

OVERSIGHT

REGULATORY UPDATE

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Here we go...

It has been a bumper autumn for regulatory initiatives affecting the (trading and) post-trading spaces. Many of the new proposals are so complex that we have had to go into some detail to explain their main features, and to outline our initial thoughts on their potential implications for our markets – including Switzerland.

What has become clear is that what you see in the public domain and behind the scenes has become quite disconnected. This has meant that while some regulatory issues such as EMIR, CRD IV and MiFID II, or even the controversy over the ECB's Oversight Policy, continue to command top billing, others such as the forthcoming CSD Regulation (RCSD), barely register as a blip on the headline radar – which is why we explore it in some detail in this edition.

As anticipated, discussions on EMIR have resumed in Brussels following the agreement on the text by the EU Ecofin Council. Another aspect of EMIR is the Swiss implementation of the trading, clearing and reporting requirements for OTC Derivatives – we cover this too.

CPSS-IOSCO and the G-20 have been in a more reflective mood than our prolific EU friends: we await the conclusions of their further work on Principles and Resolution Plans for Infrastructures.

T2S has also loomed large and our Group Board has now given approval for the further exploration of options for connecting to T2S, which we will share with you in the future.

Finally, this edition marks one year of Oversight. As I look back, I can't say that anything has particularly surprised me, only that we were right to share our intelligence about regulatory developments with you, our clients and customers.

In 2012 we will continue to look to you for suggestions on how to make 'Oversight' even better. Until then, however, may the end of year festive period bring you joy and something of a respite.

Thomas Zeeb
Chief Executive Officer
SIX Securities Services

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Oversight

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SIX Securities Services.

Welcome to Oversight - our quarterly update on market policy developments and the regulatory landscape. If you would like to subscribe to this newsletter electronically please send an e-mail to oversight@six-group.com

If you would like to learn more about topics covered in this edition, please contact:
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The EU legislative program on market infrastructures

The EMIR continues in negotiation, the MiFID proposals are out, and the shape of the RCSD has been leaked

a) General Outlook

Changes since the last edition of Oversight are highlighted in bold in the table on page 3:

b) EMIR

Following further intensive working group discussions, Ecofin finally agreed the Council's general approach on 4 October. This text now forms the basis of the Council's position in its negotiations with the European Parliament in the so-called 'trialogue'. The EU institutions would like to conclude these negotiations by the end of the year, so that the EU can remain on track in meeting the G-20 commitment for implemented legislation by the end of 2012. During the 4 October discussions, the United Kingdom in particular was able to obtain some important drafting changes. These focused on ensuring fair and open access between CCPs and trading platforms and that supervisory colleges do not discriminate against any member state as a venue for clearing services in any currency.

EMIR – POTENTIAL IMPLICATIONS FOR CCPS AND FIRMS

Although parts of the text relating to the general requirements for CCPs, particularly in relation to risk management, margining and default funds, have been known for some time, there will still be an absence of detail until ESMA produces its draft Technical Advice around Easter 2012. In addition, the interoperability arrangements will only apply to cash securities (including indices and ETFs), according to the original definition in MiFID. There will also be new authorization and supervision arrangements for SIX x-clear Ltd, which will have to be in place, we think, by the end of 2013, with again a lack of clarity, this time over how college arrangements will work for Third Country CCPs. Finally, while it is generally thought that exchange-traded derivatives will remain outside the scope of the clearing obligation of EMIR, the exact classes of standardized OTC derivative contracts which will be included have yet to be determined.

c) Draft Regulation on Central Securities Depositories (RCSD)

In late October, SIX Securities Services had sight of a draft or 'leaked' version of the RCSD. This text is not the final one, but it has given us a glimpse of the Commission's thinking.

