requirements. However, the consultation paper contains a rather broad and imprecise reference to "operational functions or any services or activities" which will requires further clarification.

The regulation should also recognise that the concept of third parties providing a number of functions in the CCP area is not limited to outsourcing. Clearing related services, including settlement netting and information provision to clearing members of a CCP may be undertaken by third parties, including by securities settlement systems, on a non-outsourced basis (i.e. with a direct contractual relationship between the clearing member and the third party concerned). These services may be rendered under collaborative arrangements between CCPs and securities settlement system which do not constitute "outsourcing" nor "delegation of responsibility". Arrangements of this type have been in place for ten years and have proven their effectiveness and robustness even in times of market turmoil. They have not been an issue from a risk management viewpoint, nor from a regulatory viewpoint.

It is our view also that any future regulation should not preclude the fact that some services, such as netting, can be competitive. Preventing anyone other than the CCP from offering operational netting services will restrict competition and potentially increase costs, with no apparent risk management gain.

The fact that there are alternative arrangements to the formal outsourcing of a CCPs functions, services or activities that are currently in successful operation in some markets, implies that information may directly be received (by clearing members and settlement agents) from Settlement Securities System and that this has an impact on some of the proposed organisational requirements (outlined in section II.1. on pages 8-9 of the consultation paper), or transparency requirements (section II.6.d on page 10).

Finally, such collaborative arrangements between a CCP and SSS will also have an impact on the portability of positions and imply that in some circumstances, the CCP should not be acting in isolation but that some functions (e.g. in case of pending settlement instructions) should also be carried in conjunction with the SSS (which may have primary responsibility for certain actions).

- **II.8.K. Settlement risk**

As stated above, Market Infrastructure legislation should build on existing CPSS/IOSCO and ESCB/CESR recommendations. We welcome the wording in Section K(a) which is broadly consistent with the ESCB/CESR Recommendations. The Regulation must recognise that settlement in central bank money may not always be practical or desirable and that risks in post-trade commercial bank money settlement can be successfully mitigated through a variety of measures.

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III. Interoperability

➢ III.1. Interoperability

The legislation that deals with interoperability established between CCPs for the purpose of providing services to a particular trading venue (section III.1.b) should not only take a view on non-discriminatory access to the transaction feed between a trading venue and the requesting CCPs. It should also consider the entire process chain from trading venue to settlement and hence also facilitate access by a requesting CSD to a feed from a CCP on the same non-discriminatory basis.

With regard to interoperability and the "written justification by the party receiving the request" (as suggested in III.1.c.) that would substantiate the potential denial of interoperability (with a CCP), we suggest that the 'competent authority' or ESMA ascertain the validity of such a justification in order to avoid refusals for anti-competitive reasons.

IV. Reporting Obligations and requirements for Trade Repositories

➢ IV.2. Requirements for Registration of a Trade Repositories

With regard to the proposed options for registration of TRs, the third 'European public utility' option requires further clarification. The text is not clear as to precisely what is intended: one Europe-wide utility or many? Existing competent authorities to perform the function or other new bodies to be set up?

The consultation paper does not spell out any convincing reasons for requiring the set up of a public utility to perform the function of a trade repository. There are already a number of parties active in the provision of information to the financial markets and there is no reason why, with the appropriate registration and regulation, they should not be able to fulfil the function of providing information to the market and regulators in the derivatives sphere. This would be entirely complementary to the provision of transaction reporting services across the EU, which are entrusted to properly authorised and regulated Approved Reporting Mechanisms (ARMs).

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