

31st January 2013

European Securities and Markets Authority
CS 60747
103 Rue de Grenelle
75345 Paris Cedex 07
France

AFME response to ESMA Consultation paper: Guidelines for establishing consistent, efficient and effective assessments of interoperability arrangements

Dear Sirs,

This letter contains the response of the Association for Financial Markets in Europe (“AFME”) to the European Securities and Markets Authority (“ESMA”) Consultation Paper on “Guidelines for establishing consistent, efficient and assessments of interoperability arrangements” of December 2012.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. For more information, visit www.afme.eu.

Yours faithfully,



Stephen Burton
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Consultation response

ESMA Consultation paper: Guidelines for establishing consistent, efficient and effective assessments of interoperability arrangements

30th January 2013

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on ESMA's "Guidelines for establishing consistent, efficient and effective assessments of interoperability arrangements". AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

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We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Executive Summary

AFME and its member firms have been long standing supporters of interoperability for cash securities. Following the introduction of competitive clearing by the London Stock Exchange in Nov 2008 where two Central Counterparties (CCPs) interoperated, AFME worked closely with the four CCPs to support the development and scalability of the 4-way interoperable model. This has now been operational for over a year between EMCF, EuroCCP, LCH.Clearnet Ltd. and SIX-X-Clear with no discernable increase in risk, whilst members have observed a competitive pricing landscape. The user demand for interoperability has been further supported with AFME members switching their clearing arrangements once choice has been offered. Whilst AFME does not have CCPs as members, we hope that our observations of the market over the past few years will compliment the responses of the CCPs.

The opportunity for a firm to consolidate the clearing of transactions from multiple venues into fewer or a single location can enable considerable savings. These include reduced

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clearing costs through economies of scale at a CCP, reduced settlement costs through cross exchange settlement netting, enhanced risk netting and reduced connectivity and membership costs. These elements contribute towards the AFME principal of achieving safe and efficient markets.

AFME members believe that the model is now a proven one, that there continues to be clear demand; however this is offset by a distinct lack of progress largely due to no market infrastructure being compelled by law to interoperate.

Exchange-owned CCPs often cite a lack of regulatory certainty in this area. We therefore welcomed Title V of the EMIR text as a first step to assuaging these concerns and the draft guidelines are valuable in detailing further the process under which interoperability may be granted and monitored.

However, there is little in the draft guidelines to compel a CCP to interoperate. Whilst these guidelines help standardise the regulatory assessment process, it is not clear that a successful assessment of a request would lead to interoperability being offered. We would advocate that if the relevant NCAs authorise the relevant CCPs, this approval should lead to mandatory interoperability being offered in those markets which should not be impeded by the commercial interests of another part of the organisation that may also own the CCP. The process should follow a timeline agreed between the NCAs and ESMA, and we feel strongly that ESMA has a key role to play in monitoring the implementation and calling the relevant parties to account if the process is unnecessarily delayed.

Key points of our consultation response

1. AFME supports the spirit of transparency set out in the guidelines and the determination of risk as the key criterion in the process of interoperability.
2. We advocate that interoperable CCPs should not contribute the default fund of another CCP.
3. We believe that identical or harmonised risk management frameworks could limit future innovation in this area and would advocate a more detailed assessment of the differences between CCP's procedures and potential benefits of harmonisation.
4. We seek greater clarity about the enforceability of the guidelines where ESMA has opined on matters that are not included in the EMIR text.
5. In regard to timelines for access to and termination of interoperability arrangements and rule changes, we would welcome the addition of a definitive interval between agreement and implementation.
6. In respect of CCP's assessing another CCP's membership, we would expect the authorisation process of EMIR to review a CCP's underlying participants and therefore view any further evaluation as duplicative.
7. It is unclear if a successful assessment would necessarily lead to interoperability. We urge ESMA to monitor, and via the NCAs, compel CCPs to establish interoperable links following successful assessments in accordance with these guidelines.

Questions

Q1. Do you think that the draft guidelines adequately capture all the relevant considerations for an NCA when receiving an application from a CCP to establish an interoperability arrangement?