While a number of features were expected, such as those mandating T+2 settlement, settlement discipline, various authorizations and supervision requirements, as well as those covering risk management and third country aspects, those relating to how a CSD does business, and is structured, did give us and other CSDs in Europe some cause for concern. Notably, in relation to the treatment of 'banking-type services', and how the provision of credit in commercial bank money

DRAFT RCSD – POTENTIAL IMPLICATIONS FOR CSDs AND FIRMS

There are some quite serious concerns identified by the EU CSD community, including SIX Securities Services. In their current form, we believe these to be unworkable, with the potential to do untold harm to the operational set-up at CSDs; increase, not reduce, concentration and systemic risk, and, most importantly, affect participants, particularly those designated as 'settlement agent banks'. The latter would be subject to additional supervisory requirements, over and above the obligations relating to counterparty, market, and even settlement risk already prevailing in the CRD. Through our European association, ECSDA, the European CSD community as a whole, including the SIX Securities Services CSD, SIX SIS Ltd, has been taking up these concerns with the Commission, also culminating in a further bilateral meeting in mid-December. These issues have also been flagged by some Member States, all of which means that the formal adoption of the CSD Regulation is set to be postponed into the New Year. It will then be left to the Cypriot Presidency of the EU in the second half of the year to significantly progress discussions in the Council. As with EMIR, ESMA will also have to produce technical standards to flesh out some of the requirements of the RCSD.



might work in the future. In particular, if a CSD wants to offer settlement in commercial bank money, it has to appoint two ('independent') settlement agent banks (as counterparties). These are then subject to a whole swathe of additional requirements.

d) Revision of the Market in Financial Instruments Directive (MiFID II/MiFIR)

The Commission issued its proposals on 20th October. The draft legal text is split into a Directive and a Regulation.

The Directive amends specific aspects relating to the provision of investment services, the scope of exemptions from the current Directive, the organizational and conduct of business requirements for investment firms and trading venues, as well as the powers available to competent authorities, sanctions, and the rules applicable to third country firms. Finally, in the Annex of services, 'safekeeping' has been moved from an ancillary service to a core one.

The Regulation sets out the requirements in relation to trade transparency, authorization requirements for data service providers, the mandatory trading of derivatives on organized venues; and supervisory actions regarding financial instruments and positions in derivatives. The latter include non-discriminatory access to CCPs, trading venues and benchmarks.

MiFID II/MiFIR – POTENTIAL IMPLICATIONS FOR POST-TRADING FIRMS

Broadly, SIX Securities Services can welcome much of the draft, notably in the reinforced access provisions, harmonized regulatory requirements, and in the continued competition between trading venues, including the introduction of a new category of Organised Trading Facility ('OTFs'). However, the proposals are complex, for instance in the differential pre- and post-trade transparency treatment across asset classes, through the restrictions imposed on High Frequency Traders ('HFTs'), and may be also in forcing firms into either more specialization, or requiring multiple authorization. For instance, only those institutions that are designated as Systemic Internalisers ('SIs') can undertake proprietary trading; OTFs typically cannot. As noted above, investment firms wishing to provide cross-border retail investment will need to do so from an established presence in a Member State. Finally, we believe that the move of 'safekeeping' to core MiFID services could have implications for both infrastructures and banks, potentially rendering them liable to capture, inappropriately, under some of the other MiFID provisions. This is undesirable and certainly for the CSD community, given that we will have our EU regulatory framework via the RCSD, a clear exemption from MiFID would be warranted.

If you would like to find out more on EU market infrastructure legislation or on any other topic, please contact:

Alex Merriman, Head of Market Policy (Alexander.Merriman@six-group.com or +41 58 399 4583). Previous editions of Oversight and other regulatory information about us are also available at: www.six-securities-services.com.

Segment of the Value Chain	Measure	Proposed (Published)	Adopted (Finalised)
Trading	Review of Market in Financial Instruments Directive (MiFID)	20 October 2011	End – 2013?
Clearing	European Market Infrastructure Regulation (EMIR)	September 2010	Between Q4 2011 and Q2 2012?
Settlement	Regulation on Central Securities Depositories (RCSD)	Q1 2012	End - 2013?
Underpinning Law	Securities Law Directive (SLD)	Q2 2012	End - 2015?

