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Financial markets infrastructure

PUBLIC CONSULTATION ON

DERIVATIVES AND MARKET INFRASTRUCTURES

Important comment: this document is a working document of the Internal Market and Services Directorate General of the European Commission for discussion and consultation purposes. It does not purport to represent or pre-judge the formal proposal of the Commission.

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INTRODUCTION

On 3rd July 2009 the Commission adopted a Communication[1] on "Ensuring efficient, safe and sound derivatives markets" which set out the problems identified in the OTC derivatives markets and the possible tools to address these problems. The Communication was accompanied by a detailed Staff Working Paper[2] describing the different characteristics of the various segments of the OTC derivatives market. Together with the publication of the Communication and Staff Working Paper, the Internal Market and Services Directorate General of the Commission launched a full consultation[3] with different options on how to implement the policy tools envisaged in the Commission's Communication. The consultation was followed by a public hearing and high-level conference on 25th September 2009.

On 25th September 2009, G-20 leaders agreed[4] that: "*All standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at latest. OTC derivatives contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements*".

On the basis of the above mentioned stakeholder consultation and following the subsequent G20 agreement, on 20th October 2009 the Commission adopted a second Communication[5] on "Ensuring efficient, safe and sound derivatives markets – Future Policy actions". These policy actions foresee, among others, legislation mandating central counterparty (CCP) clearing for a wide scope of eligible derivatives contracts, mandating reporting of OTC derivatives to trade repositories (TRs) and establishing the requirements that CCPs and TRs need to comply with to ensure their safety, soundness and efficiency.

The Commission is now in the process of finalising its draft legislative proposals. Before doing so, it needs to finalise its views on four specific issues:

I. Clearing and risk mitigation of OTC derivatives;

II. Requirements for Central Counterparties;

III. Interoperability;

IV. Reporting obligation and requirements for Trade Repositories:

The Commission services envisage that the necessary technical standards and guidelines will need to be developed by ESMA - in some instances with the cooperation of either the European Banking Authority or the ESCB.

Please also note that certain aspects concerning, inter alia, the division of purely institutional responsibilities between national and European authorities, including authorisation and supervision of CCPs, cooperation and information exchange between regulators, and surveillance of trade repositories are not part of this consultation.

[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0332:FIN:EN:PDF
[2] http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/report_en.pdf
[3] http://ec.europa.eu/internal_market/consultations/docs/2009/derivatives/derivatives_consultation.pdf
[4] http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf
[5] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0563:FIN:EN:PDF

References to 'competent authority' should therefore not be interpreted to indicate any particular arrangement. A technical reference glossary is provided at the end of this document to assist stakeholders in understanding the full meaning of the terms used.

This consultation is open until 10 July 2010. Responses should be addressed to *markt-consultations-otc-derivatives@ec.europa.eu*. The Commission services will publish all responses received on the Commission website unless confidentiality is specifically requested.

The responses to this consultation will provide important guidance to the Commission services to prepare a formal Commission proposal, which is currently scheduled for adoption in September 2010.

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I. CLEARING AND RISK MITIGATION OF OTC DERIVATIVES

Introductory Comments

The Commission services have considered a number of approaches to implement the principles agreed at G20 level according to which *"All standardised OTC derivatives should be [...] cleared through central counterparties by end-2012 at least"*.

In translating the political message agreed by the G20 in technical terms, the Commission services are of the view that 'standardised' contracts should in practice concern those contracts that are eligible for clearing by a CCP, i.e. those contracts that a CCP is able to clear. Furthermore, not all cleared contracts are appropriate to be considered eligible for a clearing obligation to apply. The Commission services are therefore considering a process that takes into account all of the potential aspects of risks connected to mandatory clearing. This should be devised in such a manner as to ensure that a clearing obligation for OTC derivative contracts will in practice achieve its final objective of reducing risk in the financial system, rather than increasing risk.

In doing so, two approaches are suggested:

1) a *bottom-up* approach according to which a CCP decides to clear certain contracts and submits its proposal to the competent authority. The competent authority, will inform ESMA once it approves the CCP to clear such contracts. ESMA would then decide whether a clearing obligation should apply to those contracts;

2) a *top-down* approach according to which ESMA, together with the European Systemic Risk Board, would determine which contracts should potentially be subject to the clearing obligation, but for which a clearing facilities does not yet exist in practice. Both approaches are necessary because, on the one hand, meeting the G20 commitment cannot be left entirely to the initiative of the clearing industry. On the other hand, a regulatory check at European level of the appropriateness of certain arrangements is necessary before the clearing obligation enters into force .

1. Clearing obligation

The clearing obligation itself therefore needs to meet a number of requirements that need to be clearly reflected in EU-legislation:

a) Financial counterparties should clear all eligible derivative contracts in the relevant CCPs listed in the register as referred to under paragraph b) of the "eligibility for the clearing obligation" section below.

b) The clearing obligation should also apply to financial counterparties which enter into eligible derivative contracts with third country entities.

c) For the purpose of complying with the clearing obligation under paragraph a), financial counterparties should become either a clearing member or a client (see glossary for definitions).

