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BNP PARIBAS SECURITIES SERVICES

CONTRIBUTION TO THE JOINT CESR/ECB CONSULTATION IN THE FIELD OF CLEARING AND SETTLEMENT

Introduction

We have pleasure in submitting BNP Paribas Securities Services contribution to the joint CESR/ECB consultation in the field of clearing and settlement.

BNP Paribas Securities Services is a subsidiary of BNP Paribas, a major international banking group and a market leader in Europe. BNP Paribas Securities Services is a transaction bank, dedicated to financial institutions as well as corporates. We serve international broker-dealers, global custodians, asset managers and issuers. The services covered include clearing, cross border settlement, custody, back-office outsourcing, fund administration and asset servicing.

With assets under custody of 2 trillion Euro, we processed 22.4 million transactions in 2001. Equities represent 95% of our securities transaction volumes and we cover all types of instruments: securities (listed and unlisted, bonds, UCITS), derivatives and cash. Our strategy focuses on Europe, where we have established a presence in 12 countries: Belgium, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Switzerland, as well as the United Kingdom.

We offer our clients effortless and efficient access to major markets across Europe: we combine our pan-European network with a personalised client approach, unmatched local market expertise, a consistently high quality product and service offerings, as well as fully integrated operations and systems technology.

As a result, BNP Paribas Securities Services is consistently recognised in all major industry surveys as the premier pan-European bank providing securities services to financial institutions.

Management Summary

BNP Paribas Securities Services contribution aims at answering in details the questions raised in the CESR/ECB consultation.

At first, we express three comments on the Group's approach:

- CPSS/IOCSO recommendations: in order to adapt these recommendations in Europe, we suggest that CESR/ECB take an initial step to clarify the definitions used. We recognise two statuses relevant to the provision of SSS services (SSS operator): Central Securities Depository (CSD) and Custodian Bank.
- Giovannini Group Report: when looking at the cost of cross-border trades, we should wonder about which model of Custodian Bank is being discussed, prior to stating that the cost represents a major limitation on the scope for cross-border securities trading in the Union.
- JP Morgan – McKinsey & Company: the survey entitled "The Future of Equity Trading in Europe" brings interesting information to the debate and recommends "a *'Leaning Tower of Pisa'* outcome, i.e. *vertical structures which gradually become more horizontal as regulations become more harmonised*" rather than "a *big bang DTCC of Europe*".

In the second part, we answer the detailed issues suggested for further consideration.

- We suggest splitting into three different aspects: scope of legal instrument, to be driven by the European Commission in coordination with CESR/ECB ; scope of standard rules, to be driven by CESR/ECB ; market-led practice, to be driven by market forces.
- A minimum level of legal and tax harmonisation is necessary within the EU, in order to solve the current issues on cross-border trades. It is also a condition to allow the emergence of a single CSD.
- Key priorities are:
 - o securities finality and full dematerialization laws,
 - o transfer of ownership, registration and UCIT deposit rules,
 - o payment finality (enhance European harmonisation) and bankruptcy laws (complete the existing rules to take into account clearing and settlement features),
 - o definition of CSD and Custodian Bank's statuses, governance, and supervision, based on the definitions provided in the document. We also recommend that a party cannot combine both roles.
- Consolidation is expected and necessary for an increased efficiency of European financial markets. We recommend a process driven by market-forces, not by regulation, as long as the necessary legal framework is in place. In particular, consolidating into one single CSD would raise a huge competition problem if this entity was to benefit from a banking licence.
- We believe that the market consolidation will be driven by the creation of multi-market hubs at Exchange level, leading to the consolidation of CCPs, CSDs and Custodian Banks serving these hubs.
- Governance: CSDs are pseudo-monopolistic entities, we recommend a user-governance and not-for-profit type of organisation ; Custodian Banks are commercial entities, evolving in a competitive environment, we recommend a shareholder-governance and for-profit type of organisation.

Lastly, we attach as appendix a joint memorandum signed by major European Custodian Banks, based in Italy, France, the Netherlands and Scandinavia, recommending a clear segregation between CSD (non banking) and Custodian Bank (banking) activities.