Market infrastructure initiatives by the European Central Bank (ECB)

Milestones have been reached in the T2S project, while the UK government has challenged the ECB's newly formulated Oversight Policy

(a) TARGET2-Securities (T2S)

The SIX Group Board of Directors approved on 17 November a twofold parallel approach to T2S, including a direct connection from SIX SIS Ltd in Switzerland as well as, if necessary and/or appropriate, the establishment of a CSD in the Eurozone. A project team within SIX Securities Services is in place to evaluate the various options available in terms of implementing one or both options and these will be presented to the Board for final approval for implementation in Q1 2012. We will keep the Swiss market and other stakeholders informed of how this strategic initiative progresses.

As mentioned in our previous edition, the ECB Governing Council, at its meeting on 17 November, approved the offer – the so-called Framework Agreement (FWA) to participating CSDs. CSDs have until April 2012 to sign, although the ECB has introduced a range of incentives (involving discounts on the development and testing costs) to encourage CSDs to sign up by 19 December.

(b) ECB Oversight Policy for infrastructures

In July, the ECB published a paper on its website on oversight arrangements for payment, clearing and settlement systems. In the paper, the ECB advocates that those infrastructures handling a certain volume of euro-denominated transactions, should be subject to location, incorporation and control requirements.

The ECB does not make any distinction between infrastructures in the EU (including those in the eurozone) and those from third countries (potentially capturing SIX x-clear Ltd and SIX SIS Ltd). Offshore payment systems such as CLS are captured. The key issue is whether the relevant clearing, payment and settlement system handles transactions in the euro. Both CSDs and CCPs would be subject to a range of requirements, including location and legal incorporation in the eurozone, and management exercising controls over the key functions, subject to relevant thresholds.

These are, for CSDs, more than EUR 5 billion per day, or more than 0.2% of the total daily average value of payment transactions processed by euro area interbank funds transfer systems which provide for final settlement in central bank money; for CCPs, the threshold applies where they have more than 5% of the aggregated daily net credit exposure of all CCPs for one of the main euro-denominated product categories

The ECB's policy has been challenged by the UK government, which opened proceedings in September before the European Court of Justice. The grounds for the challenge include violation of fundamental European freedoms, of establishment, movement of people and provision of services, infringes EU competition law, offends the principal of equality, is not proportional and exceeds the competence of the ECB. The UK is particularly concerned about the impact on the clearing house LCH.Clearnet. Our understanding is that both parties would like to reach a settlement outside of a court decision, although the ECB subsequently reaffirmed its Oversight Policy responsibilities for CCPs in a November paper entitled 'Standards for the Use of Central Counterparties in Eurosystem Reserve Management Operations', covering the clearing of current and future foreign currency instruments employed in reserves management.

ECB OVERSIGHT POLICY – POTENTIAL IMPLICATIONS FOR SIX Securities Services

As noted above, the ECB's policy has the potential to capture any infrastructure that handles a certain volume of euro-denominated transactions. Certain aspects of the policy do require clarification, notably how the thresholds are calculated, and the degree of outsourcing of functions that would be permitted. Nonetheless, our first analysis suggests that, apart from temporary spikes, the euro-denominated transaction volumes in both SIX x-clear Ltd and SIX SIS Ltd would fall below the proposed thresholds. The full implications of the ECB's policy also still have to be discussed with our regulators and overseers.