2. Eligibility for the clearing obligation

In order to determine the eligibility of contracts for a clearing obligation, it is important to have in place a clearly defined procedure in EU-legislation. The following four steps could be foreseen:

a) A CCP must be authorised by the competent authority to clear a class of derivatives. The competent authority would then immediately notify ESMA of that authorisation.

b) After receiving the notification, ESMA would decide within a fixed timeframe (i.e. six months) whether that class of derivatives should be eligible for the clearing obligation and any additional conditions that should apply, including the date from which the clearing obligation takes effect.

It would be important to ensure that the decisions taken by ESMA would be based on objective criteria aiming at systemic risk reduction. Before taking a decision, a public consultation, including all the relevant stakeholders, should be carried out by ESMA.

c) The above-mentioned decision by ESMA would be promptly published in a register. This register would contain the eligible classes of derivatives and the CCPs authorised to clear them. ESMA would regularly update this register.

d) On its own initiative and in consultation with the European Systemic Risk Board, ESMA would further identify those derivative contracts that should be included in its public register, but for which no CCP has yet received authorisation.

3. Access to a CCP

In order to give full effect to the clearing obligation, market participants must have full access to a CCP according to a clearly defined legal principle of access:

A CCP that has been authorised to clear eligible derivative contracts would have the obligation to accept clearing such contracts on a non-discriminatory basis, regardless of the venue of execution.

Questions:

What are stakeholders' views on the clearing obligation, the process to determine the eligibility of OTC derivate contracts for mandatory clearing, and its application? Do stakeholders agree that access from trading venues to CCPs clearing eligible contracts should be guaranteed?

4. Non-financial undertakings

An appropriate and balanced legislative approach for the (corporate) end-users of OTC-derivatives is critical in order to introduce, on the one hand, a reduction of risk in the financial system that does not tolerate regulatory arbitrage and, on the other, introduces a sensible system that reflects the economic and financial hedging needs of corporate end-users. Such an approach needs to provide clarity to end-users in EU-legislation and would be based on applying two thresholds in the following manner:

a) Non-financial counterparties that take positions exceeding an information threshold would notify this to the competent authority designated in accordance with Article 48 of Directive 2004/39/EC. That competent authority may require information on the reasons for exceeding the threshold and regular reports on the positions in derivative contracts.

b) Non-financial counterparties that take positions exceeding the clearing threshold would be subject to the clearing obligation for all their eligible derivative contracts.

Those abovementioned thresholds would be defined at a further stage taking into account the systemic relevance of the sum of net positions by counterparty per class of derivatives.

Question:

Do stakeholders share the general approach set out above on the application of the clearing obligation to non-financial counterparties that meet certain thresholds?

5. Risk mitigation techniques for non-cleared contracts

Importantly, not all OTC derivative contracts will be eligible for mandatory clearing and there will remain a portion of bespoke contracts. In order to ensure that the market understands and mitigates the risks in these contracts, EU-legislation would need to include specific principles and requirements in this respect.

Financial counterparties and non-financial counterparties exceeding the clearing threshold (see section 4 above) that enter into a derivative contract that is not cleared by a CCP would need to ensure that appropriate procedures and arrangements are in place to measure, monitor and mitigate operational and credit risk. In particular, they would need to have in place:

(a) to the extent possible, electronic means ensuring the effective confirmation of the terms of the contract;

(b) robust, resilient and auditable processes to monitor, where appropriate, the value of outstanding contracts, to reconcile portfolios, to manage the associated risk and to identify early and to resolve disputes between parties. The value of outstanding contracts must be measured on a mark-to-market basis. The risk management procedures must require timely and accurate exchange of collateral and appropriate and proportionate holding of capital.

Question:

Do stakeholders share the principle and requirements set out above on the risk mitigation techniques for bilateral OTC derivative contracts?

II. REQUIREMENTS FOR CENTRAL COUNTERPARTIES

Introductory Comments

The Commission services consider that robust arrangements, which are harmonized at EU-level, on risk controls and resources need to be applied to CCPs for them to continue to be considered safe and sound. It must in particular be ensured that CCPs will help contain risks in the market rather than potentially become a source of systemic risk themselves. Harmonization of these key requirements is essential at EU-level in view of the inherent cross-border nature of the activities of CCPs.

Under this section of the consultation document possible requirements for CCPs to be included in the forthcoming legislation are presented. The scope of these requirements cover the organisation of the business of a CCP – also addressing any incentive mismatches that may exist due to the ownership structure of a CCP – the segregation and portability of assets and positions, and the prudential requirements for a CCP.

1. Organisational Requirements

In line with existing requirement set out in EU financial services legislation the Commission services consider that a CCP should have robust governance arrangements, which include at least:

- 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 the 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;

– the record keeping of all the records on the services and activity provided and all transactions it has 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 and at least one third, but no less than two, of its members are independent both from other board members and from clearing members;
– the competent authority should be informed about the identity of the shareholders and it should refuse authorisation if, taking into account the need to ensure the sound and prudent management of a CCP, it is not satisfied as to the suitability of the shareholders that have qualifying holdings (the general procedure established in Directive 2007/44/EC should apply)[6].

