

clear to trade



## **Eurex Clearing**

### **Response to**

ESMA Discussion Paper on Draft Technical Standards for the Regulation on improving securities settlement in the European Union and on central securities depositories (CSD)

Frankfurt am Main, May 22<sup>th</sup>, 2014

## Acronyms Used

AG	Aktiengesellschaft, entity incorporated under German law
ASDN	Actual Settlement Day Netting
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority)
CCP	Central Counterparty
cp.	compare
CSD	Central Securities Depository
CSDR	Regulation on Central Securities Depositories, Regulation on improving securities settlement in the European Union and on central securities depositories (CSD)
EMIR	European Market Infrastructure Regulation
e.g.	exempli gratia, for example
EU	European Union
ESMA	European Securities and Markets Authority
FWB	Frankfurter Wertpapierbörse (Frankfurt Stock Exchange)
i.e	id est, that is
ISD	Intended Settlement Day
ISD+7	Intended Settlement Day plus an extended period of 7 days
ISIN	International Securities Identification Number
OTC	Over-the-Counter
RTS	Regulatory Technical Standards
SSR	Short Selling Regulation, Regulation (EU) No 236/2012
TDN	Trade Day Netting
T2S	Target2 Securities

## **A. Introduction**

Eurex Clearing, Europe's leading clearing house, offers fully-automated, straight-through post-trade services for derivatives, equities, bonds and secured funding & financing. As a globally leading central counterparty (CCP), Eurex Clearing assures the safety and integrity of markets while providing innovation in risk management, clearing technology and client asset protection. Eurex Clearing provides fully-automated, straight-through post-trade services for derivatives, equities, bonds and secured funding & financing, as well as industry-leading risk management technologies.

As part of Eurex Group, Eurex Clearing acts as the CCP for Eurex, Eurex Bonds, Eurex Repo, the FWB® Frankfurter Wertpapierbörse (the Frankfurt Stock Exchange) - both Xetra® and floor - and the Irish Stock Exchange. Eurex Clearing serves more than 190 clearing members in 16 countries, managing a collateral pool of around EUR 48 billion and processing gross risks valued approx. EUR 15.9 trillion every month. Recently, Eurex Clearing's national competent authority BaFin (Federal Financial Supervisory Authority) has approved its application as a clearing house in accordance with the European Market Infrastructure Regulation (EMIR).

Eurex Clearing has contributed to the market consultation and addressed the key comments on the draft legal text on the CSDR from a CCP point of view since we were first involved in late 2011. Hence, we welcome the opportunity to also comment on ESMA's Discussion Paper on Draft Technical Standards for the Regulation on improving securities settlement in the European Union (EU) and on central securities depositories (CSD) which was issued in March 2014.

In section B of this document general remarks we have on the discussion paper are considered. Finally, section C of this document contains responses to the questions of the discussion paper that we believe are relevant for Eurex Clearing as a CCP. As requested, we have included the question to which our responses refer to and suggested alternatives for ESMA to consider on the proposed text.

Eurex Group is owned by Deutsche Börse AG (Xetra: DB1).

## **B. General remarks**

In general, Eurex Clearing supports the objective of the CSD Regulation in regards to harmonizing the timing and discipline of securities settlement in order to guarantee safety, effectiveness and cost efficiency during the post trading process across the EU.

However, based on the level 1 text of the CSD Regulation (CSDR) some concerns regarding responsibilities and tasks in the way they are proposed to be carried out arose from our point of view. Therefore, we would like to take the opportunity and address the key points as follows:

Considering the operating model of a CCP, matched transactions are always considered in the processing. Therefore our understanding is that the rules proposing matching on Intended Settlement Day (ISD) \*-2 apply to Over-The-Counter (OTC) transactions only. Hence, a clarification by ESMA regarding the treatment of cleared transactions is required. Otherwise the application of disincentives at ISD-2 would result in significant changes to the currently applied Actual Settlement Day Netting (ASDN) operating model of Eurex Clearing and would lead to severe market impact and high costs for market participants.

With regards to the settlement fail regime described in the level 1 text of the CSDR the involvement of the CCP is only foreseen in the buy-in process (cp. Article 7, 3 & 4a). However, further activities for cleared transactions which are also relevant from a CCP processing point of view (i.e. the appropriate penalty regime as well as the execution of a cash settlement, in case the buy-in is not possible or successful) are currently only foreseen to be executed by the CSD. From our perspective considering different netting models being in place a change of the currently applied penalty regime which is appropriate for all netting models is understood as not required because delivery instructions processed under ASDN model are not available in the CSD overnight and, consequently, are assumed as not considered by the CSD. Only delivery instructions processed under Trade Day Netting (TDN) remain in the CSD for consideration; nevertheless, unequal treatment should be avoided.

