EUROPEAN SECURITIES FORUM

CONTRIBUTION TO THE JOINT CESR/ECB CONSULTATION ON CLEARING AND SETTLEMENT

In response to the call for contributions to the joint CESR/ECB consultation on clearing and settlement, we set out below our comments on the "Issues for Further Consideration" listed in the consultation document of 15 March 2002. We are particularly encouraged that the Group aims to adapt and expand on CPSS/IOSCO recommendations. For ease of reference, the questions posed by the consultation paper are reproduced in conjunction with our comments on each set of questions.

Consultation questions: "2.1 Nature of the recommendations
What should be the legal nature of the recommendations and/or standards to be issued by the Group? Are there issues for which a European legal instrument is deemed appropriate? Are there recommendations and standards that should be adopted by national law?"

ESF comment: Given the extensive problems already experienced by European financial markets due to inconsistent implementation (or non-implementation) of European rules and guidelines (e.g. in respect of national conduct of business rules), it is preferable that as much of the output of the Group is binding with direct effect in EU member states, e.g. in the form of EU Regulations. One key area where a pan-EU instrument would serve is harmonisation of member states' diverse securities laws (i.e. property laws as they relate to securities) which have the effect of complicating all inter-member state securities activity involving EU securities and thus constitute barriers to a single market. Harmonisation needs to embrace payment finality laws, securities payment finality laws, bankruptcy laws and transfer of ownership laws. We understand that the U.S. authorities solved some similar difficulties with a superordinate "universal security code".

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Consultation questions: "2.2 Addressee
Who is the appropriate addressee of the possible standards or recommendations to be drawn up by the Group: the regulators, the systems, the operators or the users? In such cases where standards and/or recommendations are addressed neither to regulators nor to legislators, what are the appropriate incentives for their implementation and compliance?"

ESF comment: There is a need for an overall EU legal framework in this sector. Standards that are not binding are not likely to have effect in a commercial industry such as clearing and settlement. Consequently, the appropriate addressee of the Group's output is almost certainly the regulators. There does not appear to be any enforceable mechanism for output that is addressed to other parties. However, measures designed to encourage market-led consolidation would also be helpful. Consolidation would ideally involve horizontal consolidation allowing users direct access to the market places of service providers. This would align market forces more closely with the objects of official policy. In any case direct access must be formalised, governed by objective criteria, and managed in a way which does not increase systematic risk.

Consultation questions: "2.3 Scope
Do you agree that the scope of the Group's work includes any entity providing clearing and settlement services or associated aspects and is not limited to any particular type of service provider? More specifically, do you agree that central securities depositories (CSDs), international central securities depositories (ICSDs), CCPs, custodians and registrars are included? Do you think that some standards should apply on a differentiated basis to these parties given that the scope of their business is not directly comparable? Should standards apply to other parties? If so, which standards and to which parties? With regard to custody and safekeeping services, what are the advantages or disadvantages of a distinction being drawn between custody services, on the one hand, and clearing and settlement on the other? Do particular considerations apply where custody and safekeeping services are provided by credit institutions or investment services firms? With regard to the securities covered, do you agree that sovereign and private debt, equity and other securities, as well as depository certificates, receipts, derivatives, etc., are included, or where would differentiation be necessary? Should some standards/recommendations be specifically addressed to cross-border transactions? If so, which ones?"

ESF comment: We agree that the scope of the Group's work should include any entity providing clearing and settlement services or associated aspects and not be limited to any particular type of service provider. We also agree that CSDs, ICSDs, CCPs, custodians and registrars should be included. It is however likely that standards should be differentiated depending on whether they apply to core clearing and settlement functions for markets as a whole, or to added value services provided by commercial competition. There is no adequate and accepted, legal definition of CSD, ICSD, custodians etc. Indeed there is already a good deal of overlap between the services they provide. For example ICSD's (which now combine with traditional CSDs) provide added-value custody services which compete with commercial custodians. It would be helpful therefore, in the interests of equality of treatment, to define the functions and not just the traditional labels attaching to the service provider. This issue becomes more important

as consolidation of clearing and settlement grows. A case could be made requiring separation of the core public "utility" services from the commercial, added-value ones.