In addition, the following detailed requirements would also be introduced:

2. Risk Committee

In order to measure and manage its risk-taking activities, each CCP should have in place and internal risk committee. This may also contribute to any disincentives arising from the structure of a user-owned CCP. The composition and functioning of the Risk Committee of a CCP should be subject to the following set of five important principles and requirements:

a) A mandatory establishment of a Risk Committee, composed of representatives of its clearing members and independent administrators. The advice of the risk committee should be independent from any direct influence by the management of the CCP.

b) The mandate, the governance arrangements to ensure its independence, the operational procedures, the admission criteria and the election mechanism of the risk committee should be clearly defined. The governance arrangements would be publicly available and would at least determine that the risk committee is chaired by an independent administrator, reports directly to the board and holds regular meetings.

c) The risk committee would advise the CCP on any arrangements that may impact the risk management of the CCP, such as, but not limited to, a change in its risk model, the default procedures, the parameters for accepting clearing members or the clearing of new classes of instruments. The advice of the risk committee would not be required for the daily operations of the CCP or in emergency situations.

c) The members of the risk committee should be bound by confidentiality. If the chairman of the risk committee determines that a member has an actual or potential conflict of interest on a particular matter then that member should not be entitled to receive any material relating to that matter.

d) A CCP would promptly inform the competent authority of any decision in which it decides not to follow the advice of the risk committee.

[6] The legislative details of such requirements will need to be consistent with those already enshrined in the Capital Requirements Directive 2006/48/EC and MiFID 2004/39/EC.

e) A CCP would allow the clients of clearing members to participate in the risk committee or alternatively, it should establish appropriate consultation mechanisms that ensure that their interests are adequately represented.

3. Conflicts of interest

A further set of clear principles and requirements would be needed to align any conflicts of interests within certain (e.g. user-owned) CCP.

a) A CCP should maintain and operate effective written organisational and administrative arrangements to identify and manage any potential conflicts of interest between itself, including its managers, employees, or any person directly or indirectly linked to them by control or close links and its clearing members or their clients or between them. It should maintain and implement adequate resolution procedures whenever possible conflicts of interest occur.

b) Where the organisational or administrative arrangements of a CCP to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of a clearing member or client will be prevented, it should clearly disclose the general nature and/or sources of conflicts of interest to the clearing member before accepting new transactions from that clearing member. If the client is not known to the CCP, the CCP should inform the clearing member whose client is concerned.

c) Where the CCP is a parent undertaking or a subsidiary, the written arrangements should also take into account any circumstances, of which the CCP is or should be aware, which may give rise to a conflict of interest arising as a result of the structure and business activities of other undertakings with which it has a parent undertaking or a subsidiary relationship.

d) The written arrangements should include the following:

- the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of one or more clearing members or clients;

- procedures to be followed and measures to be adopted in order to manage such conflicts.

e) A CCP should take all reasonable steps to prevent any misuse of the information maintained in its systems and shall prevent the use of that information held for other business activities. Sensitive information recorded in one CCP should not be used for commercial use by any other natural or legal person that has a parent undertaking or a subsidiary relationship with the CCP.

4. Outsourcing

A further set of requirements that the Commission services believe should be clearly regulated at EU-level concerns the need to lay down 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. The following three important principles and requirements would meet those concerns:

a) The competent authority should ensure that when a CCP outsources operational functions or any services or activities, it remains fully responsible for discharging all of its obligations and complies, in particular, with the following conditions:

- it should not result in the delegation of its responsibility;

- the relationship and obligations of the CCP towards its clearing members or where relevant their clients should not be altered;

- the conditions for the authorisation of the CCP should not effectively change;

- it should not prevent the exercise of supervisory functions;

- it should not result in depriving the CCP from the necessary systems and controls to manage the risks it faces.

b) The competent authority should require the respective rights and obligations of the CCP and of the service provider to be clearly allocated and set out in a written agreement.

c) A CCP should make available on request all information necessary to enable the competent authority to assess the compliance of the performance of the outsourced activities.

5. Participation requirements

The following six clearly defined principles and requirements would also contribute in an important manner to an appropriately transparent and indiscriminate functioning of a CCP. These requirements would also meet concerns that may arise in view of the ownership structure of a CCP:

a) A CCP should establish the categories of admissible clearing members and the admission criteria. These criteria should be non-discriminatory, transparent and objective so as to ensure fair and open access to the CCP and should ensure that clearing members have sufficient financial resources and operational capacity to meet the obligations arising from participation in a CCP. Criteria that restrict access should only be permitted to the extent that their objective is to control the risk for the CCP.

b) A CCP should ensure that the application of the criteria referred to in paragraph a) is met on an on-going basis and shall have timely access to the information relevant for the assessment. A CCP should conduct, at least once a year, a comprehensive review of the compliance with these provisions by its clearing members.

c) Clearing members that clear transactions on behalf of their clients should have the necessary additional financial resources and operational capacity to perform this activity. A CCP should be informed by its clearing members about the criteria and arrangements they adopt to allow their clients to access the services of the CCP.

d) A CCP should have objective and transparent procedures for the suspension and orderly exit of clearing members that no longer meet the criteria referred to in paragraph a).

e) A CCP should only deny access to clearing members meeting the criteria referred to in paragraph a), if it is duly justified in writing and based on a comprehensive risk analysis.

f) A CCP may impose specific additional obligations on clearing members, such as, but not limited to, the participation in auctions of a defaulting clearing member's position. These additional obligations should be proportional to the risk brought by the clearing member and should not restrict participation to certain categories of clearing members.