Other legislative and regulatory initiatives impacting market infrastructures and the value chain

This quarter's focus falls on a number of G-20 initiatives, including OTC derivatives, recovery and resolution frameworks, and an update on the CPSS-IOSCO work

a) Swiss market progress towards meeting G-20 commitments on OTC derivatives

SIX Securities Services has joined other institutions in examining how the Swiss market should respond to the G-20 commitment of ensuring that all qualifying OTC derivatives are traded, centrally cleared and reported. To date, the main Swiss market concerns relate to the need to avoid duplication, and the potential for lack of consistency between EMIR and Dodd-Frank. For instance, over the treatment of intra-group exposures, extra territorial effects, and the list of 'standardized' instruments (already the CFTC has exempted FX options and non-delivered forwards). There are also concerns about the deliverables in Switzerland: legally, to ensure that the Swiss framework is 'equivalent' to EMIR and Dodd-Frank, with the necessity of also ensuring that rules (e.g. changes to the Stock Exchange Act) lay down the requirements for the Swiss market. In terms of the individual segments, first comments suggest that there is no clarity yet over the favoured trading venue, and that firms would prefer to use existing global clearing and trade reporting mechanisms, rather than a specific Swiss solution being built. In relation to clearing, the development of a specific Swiss solution is also hampered by the fact that SIX x-clear Ltd, as part of SIX group's divestiture of its stake in Eurex, is subject

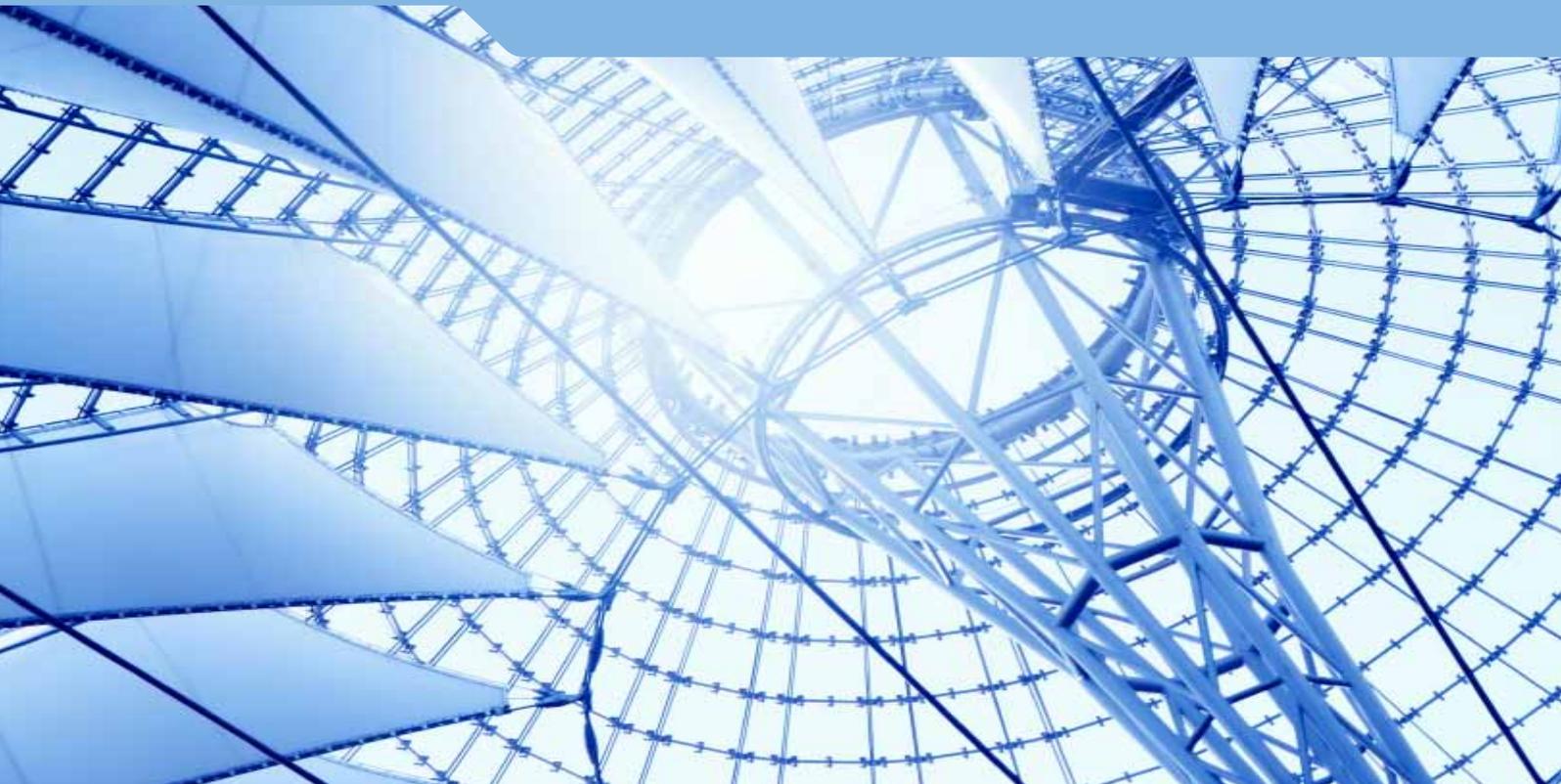
to a non-compete agreement until the end of 2013. This is now a matter of public record.

