

ASSOCIATION OF GLOBAL CUSTODIANS

Communication of the Association of Global Custodians Asia Focus Committee ¹

16 May 2019,

The Honourable Shri Ajay Tyagi,
Chairman,
The Securities and Exchange Board of India.

Dear Shri Tyagi,

Interoperability of CCP's

We refer to the letters dated 10 January, 15 April and 25 April 2019 sent to SEBI by the Asia Securities Industry and Financial Markets Association (ASIFMA) regarding the interoperability of Clearing Corporations (CCP's) in India. Along with ASIFMA, the Association of Global Custodians² (AGC) welcomes and fully supports this positive development in the market.

The changes allow market participants to consolidate their clearing and settlement functions at a single CCP. AGC member banks expect interoperability to lead to an efficient allocation of capital for market participants, thereby saving on costs as well as providing better execution of trades.

The six member banks providing custodial services in Mumbai, as a group, have fully supported ASIFMA in the development of the three letters. Representatives of some banks have also accompanied ASIFMA in meetings with SEBI to discuss the interoperability project.

In regard to the proposed operating guidelines issued by the CCP's, these indicate that the changes envisaged are quite extensive and will require significant IT development to cover all the models. The proposed model-2 is less disruptive from system development and processing perspectives

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² The Association of Global Custodians is an informal group of 12 financial institutions that provide securities safekeeping services and asset-servicing functions to primarily institutional cross-border investors worldwide. As a non-partisan advocacy organization, the Association represents members' common interests on regulatory and market structure matters through comment letters, white papers and interaction with legislative and regulatory authorities and financial industry organizations around the globe. The members of the Association of Global Custodians are: BNP Paribas; BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor & Treasury Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and Trust Company. For more information visit www.theagc.com

and would help custodian banks and market participants cut-down on developmental time and effort required to support interoperability. We are pleased to see model-2 being taken as the go-live model by CCP's. We have the following additional comments:

1. CCP draft guidelines suggest that proposed "Model-2" would be available only for one year as an interim model, whereby custodians continue to confirm settlement to CCP's on a T+1 basis in the current manner and then pay margins/settle with their chosen CCP. AGC member banks request that this model not be an interim solution, but is perpetuated. If that is not possible, the "interim" model should run for at least three years to allow sufficient time for custodians to make necessary systems enhancements to fully accommodate the final, agreed model.
2. We understand from market participants' discussions with the CCPs that there are a number of areas, which are still open and are a work in progress among CCP's. These include setting-up an inter-CCP risk management framework, changes to the bye-laws, timing of pay-outs, etc. These changes are posing serious challenges to clearing members in designing the system changes to control clearing and settlement of trades.
3. The following operational aspects are still under discussion with clearing corporations:-
 - a) The current de-confirmation process (a confirmed trade can be de-confirmed within the allowed time up to 1pm), to continue;
 - b) In regard to inter-CCP risk management, member custodian banks have requested the CCP's to issue a circular by the 10th May, defining how this risk is to be managed and what impact there will be on Clearing Members. This will help custodians firm up their Payment System Risk Management (PSRM) processes and will greatly assist in the decision-making on which CCP a custodian will sign-up with.
 - c) Member custodian banks have requested CCP's to work with SEBI to ensure no contribution (fixed or otherwise) is charged to dormant members ("dormant member" is one which has signed up with a CCP only as a back-up measure).
 - d) In regard to the Trade for Trade segment, the list of securities will be uniform for all exchanges and CCPs. Settlement will follow the practice prescribed by the chosen CCP.
 - e) In regard to brokerage settlement there should be separate settlement by NCL and MCL; ICCL will continue their current process. Both NCL and MCL need to provide custodians with requirements to report brokerage, which can be settled by them.
 - f) On transition day the CCPs need to work with SEBI and agree that settlement for both the 30th and 31st May trades takes place on 3rd June, before interoperability commences. This will ensure a cleaner transition. It will require the 1st June (Saturday) to be the

confirmation date for 31st May trades and 3rd June to be the settlement date for both 30th and 31st May trades.

All of our above comments above are predicted upon interoperability of CCP's commencing upon the SEBI announced date of 1 June 2019.

The above-mentioned operational challenges and various aspects that are still a work in progress at this stage, are posing serious difficulties and challenges to proceed with system development that will provide efficient interoperability between CCP's. We believe that pursuing interoperability without system capabilities and readiness poses the risk of creating clearing and settlement processes that would be prone to operational and systemic weaknesses.

4. With the introduction of interoperability, CCPs are required to guarantee performance not only of their members, but also "linked CCPs". As a result, liability for a non-defaulting member can also be triggered by the default of the linked CCP.

To manage this inter-CCP risk, we understand that CCP's will collect 'margin' from each other adhering to the SEBI prescribed margining framework as applicable to a clearing member. We also understand that CCP's will be liable for maintaining 'Additional Capital' on the basis of a CCP's credit strength. The basis of calculation for such additional capital has yet to be published by the CCP's. AGC member banks in India, in their capacity as clearing members, need to thoroughly examine approved inter-CCP risk management rules to determine if inter-CCP risk is sufficiently covered, as this will have a direct bearing on member liability. The assessment of incremental risk can only be completed by AGC member banks upon the relevant, approved rules being published

5. End to end testing of the systems: Interoperability is a very significant development, which is going to change the Indian market infrastructure and setup. It not only impacts the way custodians function today, but also changes the set-up for CSDs, brokers and most importantly for investors.

Considering the wider impact of this major market change, we consider it of utmost importance that all the market intermediaries go through a thorough user acceptance testing (UAT) phase with all parties involved (CCPs and Clearing Members), including regression testing, before going live.

To rule out any possibility of disruption on the go-live date, we consider thorough user testing to be absolutely essential. We envisage UAT in two phases:

- 1st phase UAT: we expect this phase to last for 2 weeks wherein we can take the real life data and run through all the processes, as it would be under the interoperability model. This phase will help all market participants to identify all blocking points/ issues, if any;
- A cooling-off period can be provided to iron-out all the issues, including fixing points internally by all market intermediaries and CCPs, wherever required;
- 2nd phase UAT: we expect this phase to be the final phase of UAT, spread over one week, wherein all the checkpoints/ processes will be re-run.

We need to highlight that AGC member banks are not fully ready from operational, systems and risk review perspectives to cut-over. If cut-over on 1 June is enforced, they would be prone to major operational risk, due to manual processes and manual reconciliation. Member banks are not comfortable that they are fully prepared for this major market change.

We understand that the broker community are also facing a similar dilemma, as they too are not fully prepared for a 1 June cut-over.

To avoid market disruption, we strongly urge and request SEBI to extend the implementation date of this major infrastructure change for at least six months, taking into consideration the above-mentioned challenges.

We would like to reiterate that the interoperability of CCP's is a very welcome development by all market participants in India and the AGC fully supports such developments in all markets worldwide.

Please feel free to contact either the undersigned or our Chairman, Ms. Karin Quek, should SEBI have any questions regarding this letter.

Yours sincerely,



Robert Edwards, (as attorney in fact)
For and on behalf of Karin Quek,
Chairman, Asia Focus Committee,
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