



**CNMV Consultation on proposed reforms to Spain's securities clearing,
settlement and registry system**

EMCF contribution

European Multilateral Clearing Facility

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Introduction

EMCF welcomes the general direction of the foreseen changes in the Spanish securities market, which we understand to aim at more alignment with the European trend of market organisation. In particular the changes in relation to the Registry References appear to us as a meaningful step in this direction, together with the introduction of a Central Counterparty Clearing House (CCP).

EMCF has compiled the information in this consultation paper from the CCP perspective. EMCF is a cash equities CCP. Therefore, our focus is primarily on the clearing aspects of the consultation paper and not on the more custody related aspects.

3. Institutional aspects, legal regime, risk management and CCP participants

§ 3.1-3.3 Role of a CCP and regulatory framework

Novation and open offer

EMCF would be interested to know whether the concept of open offer has been considered as alternative to novation for the legal way of contract formation between the CCP and clearing members. This could be relevant when interoperability would be introduced on the Spanish market. The following two aspects are relevant to the contract formation: the distinction between novation and open offer and inter CCP trade refusal.

Novation has traditionally been the legal basis for EMCF. Novation imagines that a legally binding trade is made between clearing participants that is then transferred from the clearing participants to the CCP.

Open offer does not contemplate that the trade itself is legally binding - the only legal agreements that ever exist are the trade legs between the clearing participants and the CCP. In the open offer system, the CCP does not need to be concerned about the legal intentions of the traders. Each trading participant states that it will conclude trade legs with the CCP in accordance with the terms of the trade feed, either directly or as agent for the clearing participant.

Harmonised European regulation

EMCF supports the basic notion put forward by CNMV that future Spanish legislation should mirror EMIR as much as possible.

In the view of EMCF, harmonised legislation is an important precondition for a single competitive European financial market. Clearing and settlement providers play an important role in the European capital market infrastructure. Harmonised legislation in all EU countries would fit the strategy to promote a single European financial market, and reduce the risk of regulatory arbitrage in Europe. CCPs should be subject to a regulatory framework mandated by law and comply with a uniform set of high standards. These standards should be further supported by effective supervision. The standards for CCPs will have to be carefully considered in order to mitigate potential systemic risk in CCPs.

EMCF is a proponent of pan-European regulation and oversight proposed by EMIR and endorsed by

the consultation paper. Greater harmonisation enables increasing pan-European operation of CCP services. In the current absence of a European directive for securities clearing and settlement, a CCP or CSD based in one state and offering its services in another state cannot do so on the kind of European passport available to credit institutions and investment firms. It must comply with all of the mutually divergent requirements of the different national supervisors involved. Sometimes, these requirements are even contradictory.

The current requirements are at times contradictory, which may paralyse the cross border offering of a CCP. Exchanges, MTFs and investment firms that are subject to national legislation can passport their license throughout the EU based on home country regulation. This is currently not possible for CCPs, which are assessed on the basis of Member State legislation. A pan-European clearing house like EMCF with a significant share of the European equity clearing market is subject to oversight by supervisory authorities from multiple European countries.

EMCF operates a regulatory network that encompasses multiple jurisdictions. The regulatory authorities involved with EMCF cooperate on the basis of memoranda of understanding which aim to prevent duplication of oversight. The regulatory harmony in Europe functions well in most cases as was demonstrated by the introduction of the Nordic CCP in three different jurisdictions by an entity under regulation from two other authorities. Still, the requirements put forward by some regulators prevent a level playing field in Europe and constitute barriers to entry in some markets. We therefore welcome EU legislation that grants passport rights to CCPs to avoid regulatory fragmentation.

§ 3.3 – 3.5 CCP location and ownership

It is standard practice that a CCP should have robust governance arrangements, sound business processes and should be run by capable people. The proposed wording in the consultation paper does not entail major deviations from current practice in Europe.

In the view of EMCF, it would not be necessary to impose limits on the ownership and governance structure of a CCP. There does not seem to be a correlation between the governance of a CCP and its regulatory performance. There are examples of parties that are part of an exchange silo that are lowering risk standards to attract more flow from high frequency traders, there are “user-owned user-governed” CCPs that obstruct market competition, and there are profit driven CCPs that bring significant benefits to the market.

EMCF in itself is somewhat of an oddity. EMCF has been set-up by ABN AMRO Clearing with a commercially driven business model. The competitive pressure EMCF has introduced has resulted in significant benefits to the market participants, while having one of the most prudent risk management models in the CCP market. DNB and AFM stated: “The newcomers indeed seem to be breaking the monopolies of existing stock exchanges and clearing houses”, and “Since 2006, trading and clearing fees have declined under the pressure from (expected) competition”.

It seems that a proper supervisory framework with the right and easy controllable parameters in its risk control is more important to establish than rules and regulations for governance of a CCP.

