



Default Procedures Publication Guideline

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Context

ESCB-CESR Recommendation 6 ‘Default Procedures’, paragraph 9 states:

“To provide certainty and predictability to all market participants about the measures that may be taken by a CCP and other relevant entities in the event of a default, a CCP should make available key aspects of its default procedures:

- i. the circumstances in which action may be taken;*
- ii. who may take those actions;*
- iii. the scope of the actions which may be taken, including the treatment of both proprietary and customer positions, funds and assets;*
- iv. the mechanisms to address a CCP’s obligations to non-defaulting participants; and*
- v. the mechanisms to address the defaulting participant’s obligations to its customers as far as the CCP is capable of.*

This transparency helps the orderly handling of defaults, enables non-defaulting participants to understand their obligations to a CCP and to their customers, and gives market participants the information they need to make an informed assessment about whether to trade in a given market and how best to structure their customer account agreements. The widespread availability and understanding of default procedures may also help to foster confidence in the market should a major default occur and help to sustain market liquidity by avoiding or minimising withdrawals by other market participants.”

Default Procedure Publication Guideline

EACH supports the ESCB-CESR Recommendation with regards to disclosure of Default Procedures, noting that:

- Transparency of procedures provides certainty and predictability for market participants;
- Where procedures are fully understood, this facilitates an orderly process in the event of a default; and
- Where members understand default procedures, they can make a fully-informed assessment of the risk associated with a market and, as such, their desire to participate.

Furthermore, EACH believes that presenting default procedures in a standard format across all member CCPs will serve to make procedures as transparent as possible for the benefit of all market participants (CCP members, Settlement Agents, Clients (i.e. End-Clients), etc.). As such, this standardised guidance note has been prepared.

This note, the Default Procedure Publication Guideline, provides details of the points which EACH believes should be covered by a Disclosure Document. EACH is well aware that on one hand transparency of default procedures is important as it provides certainty and predictability to market participants, facilitates orderly handling in case of an actual default,

enables market participants to make an informed assessment about markets, and on the other hand that at the same time every default is different in many aspects from the preceding ones and some degree of flexibility in managing the default is desirable and probably necessary.

EACH wishes to clarify that the Default Procedure Publication Guideline does not take into consideration the event of default of a Linked CCP. As a matter of fact each link or interoperability arrangement is different and has unique characteristics and such a default – although possible in principle – appears to be very remote and would have different systemic implications in comparison to the default of a Clearing Member; therefore it does not appear appropriate to examine the consequences of the default of a Linked CCP in the same framework of the much more realistic event of a Member's default.

EACH also wishes to clarify that Disclosure Documents will be for general information purposes only, and will be non binding in nature. A clear statement that governing laws and CCP rules and regulations will prevail over and above any Disclosure Document should be included for the avoidance of doubt.

The Disclosure Document

The following sections detail the information items that should be made available to market participants with reference to default procedures.

1. Default Declaration

The circumstances that can lead to a default being declared by the CCP should be disclosed in detail. Some examples of the circumstances which may typically be covered include:

- (i) the Participant is being declared in default by a regulator under the applicable laws of the jurisdiction;
- (ii) the Participant trading capacity is suspended, expelled or terminated;
- (iii) the Participant ends its operations either through liquidation, winding up or voluntary cessation;
- (iv) the Participant is unable to fulfil, within the time specified, its payment obligations towards the CCP, including initial margin, variation margin or intra-day margin;
- (v) any other event or series of events, whether related or not, occurring which in the opinion of the CCP has a material effect on the capacity of the Participant to meet its obligations.

Where possible, the procedure by which such circumstances are identified by the CCP should also be disclosed.

Points to be mentioned in the Disclosure Document:

- Under what circumstances can a default be declared
- Who is responsible for declaring a default
- Existence of information sharing channels between CCPs within EACH for communication of post-default events
- ...

2. Waterfall of Resources

It is believed that one area where clarity is particularly important is: what circumstances would lead to the contribution of non-defaulting members to the Default Fund being at risk; and also how/when members will be notified in the event that their contribution is going to be, or has been, used.

Clarification of the procedure followed where part or all of the Default Fund is depleted should also be provided, particularly if non-defaulting members are obliged to replenish, or have a choice to terminate their membership. This should include, where applicable, how much could they be asked to replenish, and the consequences of their inability/unwillingness to contribute.

The mechanisms and the order of available resources (so-called “waterfall”) to address the defaulter’s obligations to counterparties should also be disclosed, including:

- 1) the use of margins;
- 2) the use of other Post Default Backing such as Default Funds;
- 3) the availability of a parental guarantee or insurance policies;
- 4) the assessment¹ procedure among market or CCP’s members if any has been established.

Points to be mentioned in the Disclosure Document:

- What financial resources are available in the event of a default
- In what order are these used (the ‘waterfall’)
- When and how would the CCP notify the members that their Default Fund contributions are being used, or have been used
- What is the procedure for replenishing the Default Fund
- Is the replenished Default Fund available for the current default, or only for possible future defaults
- Is the replenishment automatic or voluntary
- Is there a limit on how much Participants could be asked to provide
- What are the consequences of not contributing to a replenishment of the Default Fund
- At what point, and under what circumstances the CCP would contribute its own capital

¹ "Assessment procedure" in this context is the procedure under which a CCP is entitled to request non-defaulting members to provide a further contribution above and beyond their contribution to the (already utilised) Default Fund.