However, no package of measures would be complete if it did not also consider the role and activities of the trading platforms. The strictest standards should apply to entities that occupy special status or enjoy a monopoly/oligopoly position in a market. It is indeed cross-border transactions that need the most urgent attention, due to the much higher costs involved in inter-member state transactions. The guiding principle in determining what rules should apply to intra-member and which to inter-member transactions is that transactions should be as simple and cheap to complete in either case, without distortions of price, regulation, technology or other forms of protectionism. In principle all securities, however defined in the present or the future, should be included in order to maximise the efficiencies of the market. However this should not be done in a way that adds regulatory burdens. There is also a question of the scope of consultation by the Group with other official bodies. Taxation issues can also be a distorting factor and it might prove beneficial to include national tax authorities.

Consultation questions: "2.4 Objectives
A priori, the objectives of central banks and securities regulators in the field of securities clearing and settlement systems could be summarised as follows: 1) risk mitigation, including investor protection, for both the system and the users; 2) efficiency, including for cross-border activities; 3) creation of a level playing field between participants and service providers, irrespective of their legal status or their geographical location; 4) promotion of integration of the EU securities markets infrastructure. Do you agree? Do you consider that these objectives are sufficient?"

ESF comment: These are good objectives but need an addition or a clarification to include: the reduction of the cost of cross-border clearing and settlement in Europe. This is intellectually distinct from "efficiency". A system can be very efficient in terms of the manpower and other resources that it employs but may be provided to the market at a super economic rent. In such cases systems are both "efficient" and expensive. Trade processing across frontiers within the EU is typically more costly than intra-member transactions. This is partly because there are at present typically more steps in the transaction chain, and partly because this fact has inhibited growth of cross border trading, thus denying so far the full benefits of economies of scale.

The true costs of cross border processing and the internal costs of market participants have been the subject of several studies. None has been truly comprehensive and their objectivity is hard to verify. It could be useful to create a standard taxonomy for such studies to follow.

Structural changes in provision of clearing and settlement could reduce risk and reduce the cost of mitigating that risk. For example, consolidation could improve the sophistication of risk management particularly in clearing through the portfolio effect of including a wider range of instruments in a common system.

Consultation questions: "2.5 Access conditions
Are you aware of access conditions to specific service providers, which could be considered discriminatory? If so, where do the main problems lie? Do you consider that the present rules do/do not establish a level playing field in this respect? Do they relate to the access criteria of the system or to other conditions such as operational features? If so, which ones?"

ESF comment: The present rules do not establish a level playing field. Specific service providers do operate within vertical silo structures that limit the options of users in material ways. These material ways relate to both access criteria of the systems and to other conditions such as operational features. The lack

of interoperability also restricts the extent to which users can use their excess collateral held in one system to collateralise exposures in another system.

Consultation questions: "2.6 Risks and weaknesses
What are the most relevant factors to risks and weaknesses in terms of clearing and settlement of domestic and cross-border transactions (i.e. legal, settlement, custody and operational risks)? As far as legal risks are concerned, what kind of problems can different legal approaches create? When looking in particular at cross-border transactions, how does the existence of different jurisdictions and the
involvement of several actors such as local agents, global custodians, foreign CSDs or ICSDs in the process of cross-border clearing and settlement affect the nature and magnitude of these risks? What would be the most appropriate manner of addressing these issues? As far as custody activities are concerned, do you agree that the segregation of assets and the reconciliation of positions are the most crucial issues to be addressed? As far as settlement risk is concerned, do you agree that the definition and timing of finality (including the need for intraday settlement finality), delivery versus payment, access to central bank money as settlement assets for systemically important systems and conditions of use of central bank money versus commercial bank money are the most crucial issues to be addressed with regard to clearing and settlement of domestic transactions? What specific impact could these issues have on clearing and settlement of cross-border transactions? Finally, as far as operational risks are concerned, what are the main factors to be considered?"

ESF comment: The existence of different jurisdictions and the involvement of several actors such as local agents, global custodians, foreign CSDs or ICSDs in the process of cross-border clearing and settlement both increase number and magnitude of relevant risks. Harmonisation of rules and consolidation of service providers would help to reduce these risks. There is no reason in principle why settlement in commercial bank money should not be acceptably free of systemic risk particularly as it can improve the speed of settlement across currencies and across timezones. Custody services however entail credit risks, which need to be recognised separately and mitigated differently. Of course, consolidation inevitably brings with it, some concentration of risk; an acceptable balance between concentration and mitigation needs to be developed. The solution is likely to include a combination of commercial and central bank money with the latter likely to play the more crucial role.