§ 3.6 Scope of clearing

EMCF provides CCP clearing for cash equities and would therefore promote compulsory CCP clearing for multilateral trades executed on the Spanish market. A CCP stands between two parties to a trade and guarantees trades in the event of a default, acting as a buyer to the seller and as a seller to the buyer. In this role, the CCP not only monitors and centralises the counterparty default risk, but the CCP also reduces the risk as it can reduce the obligations of a trading participant to other parties to a single (net) obligation to the CCP. This centralisation also greatly benefits transparency. Centralised clearing has proven its merits. This was underlined by the orderly handling of the positions resulting from Lehman's default by CCPs in Europe as well as in the US. A drive towards greater product standardisation and more CCP clearing therefore makes sense.

While making the case for CCP clearing there are two important exceptions. For cash equities clearing there is a trade-off between the liquidity in a certain stock and the value of CCP clearing. If liquidity is low and only a few trades per day settle in a certain instrument, the risk-compression of centralized clearing and netting is also low. The only benefit of a CCP would be in this case the fact that the CCP manages the risk and monitors open positions and settlement. There are other ways to achieve the same goal of guarantee of the trade upon settlement. The current guarantee scheme in effect on the Spanish exchange is a good example of different risk mitigation technique that is equally effective for products with limited liquidity.

In addition to this not all products are suitable for CCP clearing. There are roughly three conditions to centrally clear a product; the regular availability of prices, sufficient depth of market liquidity and the absence of risk attributes that cannot be mitigated by the CCP¹. CCPs should not be forced to clear a product if they are unable to manage the associated risk properly. For cash equities this requirement holds equally true as for other products. Therefore suitability of CCP clearing should be determined on a case by case basis. The result of this could be that it would be necessary to put some products outside of the scope of the CCP clearing obligation as proposed in the consultation paper.

If we understand this question to read whether it should be mandatory to clear OTC transactions in listed equities via the CCP, we wonder how such a rule will be enforced in practice, in a cross border environment.

For other products, such as fixed income, the conditions mentioned above equally hold true. Providing CCP clearing is only effective if there is sufficient liquidity. Therefore optional CCP clearing of these products should be welcomed.

From a customer perspective it is beneficial to have as many products cleared by through the same CCP. Therefore it would be advisable for CCPs that offer clearing in Spanish equities for trading on the BME to offer clearing of fixed income with the same infrastructure. This brings down the costs of connectivity for clearing participants.

¹ "Reforming OTC markets", December 2009
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§ 3.7 & 3.8 Authorisation and Governance

EMCF is a proponent of mandatory Risk Management Committees within CCPs. EMCF is currently in the process of setting up a risk committee to coordinate major decisions regarding risk management with its participants. Certain decisions by a CCP to clear other products such as OTC derivatives could lead to a significant alteration of the risk management profile of a CCP. This change in risk is ultimately passed on to the participants of that CCP. Installing a Risk Committee would enable Clearing Participants to exercise greater control and safeguard the risk profile of the CCP of which it is a member.

§ 3.9 CCP risk management, capitalization, management and access to liquidity

Real time risk management

In the current market environment CCPs should be required to perform risk management on a (near) real-time basis. The market has seen significant acceleration over recent years, enabling traders to trade within a millisecond. Increased automation in trading with sophisticated systems and algorithms has fundamentally changed the trading landscape.

The increase in speed of trading technology should be followed by an increase in the speed of risk management. EMCF fully supports the proposals from the Commission in this respect. Therefore the EC should mandate (near) real-time risk management and reporting. Allowing CCPs to perform risk management 'once a day or intra-day' would be the equivalent of equipping a Ferrari with the brakes of a 2CV.

CCPs should measure the exposure of trading participants in (near) real time. In addition to the requirement to measure client exposures in (near) real time, clearing participants should be able to receive real time reporting of cleared transactions. This way the participants themselves would be enabled (and should be obliged) to perform (near) real time risk management of the trading patterns of their clients.

Capital requirements

Comment 52 on capital requirements of a CCP is not entirely clear. In line with EMIR, EMCF believes initial capital should be linked to operating costs and enable the CCP to orderly wind-down after an event that might trigger its default.

Liquidity arrangements

EMCF agrees with the consultation paper in the sense that the requirement to have access to overnight liquidity in the Eurosystem would provide an additional layer of protection for the CCP. This does not mean that credit and liquidity (including emergency liquidity) cannot be sourced safely from a different source than the central bank. EMIR explicitly allows for commercial bank liquidity provided that the commercial bank is creditworthy and reliable. EMCF is constantly reviewing its settlement and liquidity arrangements in Europe.

Access to liquidity and credit in times of stress as well as in day-to-day operations are at the prime focus of regulators throughout Europe. One of the measures currently under review is to allow CCPs to access central banks for emergency and intraday liquidity. The conditions for access by CCPs differ throughout the European Union. Within the Eurozone, the ECB requires non-bank CCPs to be subject to the requirements for ancillary systems.

The access to the central banking system is closely linked to banking legislation and the Eurosystem

policies. Therefore, even though EMCF promotes the use of central bank money and uses central bank money when available, it would advise against legal requirements to source liquidity from central banks without at the same time providing the CCP access to the central banking system under reasonable conditions. Imposing central bank money obligations without proper arrangements for CCPs could lead to regulatory fragmentation and distortion of the competitive landscape for CCPs.