6. Transparency

Finally, it is important in the view of the Commission services to complement the transparency of the operations of a CCP with clear obligations about disclosing its pricing structure, risks, and risk management. These requirements should be articulated in EU-legislation and should reflect the following four key obligations:

a) A CCP should publicly disclose the prices and fees associated with services provided. It should disclose separately the prices and fees of single services and functions provided, including discounts and rebates and the conditions to benefit from these reductions. It should allow its clearing members and, where relevant, their clients to access specific services separately.

b) A CCP should disclose to clearing members and clients the risks associated with the services provided.

c) A CCP should publicly disclose key information on its risk management model and assumptions adopted to perform the stress tests.

d) A CCP should publicly disclose the price information used to calculate its end of day exposures with its clearing members and the volumes of the cleared transactions for each class of instruments.

Questions:

Do stakeholders share the general approach set out above on organisational requirements for CCPs? In particular comments are sought on the role and function of the Risk Committee; whether the governance arrangements and the specific requirements are sufficient to prevent and manage potential conflicts of interest; stringent outsourcing requirements; and participation and transparency requirements?

Do stakeholders consider that possible conflicts of interests would justify specific rules on the ownership of CCPs? If so, which kind of rules?

7. Segregation and portability

A key lesson from the financial crisis has been the need to have greater transparency and legal certainty about the rules and requirements surrounding the segregation of assets and positions within CCPs and its clearing members. The following 5 clear principles and obligations would introduce much-needed improvement in this area:

a) A CCP should keep records and accounts that shall enable it, at any time and without delay, to identify and segregate the assets and positions of one clearing member from the assets and positions of any other clearing member and from its own assets.

b) A CCP should require each clearing member to distinguish and segregate in accounts with the CCP the assets and positions of that clearing member from those of its clients. A clearing member should allow its clients to have a more detailed segregation of its assets and positions. The CCP should publicly disclose the risks and costs associated with the different levels of segregation.

c) On the basis of the level of segregation chosen by a client, the CCP should ensure that it is able to transfer on request at a pre-defined trigger event, without the consent of the clearing member and within a pre-defined transfer period its assets and positions to another clearing member. The latter should not be obliged to accept those assets and positions, unless it has entered into a previous contractual relationship in that respect.

d) Provided that the client is not exposed to the default of the clearing member through which it has access to the CCP or of any other clients, the counterparty credit risk rules ('0 exposure value) of the Capital Requirements Directive should apply[7].

e) The requirements under this heading should prevail over any conflicting laws, regulations and administrative provisions of the Member States that prevent the parties from fulfilling them.

Questions:

Do stakeholders share the approach set out above on segregation and portability?

8. Prudential Requirements

The need for harmonised prudential requirements for CCPs in the EU in view of their potentially systemic relevance to the stability of the financial sector has already been explained above. This section sets out the 11 critical areas (A-K) where such harmonisation should be introduced in order to permit CCPs to continue to be a source of stability rather than an increased source of risk. These areas are the backbone of the safety of CCPs and, ultimately, financial stability. In order of their critical importance

[7] Annex III, Part 2, point 6 of Directive 2006/48/EC

these principles and requirements must be set out in clear detail. The principles and requirements that should be articulated in EU-legislation are the following:

A. Initial capital

a) A CCP should have a permanent, available and separate initial capital of at least EUR [X] million.

b) Initial capital should comprise capital and reserves and shall at all times be sufficient to ensure that it allows for an orderly wind-down or restructuring of the activities over an appropriate time spam and that the CCP is adequately covered against operational and residual risks.

B. Exposure management

A CCP should measure and assess its exposure to each clearing member and, where relevant, to another CCP with whom it has concluded an interoperable arrangement, on a near to real time basis. A CCP should have access in a timely manner and on a non discriminatory basis to the relevant pricing sources to effectively measure its exposures.

C. Margin requirements

a) A CCP should impose, call and collect margins to limit its credit exposures from its clearing members, and where relevant, from CCPs which have interoperable arrangements. These margins should be sufficient to cover potential exposures that the CCP estimates will occur until the liquidation of the relevant positions. They should be sufficient to cover losses that result from at least 99 per cent of the price movements over an appropriate time horizon and they should ensure that a CCP fully collateralises its exposures with all its clearing members, and where relevant, CCPs which have interoperable arrangements at least on a daily basis.

b) A CCP should adopt models and parameters in setting its margin requirements that capture the risk characteristics of the products cleared and take into account the interval between margin collections, market liquidity and the possibility of changes over the duration of the transaction. The models and parameters should be validated by the competent authority.

c) A CCP should call and collect margins on an intraday basis, at minimum when pre-defined thresholds are breached.

d) A CCP should segregate the margins posted by each clearing member and, where relevant, by CCPs that have interoperable arrangements and should ensure the protection of the margins posted against the default of other clearing members, the institution where they are deposited, or of the CCP itself and from any other loss the CCP may experience.

