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16 June 2010

Committee on Payment and Settlement Systems
International Organisation of Securities
Commissions and Bank for International
Settlements
CH-4002 Basel, Switzerland

Dear Sirs:

We refer to your consultative report dated May 2010 and entitled "Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs".

The purpose of this letter is to provide some comments of a technical nature on some of the issues raised by the guidance contained in your report. Shearman & Sterling is an international law firm with offices in the major financial centres of the world. We represent many of the world's leading financial institutions, companies and governments and we have represented some of the world's leading clearing houses in establishing new infrastructure. These comments are intended to be of a technical nature and are not made on behalf of, and should not be attributed to, any former or existing client of our firm.

Most of the guidance issued in the report applies to all CCPs and does not have any particular relevance to CCPs that clear OTC derivatives products. Thus, guidance on matters such as legal risk (guidance 1.1), participation requirements (guidance 2.1 and 2.2), and default procedures (guidance 6.1 to 6.4) is of general application. We see nothing here worth saying that is novel to OTC products. Differing guidance for different cleared products should be avoided as it creates unwelcome different standards, and opportunities for regulatory arbitrage. In this instance, it also devalues the importance of the relevant matters for exchange-traded products. CCPs that clear OTC derivatives should not be subject to additional requirements, unless the issues are particular to OTC derivatives. Furthermore, any additional requirements must be balanced with the importance of avoiding excessive regulation that could have effect of deterring the entry of CCPs into the field of OTC derivatives clearing. This would run counter to the global consensus on the need to move OTC derivatives to CCP clearing wherever possible as a way of reducing the likelihood of a future financial crisis.

Guidance 6.4: The segregation and transfer of customers' positions and collateral

In this guidance, reference is made to the segregation and transfer of customer positions and collateral. Before any guidance can be given on this issue, it is necessary to analyse the legal concepts that govern the use of collateral and the recording of customer positions by a CCP. Even where a CCP offers segregation of customer positions and collateral, the collateral itself will typically be transferred to the CCP using a title transfer collateral arrangement. These are arrangements where full title to the collateral is transferred to the CCP so that it becomes absolute owner of the collateral with freedom to deal with it as it wishes. The CCP is merely under an obligation to return equivalent collateral to the collateral giver once the obligation secured by the collateral is satisfied.

Title transfer collateral arrangements are universally recognised in the EU following the adoption of the Financial Collateral Directive[1]. Given the outright transfer of ownership that occurs in a title transfer arrangement, it is not appropriate to describe any collateral transferred by the customer in a way that implies a residual ownership right in the customer.

We would therefore recommend that in describing customer segregation in Guidance 6.4 of your report, due regard is paid to the prevailing collateral arrangement discussed above. For example, at the top of page 19 of your report, it is stated that "... segregation can improve a customer's ability to identify and recover *its* collateral ..." (emphasis added). This suggests that the collateral belongs to the collateral, contrary to the position that exists under a title transfer collateral arrangement.

We also note that there is nothing here which should not also be relevant to the customer clearing of exchange-traded products.

Guidance 14.1 Market transparency requirements

The guidance recommends that an OTC derivatives CCP should make available market data appropriate to the markets that it serves. The scope and level of granularity of the data should be in line with the information needs of relevant authorities as well as its users and the public.

We would question the need to include guidance in this area at this time, given that there may be EU legislation on market transparency in relation to OTC derivatives. The Commission's Communication of 20th October 2009 discussed the need to ensure transparency in relation to OTC derivatives and the possibility of imposing trade reporting requirements on exchanges and market participants. If reporting requirements are imposed on parties to OTC derivatives or on trade repositories, it would be unwise to impose similar requirements on CCPs at this time.

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1 Directive 2002/47/EC.