Although liquidity can be sourced from commercial banks under most circumstances, access to liquidity from the Eurosystem should be made technically and legally possible across the Euro area, in order to allow for the possibility of provision of emergency liquidity.

**Equal
treatment at the
CSD**

CCP The credit and liquidity requirements for CCPs largely depend on their access to 'added' CCP services at the local CSD. EMCF operates a network of settlement agents that facilitate settlement in the local CSD for the 19 markets it currently services. The level of services provided by the settlement agent differs per CSD. In most CSDs EMCF settles as a standard OTC Delivery versus Payment (DvP) or Receipt versus Payment (RvP). In most CSDs EMCF is seen as an ordinary (OTC) CSD participant. This prohibits EMCF to use additional functionalities that are available for the CCP of the incumbent market. Some CSDs offer additional functionalities (end of day automatic splitting, auto shaping, etc.) that bring down the liquidity requirement for CCPs. The availability of these services is usually restricted to the incumbent CCP. As a result of this the pan-European CCPs (EuroCCP and EMCF) have significantly higher liquidity requirements and overnight credit requirements. This requires them to operate through commercial intermediaries that can facilitate additional credit and liquidity with the CSD.

EMCF promotes equal treatment for all CCPs regardless of their nationality. This requires CSD to treat the pan-European CCPs on equal footing with the local (incumbent) CCPs. This would bring down the liquidity and credit requirements for pan-European CCPs, reduce overnight positions and the overall risk of settlement.

§ 3.10 Interoperability

Interoperability will introduce additional risk factors which can be mitigated with additional buffers in the system of CCPs. These additional buffers will offset, in part, the efficiencies which can be achieved in the margin requirement through consolidation of the positions of clearing participants. Nonetheless, the risk of contagion cannot be ruled out and must be weighed against the benefits of interoperability.

Also, without open access to trade feeds, interoperability will fail to bring about efficiencies to the market. There are no signs at this stage at a European level, that such access can be expected in the foreseeable future: it appears that the key to interoperability lies with the major exchanges in Europe.

§ 3.13 System of penalties

§ 4.4 System of penalties to compensate the non failing party

The use of a CCP will usually improve settlement efficiency. In addition to that the introduction of a CCP will organise the market along the current trend in Europe, to which the Spanish markets now intends to align itself. It is possible that the departure from the present system of assured delivery will lead to another development. EMCF's experience in the Nordics shows, that comparing the market efficiency pre CCP introduction versus post CCP introduction can be delicate process in which

comparison of apples and oranges must be carefully avoided. Defining benchmarks ahead of changes can help in this process.

The consequences of fails and the root causes of the same, which can be of a technical nature, or can result from various consecutive settlement cycles, should be carefully considered. Harsh procedures may be justified in order to avoid undesirable market behaviour, e.g. the CCP must not be “cheapest to fail”, but on the other hand the measures must remain proportional. Buy-ins and stock borrowing should not be mechanical in case of illiquid securities, and should be weighed against alternatives, such as cash settlement. From a systematic perspective, the charging of compensation and penalties must be viewed separate in the light of their objectives. Compensation for losses incurred by one market participant as a result of failures in performance of another participant should be treated independent from actual penalties, aimed at inflicting intended financial damage by a competent authority. In the case of such penalties, the role of the aggrieved party as recipient of penalties collected should be carefully considered.

4. Changes in the settlement system

§ 4.1 Settlement by balances

In the settlement system, mechanics whereby the CCP can settle securities legs by initiating automatic debits in the CSD accounts of the settlement agents of the clearing participants could improve settlement efficiency. Such settlements on the basis of powers of attorney could improve efficiency, also if they would allow for partial settlements, thus reducing overnight holdings and corresponding financing at the CCP level.

§ 4.2 Requirements for participants in the new settlement system

We understand and we endorse the necessity of imposing certain financial and operational requirements on settlement system participants. We understand the risk that such participants could “create” securities through accounting mechanisms in their ledgers, potentially causing shortfalls.

About EMCF

EMCF is the largest cash equities CCP in Europe today. Based in Amsterdam and regulated by De Nederlandsche Bank (DNB) and the Dutch authority for the financial markets (AFM), EMCF services around 40% of on-exchange cash equity trades in Europe.

The establishment of EMCF is a direct consequence of the successful implementation of the Market in Financial Instruments Directive (MiFID). After implementation of MiFID the European cash equities trading landscape has fundamentally changed. A number of new entrants at the trading and clearing level have increased the competitive pressure and helped to bring about significant cost reductions. They have promoted innovation and changed the industry by introducing Multilateral Trading Facilities (MTF) and pan-European central counterparty clearing houses. The success of MTFs such as Chi-X, BATS and Turquoise has reduced spreads, driven growth in trading volumes and generated new opportunities for market participants.

EMCF played an important role in this process. EMCF was established in 2007 by ABN AMRO Clearing and is currently the exclusive CCP provider for the pan-European markets Chi-X Europe, BATS Europe, Burgundy, Quote MTF, TOM MTF and the primary Nasdaq OMX stock exchanges of the Nordic countries Sweden, Denmark and Finland.