D. Default fund

a) A CCP should maintain a default fund to cover losses arising from the default, including the opening of an insolvency procedure, of one or more clearing members.

b) A CCP should establish the minimum size of contributions to the default fund and the criteria to calculate the contributions of the single clearing members. The

contributions should be proportional to the exposures of each clearing member and should take into account the requirements under "other risk controls", in order to ensure that the contributions to the default fund at least enable the CCP to withstand 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.

c) These provisions should not prevent a CCP to establish more than one default fund for the different classes of instruments it clears.

E. Other risk controls

a) In addition to the initial capital, a CCP should maintain sufficient available financial resources to cover potential losses that exceed the losses to be covered by margin requirements and the default fund. These resources may include any other clearing fund provided by clearing members or other parties, loss sharing arrangements, insurance arrangements, the own funds of a CCP, parental guarantees or similar provisions. These financial resources should be freely available to the CCP and should not be used to cover the operating losses.

b) A CCP should develop scenarios of extreme but plausible market conditions, which include the most volatile periods that have been experienced by the markets for which the CCP provides its services. The default fund referred above and the other financial resources referred to in paragraph a) should at any time enable the CCP to withstand the default of the three clearing members to which it has the largest exposures and should enable the CCP to withstand sudden sales of financial resources and rapid reductions in market liquidity.

c) A CCP should obtain the necessary credit lines or similar arrangements to cover its liquidity needs in case the financial resources at its disposal are not immediately available. Each clearing member, parent undertaking or subsidiary of the clearing member should not be able to provide more than 10 per cent of the credit lines needed by the CCP.

d) A CCP may require non-defaulting clearing members to provide additional funds in the event of a default of another clearing member. The clearing members of a CCP should have limited exposures toward the CCP.

F. Default waterfall

a) A CCP should use the margins of a defaulting clearing member prior to other financial resources in covering losses.

b) If the margins of the defaulting clearing member are not sufficient to cover the losses incurred by the CCP, the CCP should use the default fund contribution of the defaulting member to cover these losses.

c) A CCP should use contributions to the default fund and other contributions of non-defaulting clearing members only after having exhausted the contributions of the defaulting clearing member and, where relevant, the CCP's own funds referred to under other risk controls.

d) A CCP should not be allowed to use the margins posted by non-defaulting clearing members to cover the losses resulting from the default of another clearing member.

G. Collateral requirements

a) A CCP should only accept highly liquid collateral with minimal credit and market risk to cover its exposure to its clearing members. It should apply adequate haircuts to asset values that reflect the potential for their value to decline over the interval between their last revaluation and the time by which they can reasonably be assumed to be liquidated. It should take into account the liquidity risk following the default of a market participant and the concentration risk on certain assets that may result in establishing the acceptable collateral and the relevant haircuts.

b) A CCP may accept as collateral to cover its margin requirements, the underlying of the derivative contract or the financial instrument that originate the CCP exposure.

H. Investment policy

a) A CCP should only invest its financial resources in highly liquid financial instruments with minimal market and credit risk. The investments should be capable of being liquidated rapidly with minimal adverse price effect.

b) Financial instruments posted as margins should be deposited with operators of securities settlement system that ensure non discriminatory access to CCPs and the full protection of those instruments. A CCP should have prompt access to the financial instruments when required.

c) A CCP should not invest its capital or the sums arising from the requirements above in its own securities or those of its parent undertaking.

d) A CCP should take into account its overall credit risk exposures to individual obligors in making its investment decision and should ensure that its overall risk exposure to any individual obligor remains within acceptable concentration limits.

e) Whenever allowed, a CCP should deposit the liquidity collected from its clearing members and necessary to ensure its normal functioning with the central banks of issue.

I. Default procedures

a) A CCP should have procedures in place in the event a clearing member does not comply with the requirements laid down in this chapter within the time and according to the procedures established by the CCP. The CCP should outline the procedures to be followed in the event the insolvency of a clearing member in case the default is not established by the CCP.

b) A CCP should take prompt action to contain losses and liquidity pressures resulting from defaults and should ensure that the closing out of any clearing member's positions does not disrupt its operations or expose the non-defaulting clearing members to losses that they cannot anticipate or control.

c) The CCP should promptly inform the competent authority and the latter should immediately inform the authority responsible for the supervision of the defaulting clearing member if it considers that the clearing member will not be able to meet its future obligations and when it intends to declare its default.

d) A CCP should establish that its default procedures are enforceable, taking into account the national insolvency laws applicable to the defaulting clearing member. It should take all the reasonable steps to ensure that it has the legal powers to liquidate the

proprietary positions of the defaulting clearing member and to transfer or liquidate the client's positions of the defaulting clearing member.