Furthermore, CSDs are proposed to be in charge of reporting settlement fails. Hence, similar to the processing of collecting penalties for settlement fails, it has to be differentiated between the different netting models and considered that the required reporting can only be fulfilled for delivery instructions resulting from TDN netting model.

Moreover, the method for the calculation of the cash settlement price in case when a cash compensation occurs should ensure that a late buyer receives a sufficient financial compensation for the delivery delinquency and consider an “add on” on the reference price allowing the cash settled buyer to purchase not delivered financial instruments in the market without any loss. It further needs to be clarified if the calculation method will be determined by ESMA or left within the area of responsibility of the institution executing the cash settlement.

Last but not least Eurex Clearing would like to call attention that according to Article 72a of the CSDR level 1 text a replacement of the discipline rules according to Article 15 of Regulation (EU) No 236/2012 (SSR) by Article 7 CSDR is proposed. Until the

Regulatory Technical Standards (RTS) will be in force no legal framework on settlement discipline will be in place. Hence, Eurex Clearing proposes a clarification of the interim period between the CSDR going into force and the ESMA technical standards being set into production.

After the RTS are published the timing for implementing the requirements of the technical standards will be of essence as preparations for T2S will be ongoing in parallel.

## C. Detailed comments on the discussion paper

**Question 5:** Do you agree with the above proposals? What kind of disincentives (other than monetary incentives such as discounts on matching fees) might be envisaged and under which product scope?

### **Eurex Clearing comments:**

The understanding of Eurex Clearing is that the proposed handling is focusing on OTC transactions only and not on transactions cleared via a CCP even though it is not explicitly stated in the text that CCP transactions are excluded from the proposed rules. Moreover this understanding is resulting from the situation that CCPs would always consider matched transactions in their processing which could be received either out of the novation of matched transactions received by a CCP or from the CCP stepping into to match transaction based on open-offer at the point in time when matching occurs. The two possibilities are explained as follows:

Novation: The bilateral (already matched) agreement between seller and buyer is cancelled and replaced by two agreements (seller as well as buyer) with the CCP.

Open Offer: The two counterparties of a transaction (seller and buyer) never reach a bilateral agreement because the CCP steps in at the point in time when matching occur.

Finally transactions (delivery instructions) resulting out of the CCP netting process provided by a CCP to the CSD for settlement must be differentiated from OTC transactions where typically matching in the CSD is required.

Therefore, Eurex Clearing is of the opinion that the respective rules would only apply to OTC transactions whereby matching is required in the CSD (i.e. uncleared business). This is resulting from the understanding that transactions cleared by a CCP are already matched when they are considered by the CCP; hence, the subsequent technical delivery instructions should not fall under this rule.

**Question 9:** Do you agree with the above monitoring system description? What further elements would you suggest? Please present the appropriate details, notably having in mind the current CSD datasets and possible impact on reporting costs.

**Question 10:** What are your views on the information that participants should receive to monitor fails?

**Question 11:** Do you believe the public information should be left to each CSD or local authority to define or disclosed in a standard European format provided by ESMA? How could that format look like?

### **Eurex Clearing comments:**

In general, regarding the format, Eurex Clearing does not have any specific preferences and the granularity of information to be reported seems to be reasonable. However, it

needs to be considered that there are different netting models and only delivery instructions from the TDN model are available at the CSD for consideration in reporting and / or fining. Therefore, considering the characteristics of the ASDN model the corresponding information is only available on CCP level, because:

- Transactions are netted directly before the ISD resulting in technical delivery instructions which are subsequently sent to the CSD (i.e. CSDs only receive information on instructions but not on individual trades).
- Delivery instructions not settled until the end of the settlement day are deleted in the CSD and reconsidered in the CCP netting for the net settlement day. Hence, internalization of failed transactions within the originator is possible and resulting market impact can be reduced.

Furthermore monitoring in case of ASDN can only be executed by CCPs and is already in place due Article 15 of Regulation (EU) No 236/2012 (SSR). It is worth to mention that resulting out of the TDN model information of single trades is only available at the CCP and only technical delivery instructions which are sent to the CSD are available for reporting by the CSD.

Finally, it has to be distinguished between different entities which are part of the entire process chain: Trading Members participating on the trading venues, Clearing Members participating in the CCP and Settlement Institutions/ custodians known to the CSD. The CCP has the information on Clearing Member level while CSDs have information on Settlement Institution / custodian level only. Therefore, it has to be further defined what kind of information is required for reporting. The information on the different levels has to be distinguished in order to ensure the provision of an appropriate reporting.