We believe that the current draft guidelines do not adequately capture all the considerations that a National Competent Authority (NCA) should apply when assessing potential CCP interoperability requests. In general the guidelines seem to suggest an approach that relies on a tick box exercise, relying on whether a CCP has performed a task, rather than how well it performed it, and whether the approach is in line with the expectation of the NCA. However, we feel that greater specificity and reference to RTS would be helpful in creating continuity across the NCAs.

We are broadly supportive of the guidelines and find the risk based approach helpful in eliminating any commercial considerations from the assessment process. The current four way interoperable CCP construct is a good example of regulators, CCPs and the industry working together for a common good. However, there are cases where, in spite of an approved risk model governing interoperability, markets or exchanges have withdrawn planned interoperability just prior to launch, with no substantive justifications. Therefore, we would support the relevant NCAs monitoring the process and ESMA being provided with oversight and the relevant power to intervene should one of the parties deviate from the implementation path.

We have also observed other barriers to entry in some jurisdictions that are not addressed in the guidelines. These include the requirement for a CCP to be a Credit Institution, a potential requirement to be based in the Euro zone only and an obligation to hold a TARGET2 cash account. Whilst it can be argued that these measures are prudent in uncertain times, we have observed that CCPs which do not meet these criteria continue to process trades with no evidence that they are less robust or that their risk methodologies are insufficient to manage their counterparty risk effectively. We would advocate that NCAs should have the flexibility to require certain additional assessments, but these should be justifiable and transparent, and be based on risk management as per the principle set out in the guidelines.

The proposed detailed guidelines lack the level of detail required to allow for a harmonised approach to interoperability arrangements in different EU countries. Consequently, NCAs might interpret the guidelines differently which may lengthen the approval process or offer the opportunity for regulatory arbitrage. Please see more detailed comments for some of the guidelines below.

Guideline 1 Legal Risk

a) Documentation

The proposed guideline on the legal analysis does not suggest that the NCA should perform an investigation to determine if the CCP's assessment has sufficient substance. We would be in favour of revising the text to ensure a diligent examination by the NCA to establish whether the assessments performed by the CCP's legal team meet the NCA's expectation.

The guidelines state that the documentation governing the interoperability arrangement "is compatible with the risk mitigation processes of the CCP." A definition of Risk Mitigation Processes would be welcome and avoid potential confusion in future.

Guideline 1 states that a CCP must establish a process to consult its risk committee and clearing members where the establishment of an interoperable link will materially impact the risk that

the CCP bears or that of its members. AFME advocates that CCPs provide full transparency on the contents of the legal documentation to their members irrespective of whether it would result in a change to the overall risk framework.

b) Legal analysis

It is unclear if, having conducted an assessment on a fellow CCP, the “home” CCP passes information to its NCA as part of the overall analysis

Guideline 2 Open and fair access

Title V and these Draft Guidelines are an important step in the right direction, However, it must be remembered that the process of interoperability is dependent on a trading platform offering its trade feed to CCPs. The non discriminatory access provisions in MiFIR will attempt to create certainty for the platforms. However, these should not be forgotten in the overall process of interoperability and the timeframes that we strongly believe should be implemented and monitored by NCAs and ESMA. We believe that there should be fully transparent, pre-defined and pre-agreed/authorisation criteria for CCPs to be able to gain access to a trading feed. This process should include a pre-determined timeframe for CCPs (and trading venues) to respond and implement an interoperable solution. We would favour ESMA and the relevant NCAs conducting a monitoring procedure. There are a number of trading venues currently unwilling to interoperate and providing no clear rationale for their decision even though there is strong demand from their members and a proven interoperability model for the respective CCPs. The current interoperating CCPs have already received authorisation from their own NCA and the interoperable CCPs' NCA. Given the level of due diligence already undertaken, we would be concerned if any criteria, other than those based entirely on risk grounds, were used to remove existing interoperability agreements.

Guideline 2, para 2(i) and (ii) –regarding the termination of an interoperable arrangement, we note that the words “duly justified” do not appear in EMIR Title V, but have been added by ESMA and it is therefore unclear to us how these guidelines will be enforced over and above the Regulation. Equally EMIR does not state that the CCP has to provide adequate justification to its NCA of its reasons to terminate the arrangement. EMIR does not cover termination of such arrangements at all. Additionally, we would welcome a clarification of who will determine whether the justification is “adequate” and by reference to what parameters (e.g. is the intention to terminate based solely on suitably appropriate risk grounds?).