J. Review of models, stress testing and back testing

a) A CCP should regularly review the models and parameters adopted to calculate its margin requirements, default fund contributions, collateral requirements and other risk control mechanisms. It should subject the models to rigorous and frequent stress tests to assess their resilience in extreme but plausible market conditions and should perform back tests to assess the reliability of the methodology adopted. The CCP should inform the competent authority of the results of the tests performed and should obtain its validation before adopting any change to the models and parameters.

b) A CCP should regularly test the key aspects of its default procedures and take all the reasonable steps to ensure that all clearing members understand them and have appropriate arrangements in place to respond to a default event.

K. Settlement risk

a) A CCP should, when available, use central bank money to settle its transactions. If central bank money is not accessible, steps should be taken to strictly limit credit and liquidity risks.

b) A CCP should clearly state its obligations with respect to deliveries of financial instruments, including whether it has an obligation to make or receive delivery of a financial instrument or whether it indemnifies participants for losses incurred in the delivery process.

c) In the event that a CCP has an obligation to make or receive deliveries of financial instruments, the CCP should eliminate principal risk through the use of delivery versus payment mechanisms to the extent possible.

Questions:

Do stakeholders share the general approach set out above on prudential requirements for CCPs? In particular: what should be the adequate level of initial capital? Are exposures of CCPs appropriately measured and managed? Should the default fund be mandatory and what risks should it cover? Should the rank of the different lines of defence of a CCP be specified? Will the collateral requirements and investment policy ensure that CCPs will not be exposed to external risks? Will the provisions ensure the correct management of a default situation? Are the provisions above sufficient to ensure access to central bank liquidity without compromising central banks' independence?

9. Relations with third countries

The Commission Services consider that, in view of the global nature of the derivatives sector and clearing, it is necessary to consider an appropriate approach with regard to CCPs established in third countries wishing to provide clearing services to entities established in the EU.

In this respect, and building on existing procedures in EU-financial services legislation, the following approach could be considered:

A CCP established in a third country could be allowed to provide clearing services to entities established in the European Union, subject to certain criteria such as

- the CCP being authorised and subject to effective and stringent supervision and regulation in that third country;

- the Commission having adopted a decision recognising the legal and supervisory framework of that third country as equivalent to the regulatory framework of the European Union;

- the existence of appropriate co-operation arrangements between the relevant competent authorities

Questions:

Do stakeholders share the general approach set out above on the recognition of third country CCPs? Are the suggested criteria sufficient? Do stakeholders consider that additional criteria should be considered?

Do stakeholders agree with the extension of the clearing obligation to contracts cleared by third country CCPs to ensure global consistency?

III. INTEROPERABILITY

Introductory Comments

The Commission services note that Europe's post-trade sector remains fragmented along national lines. This undermines the efficiency of each national system, as economies of scale of what is effectively a European market are not optimally exploited by a system constrained by national borders. Nationally fragmented market infrastructures could make cross-border trades more costly.[8] As a consequence, they do not adequately serve the Internal Market.

1. Interoperability

The right of interoperability would need to be clearly reflected in EU-legislation and could be based on the following 3 principles:

a) A CCP could have the right to enter into an interoperable arrangement with another CCP, if the requirements below are fulfilled.

[8] For a review, see European Commission (2006), Draft Working Document on post-trading activities, http://ec.europa.eu/internal_market/financial-markets/clearing/communication_en.htm#draft

b) When establishing an interoperability arrangement with another CCP for the purpose of providing services to a particular trading venue, the CCP would have non discriminatory access to the data of that particular trading venue that it needs for the performance of its functions and to the relevant settlement system.

c) Any direct or indirect restriction to the right of interoperability, data feed access, and/or settlement system referred to in paragraphs a) and b) would be solely aimed at controlling the risk that might arise from an interoperability arrangement. Any denial of interoperability, data feed and/or settlement systems access would be justified in writing by the party receiving the request and would state the risk considerations on which the denial is based.

2. Managing risks arising from an interoperability arrangement

However, the Commission services also consider that interoperability between CCPs could be granted only when specific conditions are met, so as to insure that an interoperability arrangement does not add an unacceptable layer of risks to the CCPs concerned. The Commission services are of the view that the right to enter into an interoperability arrangement should at present be limited to cash instruments only. This does not imply any legal prohibition for other types of interoperability arrangements, but such arrangements are not covered by this Legislation: they will continue to be covered by the general Treaty freedoms of services and establishment).

For these reasons, the following core principles and requirements would need to be reflected:

a) CCPs that enter into an interoperability arrangement would need to put in place adequate policies, procedures and systems to effectively identify, monitor and manage the additional risks arising from the arrangement so that they would be able to meet their obligations in a timely manner.

- agree on their respective rights and obligations, including the applicable law governing their relationships.

- identify, monitor and effectively manage credit and liquidity risks so that a default of a clearing member of one CCP would not affect an interoperable CCP. If one of the CCPs with which an interoperability arrangement has been concluded would be in default, the terms of the arrangement should outline the process for managing the consequences of the default.