1 The Group's approach

The Group has taken a range of documents as a basis for its review of the clearing and settlement infrastructures in the European Union. BNP Paribas Securities Services would like to express three comments.

1.1 CPSS/ IOSCO Recommendations

The CPSS/IOSCO "Recommendations for Securities Settlement Systems" stress matters which we consider key for the stability in the industry. The document is focused on Securities Settlement Systems (SSS) in a broad meaning that is also including Custodian Banks as part of the settlement infrastructure.

BNP Paribas Securities Services considers these are minimum standards for institutions involved in the settlement process and supports the fact that standards deriving from these recommendations should apply to Custodian Banks.

Nevertheless, prior to specifying standards, we recommend that CESR/ECB take an initial step to clarify the definitions used: legal statuses of the players involved in clearing and settlement, roles and responsibilities defined in accordance with their legal statuses. We enclose in the document a proposal to define the Central Securities Depository (CSD) and Custodian Banks terms, which we recognise as the two statuses relevant to the provision of SSS services.

In particular, we suggest to encompass under the Custodian Bank definition the various entities introduced in the CPSS/IOSCO report (custodian, global custodian, international central securities depository and local agent): these terms reflect entities which perform similar operational functions but adopt different marketing positions.

1.2 Giovannini Group Report

The Giovannini Group report focused on the "Cross-border clearing and settlement arrangements in the European Union" and was based on the CEPS (Centre for Economic Policy Studies) analysis of the costs of cross-border clearing and settlement services dated December 2001: "The securities settlement industry in the EU – Structure costs and the way forward".

This report correctly stated that SSSs form the backbone of the financial market infrastructure. Therefore, the evolution of the industry should be carefully considered, by measuring its potential impact in terms of investors' protection, systemic risk and efficiency.

For clarification purpose, a cross-border trade is applicable to a trade executed by a broker-dealer on a "foreign" market. In fact, the cost of cross-border trades depends merely on the Custodian Bank's organisation model.

Hence, prior to stating that:

- transactions within the European economy that occur across Member States are far more complex, are hindered by a number of significant barriers and are much more costly than domestic transactions,
- the additional cost that is associated with this fragmented infrastructure (19 CSDs and 2 ICSDs) represents a major limitation on the scope for cross-border securities trading in the Union,

we should first wonder about which model of Custodian Bank is being discussed.

Two models exist, direct clearing and custody, and global custody, which serve different investment patterns and result in different cost structures. The same entity, BNP Paribas Securities Services for instance, may combine both models as they correspond to different client segments. It is worth noting that similar patterns exist in Europe and in the United States.

- **Direct clearing and custody**

This model involves that the Custodian Bank directly opens an account at the CSDs. Clients retain a direct market membership and the Custodian Bank provides the whole range of post-trade services. When the market benefits from a CCP, the Custodian Bank often acts as Global Clearing Member.

In this model, the Custodian Bank opens a client account locally in its books under the local legislation and repeats a similar procedure in each market where it has gained the client's custody mandate. When the client appoints a single provider for a number of markets, he benefits from a standardised service, for instance in terms of interface format, reporting facilities, cash and securities forecast.

Nevertheless, clients rarely appoint one Custodian Bank to serve all European markets: they generally prefer to split the various markets between two or more service providers, in order to maintain the competitive pressure.

Direct clearing and custody access allows the processing of non-resident clients' cross-border transactions with similar efficiency as for domestic trades.

Local connectivity allows the use of very cost-efficient and secure settlement procedures (for instance netting at the CCP and Central Bank Money settlement at the CSD). Hence, costs are not driven by the nature of the trade (cross-border or domestic), but by the volumes of transactions generated by the client.

Transaction-driven clients (broker-dealers for instance) tend to opt for the direct custody service, because of its pricing, local market connectivity and range of services:

- global instrument coverage (equities, fixed income, UCITS, derivatives),
- efficient processing of back-to-back and arbitrage transactions,
- same-day securities lending and borrowing,
- credit and securities financing tools,
- broker insourcing services,
- custody and tax reclaim services.

- Global custody

This model involves that the Custodian Bank centralises all operations for one client in a single securities and cash account, held under a given legal jurisdiction, whatever the underlying securities type and / or market in which such security is traded and settled.