- At what point, and under what circumstances the Insurance Policy (or any other Financial Resource available to the CCP) would be available for redemption
- ...

3. Impact of a Default on Settlement Procedures

Information on securities settlements should be provided.

It is considered crucial that a CCP should provide information on settlement procedures. In particular, each CCP should be explicit in stating what the impact may be for normal settlement practices whilst a CCP is in the process of managing a default. This should apply to cash payments against delivery of securities. However, it is not expected that Credit Variation Margin or other pure cash payments from the CCP to solvent members should be affected.

Points to be mentioned in the Disclosure Document:

- Clarification of the circumstances which may result in the CCP choosing to fail to fulfil some of the defaulter's obligations (cash, securities, variation margin) for a short time frame, or where there might be changes to the normal settlement practices
- Outline how the CCP would manage NCMs' / End Clients' settlements in case of the default of their Clearing Member
- ...

4. Legal Relationship between the CCP and NCMs/ End Clients

Different Legal relationships and obligations should be clearly disclosed.

CCPs may have various types of relationship with different entities, namely: General Clearing Members, Direct/Individual Clearing Members, Non-Clearing Members, Segregated Clients and Non-Segregated Clients, Settlement Agents, Paying Banks, etc. Each CCP should clarify the legal nature of each of these relationships, and also provide details of the principal-to-principal relationship and what this means with regards to client protection.

Points to be mentioned in the Disclosure Document:

- What is the account structure at the CCP
- How are NCMs' / End Clients' positions margined
- Does the CCP have a direct relationship with NCMs / End Clients
- What is the legal relationship with NCMs / End Clients
- Existence of any legal obligation of the CCP towards NCMs / End Clients in default handling
- What is the treatment of NCMs related (ie part of the same group) to its defaulting GCM
- Does the CCP collect information on NCMs / End Clients
- ...

5. Treatment of House/Client Positions

The treatment of both proprietary and customer positions, funds and assets should also be disclosed in some detail,

Each CCP should clarify under what circumstances customer positions are transferred, and those where positions are liquidated.

In cases where positions would be transferred, terms and conditions should be set out in the CCP's procedures, including:

- 1) where segregated and/or non segregated clients positions are transferred automatically, provisions on how the customer will be informed that its positions will be transferred;
- 2) where customers must request a transfer of their positions, any documentation that will be made available for non defaulting members requesting customers' positions transfer;
- 3) possible rules for transfers (possibility to transfer the entire portfolio or selected positions, choice of the clearing member they wish to be transferred to; etc)
- 4) the price of the position at transfer;
- 5) the treatment of pending settlements, between the customers and the transferring firm;
- 6) a possible requirement for re-margining positions, for example, where margins cannot be transferred with the positions;
- 7) any differences in the treatment of different classes of customers.

In cases where positions would be liquidated, terms and conditions should be provided. In particular, where all proprietary and client positions will be netted together into a single position for liquidation, clients should be provided with details of how such a process is undertaken, which should include clarification of how the liquidation price of client positions will be identified.

In the event that the position to be liquidated is of a size that may threaten the stability of the market, it should be clarified whether CCPs are provided with additional flexibility to dispose of such position within a certain timeframe.

Points to be mentioned in the Disclosure Document:

- Do the CCPs procedures provide a defined ordering in which different types of positions should be resolved
- The CCPs procedures for dealing with NCMs and segregated and non-segregated clients should be described. For example, can the CCP transfer them to another Clearing Member? or close them out?
- The CCP should describe the procedure for dealing with End Client positions transfers. It should be made clear whether the client should contact the CCP directly, or whether they need to contact the Clearing Member they wish to transfer to. The CCP should also clarify what will happen to any margin they have lodged with the defaulted Clearing Member, and whether the client can choose which specific positions to transfer
- Descriptions of the CCP's rules on client protection should also be included
- ...

6. Assurances

It is recommended that CCPs establish mechanisms whereby information can be efficiently and effectively communicated to market participants and the general public² in the event that default procedures are implemented. In particular EACH considers it important that CCPs put in place procedures aimed at re-assuring non-defaulting Participants and the general public about its ongoing ability to perform its business-as-usual activities, namely:

- that trades of non-defaulting participants are being registered,
- margins are being called and paid out as normal, and
- that the defaulting member and its NCMs are positively removed from order books and have no capacity to continue trading in any form and that other CCPs have been informed of the default event.

Also, given that different jurisdiction and market practices are used around Europe, it is also considered important that CCPs clarify to Members and the general public the legal status of trades (if any) executed during the day of default by the Defaulting Member itself.

Points to be mentioned in the Disclosure Document:

- Other impacts – if any – on existing members when the CCP is managing a default. It should be clear whether business is continuing as usual, who in the CCP can be contacted for information, and how updates on the default will be disseminated.
- Description of CCP procedures in place to immediately stop the defaulter from entering into more trades in each market
- Details of how the CCP guarantee can be terminated. For example, does the CCP guarantee all trades that have been conducted with the defaulter up until the point of default, or are there any circumstances where the CCP may not.
- ...

² Communication between CCPs and their Regulators are evidently beyond the scope of this document.