- identify, monitor and address potential interdependences and correlations that arise from an interoperability arrangement that may affect credit and liquidity risks related to, inter alia, clearing member concentrations, and pooled financial resources. In particular, they should have robust controls over the re-hypothecation of clearing members' collateral under the arrangement, if permitted by their competent authorities. The arrangement should outline how these risks have been addressed taking into account sufficient coverage and need to limit contagion.

b) If the risk management models used by the CCPs to cover their exposure to their clearing members as well as their reciprocal exposures are different, the CCPs would need to identify them, assess risks that may rise and take measures, including additional financial resources, that limit their impact on the interoperability arrangement as well as

their potential consequences in terms of contagion risks and ensure that these differences do not affect each CCP's ability to manage the consequences of the default of a clearing member.

3. Approval of interoperability arrangements

Prior regulatory approval by all the relevant authorities involved is deemed appropriate in order to give effect to an interoperability agreement. The procedure would need to be to be set out clearly.

Question:

Stakeholders' views are welcomed on the general approach set out above on interoperability and the principles and requirements on managing risks and approval.

IV. REPORTING OBLIGATION AND REQUIREMENTS FOR TRADE REPOSITORIES

Introductory Comments

The Commission services confirm that the most important role of trade repositories is to enable the collection and assembling of complete information on outstanding contracts. All the relevant authorities in the European Union should have unfettered access to that information to perform their statutory functions. In order to ensure this, different options can be considered with regard to *what* should be reported and to *whom*. These options are set-out below.

In view of the systemic relevance of trade repositories and in view of their mandatory use under this Legislation, certain minimum requirements to protect the data collected and to ensure access to them are necessary.

1. Reporting obligation

As regards a reporting obligation, there are two options that deserve attention. In order for them to be fully understood correctly, they require precise articulation as follows:

Option A

a) Financial counterparties would report the details of any derivative contract they have entered into and any modification, including termination, thereof to a registered trade repository. The details would be reported no later than the working day following the execution, clearing, modification or termination of the contract.

b) A financial counterparty would report the details of a derivative contract with a non-financial counterparty or any other entity also on behalf of the latter, unless these entities report these details themselves.

Option B

a) The details of every EU derivative contract, and any subsequent modifications, including termination, thereof would be reported by the contract's counterparties to a

registered trade repository. The details should be reported no later than the working day following the execution, clearing, modification or termination of the contract.

For both options

c) If a registered trade repository is not capable of recording the details of a specific derivative contract, or if no registered trade repository exists for that type of contract, financial counterparties should report the details of their positions in those contracts to the competent authority.

d) ESMA should develop draft technical standards to determine the details, type, format and frequency of the reports referred to for the different classes of derivatives. These should at minimum ensure that:

- the parties to the contract and, if different, the beneficiary of the rights and obligations arising from it are appropriately identified;

- the characteristics of the contract, including the underlying, the maturity and the value are reported.

2. Requirement for Registration of a Trade Repository

Registration of a trade repository is important for regulators and market participants to have the necessary clarity to whom reporting should be directed. Registration in the EU could follow the following principles and requirements:

a) A trade repository must apply for registration for the purpose of the reporting obligation, provided that it is a legal person established in the European Union.

b) The Registration must be effective for the entire territory of the European Union once the registration decision issued by ESMA has taken effect.

c) A registered trade repository must comply at all times with the conditions for initial registration. A trade repository shall, without undue delay, notify ESMA of any material changes to the conditions for initial registration.

Options for registration of trade repositories

Three options can be envisaged to ensure that EU regulators have access to all the relevant information they need to carry out their tasks and responsibilities:

Option 1 – Trade Repositories located in the EU

Given the importance of accessing data recorded by trade repositories, European authorities might want to avoid to be subject to third countries laws and regulation to access to the necessary information they need for the performance of their functions. Measures taken in this respect will comply with European Union's obligations under any international agreements.

Under this option, registration of trade repositories would require the establishment of the latter in the European Union. Therefore third country trade repositories would need to

establish a subsidiary in the territory of the European Union if they want to be registered for the purpose of the reporting obligation.

Under this option, it would be necessary to ensure that registered trade repositories receive all the information that European authorities need to exercise their tasks. Therefore, option B above - all contracts with an EU reference entity - would need to apply.

Option 2 – Recognition of third country trade repositories

This option would ensure that market participants continue to report to existing global repositories and that European authorities can access such trade repositories for all the information they need relating to a particular asset class.

Under this option the process outlined above for the equivalence and recognition of third country CCPs would apply mutatis mutandis for trade repositories. In addition, the cooperation arrangement between ESMA and the third country competent authority shall ensure that European authorities have immediate access on an on-going basis to all information that they need for the exercise of their duties.

In case access to European authorities were to be restricted for whichever reason, the conditions for recognition and registration by ESMA would no longer be met. This would imply that if no other trade repository exists for that particular asset class, positions would need to be reported directly to the competent authority designated according to Article 48 of MiFID (see paragraph c of the reporting obligation).

Option 3 – European 'public' utility

In view of the public nature of the information held by trade repositories, consideration may be given to whether only public utilities should perform this function.

Under this option, registration of trade repositories for regulatory purposes would imply a 'public' status (the precise conditions would need to be established in legislation).

As for option 1, it would be important to ensure that such entities will receive all the necessary information that European authorities need, as suggested under option B of reporting obligation.

Questions:

What are stakeholders' preferred options on the reporting obligation and on how to ensure regulators' access to information with trade repositories? Please explain.