Authorisation. Our members would welcome clarity on which NCA will opine on the authorisation of a CCP and what arrangements would be made in the event of a non-approval, since members’ ability to clear specific markets could be greatly impacted.

Guideline 3 Identification, monitoring and management of risks

Guideline 3(2)(a)(ii) –We can understand the rationale for a CCP to have comprehensive information on the operations of an interoperable CCP. It is questionable whether a CCP would voluntarily share confidential information relating to its risk management procedures, for fear of losing any competitive advantage it may feel it has over other CCPs as a result of its risk management methodologies. However, we believe it is essential that interoperating CCPs should be compelled to share their risk algorithm, calculation frequency and pricing variables, as this would enable the measurement of a CCP’s risk by another.

Guideline 3(2)(a)(v): The process for informing interoperable CCPs of any change to rules of the CCP does not mention any timeframes. We would strongly advocate that ESMA define a notice period prior to a change taking effect. This process should include a pre-determined timeframe for CCPs to respond and implement an interoperable solution and we would favour ESMA and the relevant NCAs to conduct a monitoring procedure. In addition such changes should be aligned to any CCP clearing member communication to avoid uncertainty. It may also be

desirable if ESMA could elaborate how changes should be agreed upon by interoperating CCPs. In addition ESMA may want to clarify the magnitude of change that should be advised (e.g. a small change to a report may require little notice at all whereas a change to the risk model would be significant for all parties).

Guideline 3(2) (a) (vii) there is no suggestion in title V EMIR that CCPs should “assess the need for harmonisation of their respective risk management frameworks” – CCPs may view their own risk management frameworks as having certain competitive advantages over those of other CCPs. Our view is that identical or harmonised risk management frameworks could limit future, improvements in this area by a CCP. The NCAs and ESMA should be responsible for assessing the risk management frameworks and determining if the any differences or future innovation could be detrimental.

Guideline 3(2)(a)(x): To be consistent with EMIR Article 42 (3), we would suggest that CCP’s default management procedures are designed to ensure that “the default of the clearing member to which it has the largest exposures or of the second and third largest clearing members, if the sum of their exposures is larger” does not affect the operations of the interoperable CCPs or expose them to additional risks.

The respective measures in an interoperability agreement should take into consideration the potential default of an interoperating CCP’s major clients.

Guideline 3(2)(a)(xii): We believe that the termination of an interoperability arrangement should in every case be made known to the CCP participants with at least 6 months notice to ensure that there is no disruption and to allow for participants to revise their own arrangements, which requires technology investment, in a controlled and risk managed manner.

Guideline 3(2)(b)(v) goes beyond EMIR – we found no clause in Title V that states that a CCP cannot require another interoperable CCP to contribute to its default fund or the other financial resources mentioned in Art 43 EMIR, AFME does not support this proposition and the current process does not require contribution by a CCP to another’s default fund., In the event of a CCP default, the standing CCP would be liable for loss allocation on a defaulting member of the interoperating CCP. The default fund contribution and possible loss sharing would then need to be re-allocated to all members of each CCP, leading to increased risk and costs. We would ask that ESMA provides greater clarity on the definition of “financial resources”.

Guideline 3(2)(d)(i): Rather than each CCP assessing the membership criteria of another, we foresee an improved method whereby the assessment is part of the EMIR approval process undertaken jointly by ESMA and NCAs. We would welcome a more specific timeframe in terms of regular reviews (i.e. at least once every year and with every change of procedure) in order to cater for a harmonised approach amongst NCAs. Further detail about the requirements to verify details of the arrangements that should be in place to mitigate risks from differing models would be welcomed.

Guideline 3(2)(e)(ii): Within this section it might be questioned how CCPs should obtain such information to ensure there is no issue. In addition it appears it is unclear how a CCP should monitor the business of entities operating at different CCPs given that the commercial arrangements between CCPs and their clearing members or service providers will be maintained on a confidential basis. The principal of interoperability is that a CCP manages the default risk of its clearing member via its own default management process. Interoperating CCPs, and the respective collateral, is used to manage scenarios where the CCPs themselves are not able to settle their obligations to each other.