It is very worthy for custody-driven clients (asset managers for instance) who target wide-ranging assets, with investment rather than trading objectives, and appreciate a one-stop shopping service.

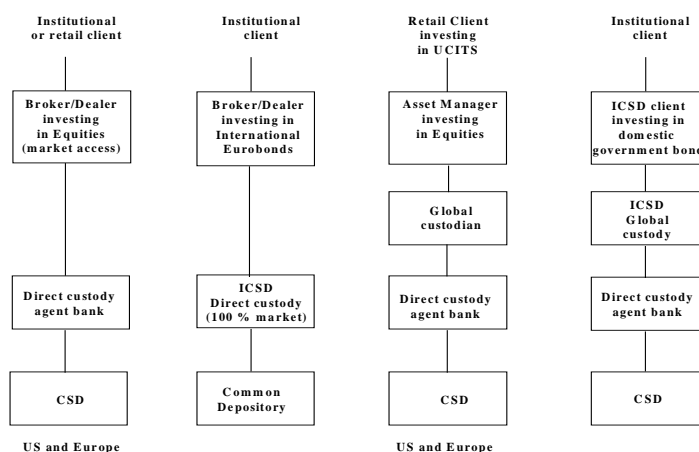
The global custody service implies three levels in the custody chain:

- BNP Paribas Securities Services as holder of the portfolio of all securities for its customers though a network of sub-custodians,
- sub-custodians as holders of BNP Paribas Securities Services portfolio,
- CSDs as final holder of securities, or common depositories (in the case of «eurobond» held by ICSDs).

This process adds to the costs by replicating at the global custody level the tasks performed either directly at the CSD or indirectly at the sub-custodian (direct custody Custodian bank) level.

It also involves a lack of direct connectivity, which involves delays in processing corporate actions and adapting to market evolutions.

Client buying patterns



Overall, efficiency is not an issue in Europe: we have efficient markets and the direct custody model allows an efficient processing of cross-border trades.

The issue is more about “de facto” making Europe one market, with one CSD fitting the whole of Europe and serving all instrument types.

1.3 JP Morgan – McKinsey & Company report

As a complement, we recommend that the CESR/ECB Group takes into consideration the survey published on 13th February 2002 by JP Morgan – McKinsey & Company: "The Future of Equity Trading in Europe" which brings new information to the debate.

This report analyses the complete transaction value chain from trading to custody and made the following findings:

- the total cost of a wholesale cross-border trade is 1.3 times the domestic cost of wholesale,
- cross-border trade pricing is already under significant pressure in the EU owing to the introduction of the Euro and the growing centralisation of dealing desks at the largest institutional investors,
- clearing and settlement in Europe is already remarkably efficient,
- margins in Europe remain higher than in the United States owing to smaller overheads and back-office costs.

As a consequence, the influence of CCP or CSD consolidation is rather small and rather than "a 'big bang' DTCC of Europe", the report recommends (p. 42) "a 'Leaning Tower of Pisa' outcome, i.e. vertical structures which gradually become more horizontal as regulations become more harmonised".

It is also worth noting that settlement costs represent a minor share of the total cost of a cross-border wholesale transaction. This share is even smaller when we consider the nominal value of the transaction. Hence, settlement costs cannot be considered as a major barrier to the integration of the European market.

A number of studies, including the Deutsche Börse White Paper¹ on Cross Border Equity in Europe have shown the importance of factors such as the national preference, the market image of the issuer, the attraction of US markets. On retail markets, it is also worth mentioning the limited trend for direct investment: retail investors tend to invest in UCITS, both on domestic and foreign markets.

2. Issues for further consideration

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?

Answering these questions involves splitting into three different aspects:

- **scope of legal instrument**, to be driven by the European Commission in coordination with CESR/ECB,
- **scope of standard rules**, to be driven by CESR/ECB,
- **market-led practice**, to be driven by market forces.

¹ Deutsche Börse Group/Clearstream International : Cross Border Equity Trading, Clearing & Settlement in Europe White Paper - March 2002

a) Scope of legal instrument

A key issue for the market is to obtain a minimum level of consistency in legal and regulatory frameworks across Europe.