Requirements for trade repositories

Regardless of the preferred policy option (1, 2 or 3), a trade repository should have robust governance arrangements, which include at least:

– a clear organisational structure;
– adequate policies and procedures;
– a business continuity policy and disaster recovery plan;

– information technology systems adequate to the complexity, variety and type of services and activities performed;
– the fitness and properness of the persons who effectively direct the business;
– objective, non-discriminatory and publicly disclosed access and participation requirements;
– publicly disclosed and cost-related prices and fees.

In addition detailed requirements should also apply in respect of 3 important areas: a trade repository's operational reliability, safeguarding and recording, and transparency and data availability. The following principles and requirements would reflect this:

1. Operational reliability

a) A trade repository should identify sources of operational risk and minimise them through the development of appropriate systems, controls and procedures. These systems should be reliable and secure, and have adequate capacity.

b) A trade repository should establish, implement and maintain an adequate business continuity policy and disaster recovery plan aiming at ensuring the preservation of its functions, the timely recovery of operations and the fulfilment of the trade repository's obligations. This plan should at a minimum foresee the establishment of backup facilities.

2. **Safeguarding and recording**

a) A trade repository should ensure the confidentiality and integrity of the information received.

b) A trade repository should promptly record the information received and should maintain it for at least five years following the expiration of the relevant contracts. It should employ timely and efficient record keeping procedures to document changes to recorded information.

c) A trade repository should calculate the positions per class of derivatives and by reporting entity from the details of the derivatives contracts reported to the trade repository.

3. Transparency and data availability

a) A trade repository should publish aggregate positions by class of derivatives on the contracts reported to it.

b) A trade repository should make available to ESMA, to the competent authorities supervising reporting undertakings and the relevant CCPs and to the central banks of the ESCB concerned the information they need.

Questions:

Do stakeholders share the general approach set out above on the requirements for trade repositories? In particular, are the specific requirements on operational

reliability, safeguarding and recording and transparency and data availability sufficient to ensure the adequate function of trade repositories and the adequate protection of the data recorded?

V. TECHNICAL REFERENCE GLOSSARY OF DEFINITIONS

This heading presents those terminological definitions that are necessary to interpret the previous sections of this consultative document.

'central counterparty (CCP)' means an entity that interposes itself between the counterparties to the contracts traded within one or more financial markets, becoming the buyer to every seller and the seller to every buyer and which is responsible for the operation of a clearing system;

'trade repository' means an entity that centrally collects and maintains the records of OTC derivatives;

'market infrastructure' means either a CCP or a trade repository;

'clearing' means the process of establishing settlement positions, including the calculation of net positions, and the process of checking that financial instruments, cash or both are available to secure the exposures arising from a transaction;

'derivatives' means financial instruments as defined by Annex I Section C numbers (4) to (10) of Directive 2004/39/EC;

'class of derivatives' means a number of derivative contracts that share common, essential characteristics;

'over the counter (OTC) derivatives' means derivative contracts whose execution does not take place on a Regulated Market as defined by Article 4(14) of Directive 2004/39/EC;

'eligible derivative contract' means an OTC derivative contract which belongs to a class of derivatives determined as eligible by ESMA in accordance with the eligibility for the clearing obligation procedure;

'EU derivative contract' means an OTC derivative contract involving at least one financial or non-financial counterparty or having as underlying an EU entity, country or variable;

'financial counterparty' means investment firms as defined in Directive 2004/39/EC, credit institutions as defined in Directive 2006/48/EC, insurance undertakings as defined in Directive 73/239/EEC, assurance undertakings as defined in Directive 2002/83/EC, reinsurance undertakings as defined in Directive 2005/68/EC, undertakings for collective investments in transferable securities (UCITS) as defined in Directive 2009/65/EC, institutions for occupational retirement provision as defined in Directive 2003/41/EC and alternative investment funds managers as defined in Directive 2010/.../EC;

'non-financial counterparty' means a legal entity established in the European Union other than financial counterparties;

'operational risk' means the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and including legal risk;

'counterparty credit risk' means the risk that the counterparty to a transaction defaults before the final settlement of the transaction's cash flows.

'cash settlement risk' means credit and liquidity risks stemming from the use by a CCP of a credit institution as defined by Directive 2006/48/EC to effect settlement with its participants';

'interoperability' means two or more CCPs entering into an arrangement with one another that involves cross-system execution of transactions;

'central bank of issue' means the central bank issuing the reference currency of a cleared transaction;

'clearing member' means an undertaking which participates in a CCP and which is responsible for discharging the financial obligations arising from it;

'client' means an undertaking with a contractual relationship with a clearing member which enables the client to clear its transactions with that CCP;

'capital' means capital within the meaning of Article 22 of Directive 86/635/EEC in so far it has been paid up, plus the related share premium accounts, it fully absorbs losses in going concern situations, and in the event of bankruptcy or liquidation ranks after all other claims;

'reserves' means reserves within the meaning of Article 23 of Directive 86/635/EEC and profits and losses brought forward as a result of the application of the final profit or loss;

Questions:

Do stakeholders agree with the definitions set out above?