Guideline 3(2)(f)(i)(c): From our perspective it is unclear why the calculation of inter-CCP margin might differ from that of a clearing member. Based on our above comments interoperating CCPs would still be participating entities at the other CCPs and as such be subject to a similar treatment.

Guideline 4 Deposit of Collateral

We fully support the use of bankruptcy remote procedures although it would be helpful to clarify the meaning of bankruptcy remote to avoid any misunderstanding. These measures are enforced today between the four interoperable CCPs via an agreement between the CCPs and an ICSD. Subject to the definition of bankruptcy remote proceeds, there is an opportunity to clarify within the detailed guidelines that interoperating CCPs should be allowed to deposit collateral with operators that fulfil the operational infrastructure requirements and have robust legal protection in place.

We note that Article 44 of the EMIR RTS “Highly secured arrangements for the deposit of financial instruments” calls for the use of CSDs but also caters for the use of Central Banks, Financial Institutions or foreign financial institutions should the earlier not be feasible. Given that EMIR caters for “regular” collateral to be deposited with these institutions, it should allow for the same in an interoperability arrangement, provided the relevant infrastructure and legal protection is afforded.

Guideline 5 Cooperation between NCAs

In our view, the description of NCA cooperation during assessment phase should be amended to reflect ongoing cooperation and ongoing assessment rather than the initial phase only.

Q2: Are there areas where it would be helpful to have more detail on the relevant considerations for an NCA when receiving an application from a CCP to establish an interoperability arrangement? If so, please specify what those details should be.

From the draft guideline it appears unclear how settlement fails between interoperating CCPs should be handled. We would appreciate a further guideline on how NCAs should evaluate the processes how settlement fails are treated, e.g. should a buy in occur between CCPs in an interoperable environment? A standardised process would lead to reduced cost and complexity and increased safety and efficiency.

Q3: Is it appropriate to consider an assessment by CCPs of the membership criteria of interoperable CCPs?

Currently, only cash equities have a significant interoperable footprint. These securities are highly liquid with short settlement cycles which in many markets will shorten further to T+2 via the upcoming CSD Regulation from Jan 1, 2015. We believe that the risk management process of CCPs for these securities is sufficiently robust. Moreover, under EMIR, all CCPs will have to be authorised and that will require a re-examination of the membership criteria by the NCAs. Therefore, we would argue that any assessment of the CCPs’ underlying participants should be addressed in the process of CCP authorization by the NCA, and not by CCPs. Adding an additional requirement for a CCP to assess another CCP’s membership criteria seems duplicative and unwarranted if the NCA makes a thorough initial assessment of the CCP.

Q4: Do you have additional comments on the draft guidelines?

AFME members are strong advocates of interoperability which enables choice and competition. AFME has demonstrated that demand exists and when choice has become available, its members have proved their willingness to consolidate their clearing into fewer central counterparties. However, interoperability has not been fully offered, in spite of demand and a proven risk management process between CCPs, which has constrained choice and efficiency.

AFME supports the spirit of transparency that has been set out in the guidelines, specifically in relation to the need for clearing members to have access to key documents that underpin interoperable arrangements. These include, but are not restricted, to the content of their Master Clearing Link Agreements (MCLA), and inter-CCP procedures.

It has been frustrating that further progress has not been made in this area. These draft guidelines are helpful and an excellent step forward. However, we have witnessed how commercial aspects have formed a barrier to interoperability and that is unlikely to change without ESMA and the relevant NCA taking action to enforce interoperability, in the spirit of both non discriminatory access and genuine choice of CCP within the Single Market.

Conclusions

Notwithstanding the requirement for non discriminatory access covered by MiFID2, which is essential for interoperability to proceed, AFME members believe these guidelines will provide market infrastructures with a single set of balanced criteria by which they can assess a CCP. This may require an element of compulsion by regulators to ensure that market infrastructures do not assemble other barriers as a means of avoiding interoperability. We hope our responses to this consultation paper will assist ESMA's understanding of our key concerns. We look forward to discussing the issues addressed in this paper with ESMA, and would be happy to respond to any queries from ESMA on the views and questions set out.