Annex 2.1: The appropriate scope of CCPs' ability to take extraordinary emergency actions

This section of the report seeks to limit the situations in which emergency action may be taken by the CCP. Thus, at the top of page 30 of the report, it is recommended that an emergency action should be limited to situations in which there is significant risk that failure to take action would result in the failure of the CCP. CCPs should not take emergency actions that, as far as can be judged with available information, would result in a greater level of uncertainty or systemic risk to the financial system. Further, a CCP should define the circumstances that may constitute an "emergency" and the steps that it can take to manage the situation. Again, there is no reason why these issues are relevant to OTC products rather than of general application to all clearing.

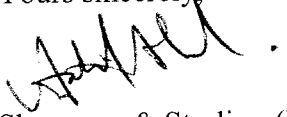
Furthermore, we would question the wisdom of unduly restricting the range of actions CCPs can take to deal with emergency situations by reference to unduly high tests and thresholds. Restricting emergency actions to situations where there is a significant risk that failure to take action would result in the failure of the CCP would hamper CCPs from taking appropriate action rapidly enough to mitigate the impact of unforeseen circumstances. Even if there is no risk that a CCP would fail, a situation may nevertheless pose a risk of severe financial loss on a CCP or induce an undesirable practice. In such a situation, it would be unduly burdensome to require CCPs to refrain from taking action unless its solvency were at risk. For example, CCPs will typically reserve the right to invoice back an entire book of contracts declared void by a court decision if the result of such decision would be to impose severe financial loss on the CCP without jeopardising its solvency. This happened once in the 1980s. The ability of a CCP to minimise financial losses generally is fundamental to their role in supporting market stability and expanding services to cover risky derivatives products. At a time when regulators around the world have converged on the desirability of expanding central clearing to as many derivatives products as possible, it would be counterproductive to restrict the flexibility CCPs possess to reduce financial loss and preserve their guaranty funds and capital. Furthermore, a situation may nevertheless warrant emergency action because of the risk that it will otherwise give rise to contagion in the market and exacerbate any financial loss suffered by the CCP, even if the situation does not threaten a CCP's solvency. Finally, in our experience, CCPs, in consensus with their users, have not considered it prudent to define the situations that constitute emergencies using anything more than a general test; certainly, we are not aware of any CCP using a definition that incorporates an exhaustive list of specific situations that constitute emergencies.

Although there is a balance to be struck between the negative consequences of emergency action on the market, and the CCP's own commercial interests, such a balance has in most cases already been struck by the rules and regulations that CCPs must comply with when dealing with emergency situations. CCPs should not be subject to rules on how to strike this balance on an ongoing basis, and, in particular, at a time of financial stress. It is a generally

accepted principle that CCPs should be given freedom to carry out their default procedures without interference by the authorities (such as insolvency officials) or without having to grapple with vague tests of when emergency action is justified. This position is reflected throughout the EU by the Settlement Finality Directive[2], and, in the United Kingdom, by legislation implementing this directive as well as Part VII of the Companies Act 1989. Without these laws, CCPs would have to exercise judgment on fine points of insolvency law and its own solvency prior to taking emergency action in a default.

We do not believe it would advance the interests of the financial markets and their users to undermine the protection that is afforded by these laws by fettering the ability of CCPs to apply their default rules and procedures. Such rules and procedures are already reviewed and approved by national regulators. In the UK, the Financial Services Authority has the power to disallow excessive regulatory provisions contained in a CCP's rules[3]. Furthermore, a UK regulated CCP is required to give the FSA notice of any proposal to make any regulatory provision[4]. There have not so far been any instances of CCPs making unwarranted use of their emergency powers, nor have CCPs used such powers to trigger market disruption. Indeed, the history of CCP participation in the financial markets, including the role played by them in handling the Lehman Brothers default, tends to substantiate the market stabilising role played by CCPs and their success in managing market stresses.

Yours sincerely,



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2 Directive 98/26/EC.

3 Section 300A of the Financial Services and Markets Act 2000.

4 Section 300B of the Financial Services and Markets Act 2000.