SIX Securities Services would particularly welcome comments from interested/concerned parties on what is the best way forward for the Swiss market. Please contact Alex Merriman, Head of Market Policy (Alexander.Merriman@six-group.com or +41 58 399 4583).

(b) Resolution framework for infrastructures

Our comments on the Financial Stability Board (FSB) Consultation on effective resolution of systemically important banks via the response of our CSD association, ECSDA, were acknowledged in the feedback statement. While the authorities continue to believe that RRP's are essential for CCPs, their main focus is on ensuring that CCPs' default waterfalls are rigorous and do not trigger the early repayment of the CCP's own funds. In addition, there is a fear mirrored in proposals for tackling crisis situations for banks, that the authorities' powers of intervention are not sufficient to meet the failure of a CCP.

The sub-group of the CPSS-IOSCO working group proposals for RRP's for infrastructures (notably for



CCPs) are still expected for consultation sometime early in the new year, at the same time that the revised Principles, referred to earlier, are published.

(c) BCBS second consultation on capitalisation of bank exposures to CCPs

The Basel Committee issued this paper during November, for comment by the end of the month. It clarified that, although it was still the BCBS's intention to apply a 2% risk weight for trade exposures to a CCP, the scope of the proposal was confined to financial derivatives (both exchange-traded and OTC), repos/ reverse-repos, and SLB transactions. The annex makes clear that 'exposures arising from the settlement of cash transactions (including equities, fixed income, spot FX and spot commodities) are not covered by this treatment', except where the clearing member guarantees that its client will not suffer any loss due to changes in the value of its transactions through the CCP's failure. A complex formula also underpins the calculation for a bank's exposure to a CCP's default fund, although compared with the original, a degree of flexibility has been introduced with a variable decreasing capital factor. Other aspects such as the own funds factor and the exposure scale are unchanged. These changes will need to be reflected in the EU implementation of Basel III, CRD IV, which is currently being negotiated in the EU Council, and which was the subject of a progress report at the 30 November Ecofin.

Further BCBS consultative proposals on the margining standards for non-centrally cleared OTC derivatives are promised by the middle of 2012.

(d) CGFS report on systemic implications of clearing OTC derivatives via central counterparties

The BIS's Committee on the Global Financial System (CGFS) reported in November on the potential systemic impact of clearing a greater volume of OTC derivatives via central counterparties. They concluded that expanding direct access to CCPs could reduce risk concentration (among the largest global dealers), provided that the CCP's risk management procedures kept pace with the new environment of enhanced access, and that indirect clearing arrangements were made as robust as direct clearing ones. The report also noted that inter-CCP links (for instance interoperability) needed careful consideration. While this could also mean the establishment of more domestic CCPs to clear this business, and closer to national oversight arrangements (and the ability to intervene in emergency situations), this could also lead to a fragmentation in trading and other positions.

For further information on any of these issues, please contact: Alex Merriman, Head of Market Policy (Alexander.Merriman@six-group.com or +41 58 399 4583).