Consequently, Eurex Clearing understands that the system monitoring settlement fails will only apply for delivery instructions remaining on CSD level after settlement date.

**Question 12:** What would the cost implication for CSDs to report fails to their competent authorities on a daily basis be?

**Question 13:** CSDR provides that the extension period shall be based on asset type and liquidity. How would you propose those to be considered? Notably, what asset types should be taken into consideration?

**Eurex Clearing comments:**

In general, a buy-in regime is already in place on CCP level (for ESMA regulated securities and all others as well).

If the buy-in regime will be redesigned, the determination of the auction date should take into account that different markets have different level of liquidity. Hence, a financial instrument illiquid on one market can have a different level of liquidity on another market. Therefore, different levels of liquidity on different markets and also cross-market deliveries have to be taken into consideration (i.e. a harmonized buy-in

period should be applied for specific financial instruments across Europe to reduce the market impact).

It would require consideration that the extension period is not applicable for cleared transactions, which is impacting market participants in their operation of cleared and un-cleared business.

**Question 14:** Do you see the need to specify other minimum requirements for the buy-in mechanism? With regard to the length of the buy-in mechanism, do you have specific suggestions as to the different timelines and in particular would you find a buy-in execution period of 4 business days acceptable for liquid products?

**Question 15:** Under what circumstances can a buy-in be considered not possible? Would you consider beneficial if the technical standard envisaged a coordination of multiple buy-ins on the same financial instruments? How should this take place?

**Eurex Clearing comments:**

Since currently buy-ins for shares under the EU SSR are executed on 4 days after the ISD without causing any issues, the four business days are feasible for liquid assets and, therefore, from our point of view no longer execution period is required. In order to fulfil its obligation as a CCP and deliver financial instruments to the Clearing Member which did not receive delivery on time, Eurex Clearing prefers to continue with the period of four days in respect to liquid assets and proposes to keep the currently applied method of executing buy-ins for cleared business on level Clearing Member and International Securities Identification Number (ISIN) in order to minimize the number of buy-ins required to be conducted.

Granting the possibility for the receiving party to choose between the cash settlement and the deferral of the buy-in is not feasible at least in a CCP environment because (a) the transaction is concluded for the delivery of financial instruments on a specific settlement date already overdue and (b) any deferral would only increase the risk for the buyer of not receiving those financial instruments at a price close to the originally agreed one. Eurex Clearing prefers to abstain from such flexibility given that overall sufficient time was granted.

Apart from that we would like to point out that, according to the level 1 text, participants trading less liquid shares that are cleared through a CCP cannot avail of the prolonged extension period of up to ISD+7, before the buy-in procedure starts. Therefore, as part of the RTS, we recommend that ESMA calibrates a buy-in process and timeframes that mitigate any incentives to participants to move away from central clearing.

Furthermore, the current proposal to seek approval by the competent authority for abstaining from a buy-in where such buy-in cannot be executed (e.g. because the financial instruments are not available anymore) is, considering the time required, not feasible from a CCPs point of view. Hence, Eurex Clearing suggests to leave the decision on the execution of the buy-in solely with the CCP to avoid all delays potentially affecting market participant negatively.



Finally, Eurex Clearing would like to make transparent that Article 72a currently foresees that Article 15 of Regulation (EU) No 236/2012 (SSR) will become obsolete with the CSDR coming into effect. Unfortunately, the implementation of the appropriate technical standards according to CSDR will be in place at a later point in time. Eurex Clearing identifies a potential gap in the overall environment treating CCP cleared shares. In consequence, we propose to ensure appropriate transitional provisions to mitigate this risk.

**Question 16:** In which circumstances would you deem a buy-in to be ineffective?

**Eurex Clearing comments:**

Eurex Clearing requests ESMA to clarification whether the exemption for repurchase transactions from the buy-in based on Article 7(4)(b) of the CSDR applies for the opening leg or the whole repo transaction.

**Question 17:** Do you agree on the proposed approach? How would you identify the reference price?

**Eurex Clearing comments:**

We suggest that the cash settlement price should ensure that a late buyer receives a "sufficient" financial compensation for the delivery delinquency and should consider an "add-on" on the reference price allowing the cash settled buyer to purchase the financial instruments in the market without any loss.

Our understanding of the approach described in (62) is that it does not take the future market trend into consideration, as only the price of the previous day is considered. As a result the buyer might be subject to an economic disadvantage if the buyer is required to stock up on the market at a higher price.