Consultation questions: "2.7 Settlement cycles
What are the arguments for and against harmonised and/or shorter settlement cycles? It appears, for instance, that while a very short cycle could increase settlement default rates, a longer cycle could increase uncertainty and settlement risk. Is there a need to adopt different settlement cycles for different securities, such as for equities and government debt instruments, etc?"

ESF comment: There are benefits to ensuring that the settlement cycles of different securities are harmonised given the increasing frequency of complex trades and that the cycle(s) is shortened progressively as default rates are brought down by system improvements. This may also require some change to forex settlement and other payments systems. This comment relates at least for the foreseeable future to settlement between market participants. Settlement with their own private clients is likely to vary but the risk attaches in that case to the intermediary rather than the market.

Consultation questions: "2.8 Structural issues
The structure of the securities clearing and settlement industry in Europe has been hotly debated recently. An integrated market can be achieved via a number of routes, with concentration, interoperability and open access being the most obvious alternatives. What are the arguments, if any, for a public policy intervention relating to (i) centralised or decentralised structures for infrastructure and service providers; and (ii) the governance structure of infrastructure and service providers? Are custodians, CCPs, CSDs and ICSDs to be considered as commercial firms, driven by regular competition, or should they (or some categories of these entities) be considered as utilities whether or not they operate within a monopoly environment? Does the same reasoning apply to the provider of trading services?"

ESF comment: The governance of the service providers is critical to their provision of cheaper services to users. User involvement in the governance of the service providers is the most likely alignment of market pressures to prevent abusive pricing at the expense of users and the European capital market. CCPs, CSDs and ICSDs usually cannot be considered as operating in competitive markets in relation to their core clearing and settlement functions (as opposed to custody), because they usually have either monopoly or oligopoly status in their own market.

User involvement in the ownership and governance would align incentives to reduce costs and to reduce risks. This also suggests separation of ownership and governance of trading platforms from that of clearing and settlement providers ("horizontal model"). In practice, a horizontal structure is likely to have some continuing minority involvement of stock exchanges. It is also possible that clearing and settlement could combine with each other, especially when settlement cycles are shortened. By contrast the "vertical model" (whereby trading platforms own clearing and settlement providers) does not have the common alignment of interests of regulators, service providers and users with regard to the minimisation of risk or cost. Consolidation of service providers would almost certainly increase the efficiency of the trade-processing sector in Europe. It is true that a consolidated "utility" structure would involve a degree of concentration of risk but genuine competition between clearers is not really possible because of the sub-optimal risk and cost management that is inherent in a fragmented market. In our view clearing is a

"natural" monopoly - but should not be a state-protected one. However, this would not mean that risk capital would not be remunerated at market rates or that the entity would be prevented from building and retaining a surplus. Indeed a surplus is key to such an entity's remaining dynamic, up-to-date and responsive to market developments. This is important as the serviced population expands with the enlargement of the EU. The system should generate its own reserves to deal with such expansion.

It seems much more likely that a level playing field can be created using a unified structure than by one that is fragmented and ostensibly interoperable. Interoperability and open access are two sides of the same coin – neither will work without the other. However, interoperability may itself necessitate expensive measures in order to connect all the relevant parties to each other (whether through a hub or otherwise). It may be possible to achieve many of the benefits of interoperability by the (relatively less expensive) mechanism of harmonising communication standards. However, it is questionable whether interoperability, quite apart from the initial capital expenditure that would be required, would actually achieve the efficiency gains needed for a single capital market. This is because interoperability is likely to lead to more complexity of interfaces on the market side as well as more inefficient use of margin and collateral. Indeed, interoperability could be a fig leaf, which ostensibly promises openness but in fact creates structural rigidities.

Consolidation into a single European capital market could take the form of a “mega silo” with effectively a single stock exchange which owned a single pan-European clearing and netting provider, with few or even a single CSD. This would no doubt deliver many of the efficiencies which the market wants, but the ownership and governance of the mega silo would be driven by a for profit model primarily serving the interests of the trading platform. In our view this would misalign the interests of the owners, of users, regulators and investors in a way which would be unacceptable.

There is clearly an important question for regulators whether clearing and settlement should be subject to some form of economic regulation, but we would argue that a quasi-utility model would be more likely to have its interest aligned with those of such a regulator and thus permit such regulation to be relatively light and at a higher level of principle.

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