Currently, if the required securities cannot be (partially) acquired by way of executing a buy-in Eurex Clearing performs a cash settlement whereas the cash settlement amount is determined as follows:


The last settlement price of the respective class of securities as determined by Eurex Clearing plus a premium of 100%, the selling price and the purchase price of the relevant transactions will be compared and the highest one is considered in the determination of the cash settlement price. For transactions in fixed income securities, the cash settlement amount is determined without taking into account accrued interest and by adding a premium of 300 basis points. The highest price determined is multiplied by the number of non-delivered securities owed.

This approach guarantees that the Clearing Member who did not receive the financial instruments in time is compensated at a price which allows to purchase the respective financial instruments on the market without having the risk of an economic disadvantage.

For a better understanding of the difference between the currently applied cash settlement procedure for shares of Eurex Clearing and the cash settlement process suggested by the CSDR, please refer to the example below:

Calculation of Cash Settlement Amount for the Buy-side= (Max(Settlement Price +100%; Price of the Sell transaction; Price of the Buy transaction) - Price of the Buy transaction))\* Number of shares

Scenario	Sell		Buy		Market Price	Cash compensation received by the buyer from Eurex Clearing (assuming 1 share is considered for cash settlement)	
	S	B	S	B		Current Cash Settlement price used	Future Cash Settlement price (according to CSDR)
1	S	15	B	10	20	30	10
2	S	10	B	10	10	10	0
3	S	5	B	10	5	0	0


  
CCP

Given the results Eurex Clearing suggests allowing the model already used for cash settlement in order to avoid the risk of the economic disadvantage for the respective buyer. Although the CSDR text foresees the execution of a cash settlement in case the financial instruments can (partially) not be bought-in, Eurex Clearing has the understanding that the cash settlement is aimed to be executed by the CSD only.

Considering the level 1 version of the CSDR, Eurex Clearing understanding is that the current processing needs to be changed because the CSDR foresees (a) to treat both transactions individually and (b) is not allowing an add-on which is aimed to provide sufficient safety for the buyer that he can re-purchase the financial instruments in the market without the risk of a loss.

Subsequently, with respect to cleared transactions, ESMA should take into account that a single failed settlement instruction may be the netting result of many trades. Therefore, the RTS should clarify that for cleared transactions CCPs should be in charge of determining the security price at their discretion for the purpose of calculating the cash settlement price rather than rely on the original trade source.

Eurex Clearing further suggests to allow the execution of the cash settlement by the CCP for cleared business.

**Question 18:** Would you agree with ESMA's approach? Would you indicate further or different conditions to be considered for the suspension of the failing participant?

**Question 19:** Please, indicate your views on the proposed quantitative thresholds (percentages/months).

**Eurex Clearing comments:** We would ask ESMA to clarify if the quantitative thresholds will be calculated on the value/number of the settlement instructions of a failing participant cleared with a CCP or to the total value of settlement instructions across all venues (i.e. trading venues, CSDs, CCPs).

Due to the large difference in the value of settlements for each clearing member across different asset classes within a CCP, we suggest CCPs calculate a separate fail percentage for each clearing member per clearing service. The CCP will then suspend a participant in relation to its activity in a particular clearing service where it fails consistently, without impacting its activity in another clearing activity.

**Question 21:** Would you agree that the above mentioned requirements are appropriate?

**Eurex Clearing comments:**

Eurex Clearing wants to make transparent that any penalty calculation needs to take the netting model(s) used by Eurex Clearing into account. Therefore, due to Actual-Settlement-Date-Netting Eurex Clearing cancels open delivery instructions at the latest when the settlement system is closed. Consequently, information on open delivery instructions is not available in the CSD anymore and therefore the CSD cannot calculate respective penalties.

Contrariwise, delivery instructions for markets/ financial instruments where TDN is processed remain in the CSD for consideration on the next settlement day; hence, those delivery instructions are able to be considered for penalty calculation by the CSD. Penalties are calculated on technical delivery instructions and not on single transactions and that those are charged by the CSD towards the Settlement Institution/ custodian bank and not the Clearing Member who is the legal counterpart of Eurex Clearing (Please consider that different legal entities can act as Clearing Member and Settlement Institution/ custodian bank).

## **D. Closing**

We hope that you have found our comments useful and remain at your disposal for further discussion.

If you have any questions please do not hesitate to contact:

Oliver Haderup  
Executive Director  
Regulatory Compliance  
Eurex Clearing AG

Michael Hohmann  
Senior Vice President  
Clearing Initiatives  
Eurex Clearing AG