The current situation is a source of distortion in competition between European players. As the Lamfalussy Committee pointed out, there is insufficient European legislation: this is a serious impediment to the constitution of an integrated pan-European securities market². The report stresses the need of minimum harmonisation in legislative, tax and regulatory regimes.

The activities of clearing and custody (and related services) are particularly affected by this situation. Some legal regimes are much more precise than others are and in some European countries there is even no legal definition of the clearing activity. France is apparently the only country where the rules for the accounting of securities are as precise as those are for cash.

The main areas needing European harmonisation are:

- Securities Dematerialization

In Europe, a number of legal regimes still exist to qualify securities.

- **Full dematerialization** is used in France and in Finland: a dematerialised security³, in the full sense of the word, is a security the issue and holding of which are evidenced solely by computerised or electronic entries in a system maintained by the issuer or by a recordholder acting for the issuer. Under such a regime, there is no possibility for securities holders to request a physical certificate representing the security.
- **Physical securities refer to certificated securities, that is if the issuer issues one or more certificates in respect of them.** This is the most common regime in Europe, used for instance in Spain, Belgium, Germany and Luxembourg. Certificates may be issued either in respect of individual holdings or in the form of jumbo or global certificates created in respect of the entire issue: in this case, the securities are **immobilised**, allowing the book-entry of securities transfers, but in some cases individual certificates may be issued to investors who request them. Hence, this **conventional dematerialization regime** combines the immobilisation of part of the issue with the physical holding of bearer certificates.

We recommend to harmonise on the basis of the full dematerialization regime, which brings cost and safety benefits.

- The book-entry processing of securities is an excellent way to promote efficiency and drive the costs down.
- This regime preserves anonymity towards the market, using the bearer form, but allows the transmission of registration information to the issuer in the case of registered securities and is fully transparent to the regulator when searching evidence of fraud or preventing money laundering.

Also, we should be careful not to confuse the full dematerialization regime with the conventional one. The Financial Action Task Force on Money Laundering indicated in a recent report⁴ that bearer securities represent a risk, by the fact that they facilitate tax evasion and money laundering. This report should clearly indicate that it refers to bearer certificates, that is physical securities, not to

² Final Report of the Committee of Wise Men on the Regulation of European Securities Markets - February 2001

³ Hague Conference on Private International Law - The Law applicable to dispositions of securities held through indirect holding systems – Prel.Doc.N°1 – November 2000

⁴ FATF-GAFI Report XIII – February 2002 – Rapport sur les typologies du blanchiment de capitaux

dematerialised securities: the situations described cannot actually occur in a full dematerialization regime.

- Securities Finality

Harmonising securities finality will avoid the current risks of co-ownership of the same securities. It is the CSD mission to ensure such finality, and no market participant should be entitled to state this finality on a unilateral basis.

In particular, we suggest that the UCITS are deposited with CSDs in order to ensure a secure holding of the issue account (on the basis of accounts with variable nominal) and the delivery versus payment exchange of UCITS based on CSD rules.

- Transfer of Ownership

There is not one single regime indicating the rights attached to the book-entry of securities. This raises issues on the nature of the right held by the investor towards the issuer and the market, and particularly on when the transfer of ownership takes place.

Harmonisation should be driven at the European level, to stipulate that the transfer of ownership takes place either at trade date or actual/contractual settlement date, and remove the current legal uncertainty, which particularly affects cross-border trades.

In addition, we suggest harmonising throughout Europe the processing of registration details (change of ownership of registered shares, for instance BRN in France and RR in Spain). Today, the processing varies according to the country and to the type of securities (equities or government bonds in Spain for instance). We suggest disconnecting the processing of registered shares in two steps:

- transmission of the trade details to the market on a bearer form,
- separate transmission of the registration details to the CSD with specific control procedures.

- Payment finality and bankruptcy laws protecting customers' assets

We recommend to enhance the European harmonisation in payment finality laws, as the application of the law varies from country to country.

We also suggest to complement the European bankruptcy rules to take into account specific clearing and settlement features and avoid a Bearing situation whereby the delivering counterparty actually loses twice (first the securities which it is irrevocably committed to deliver and then the cash, which is claimed as a fungible asset within the bankruptcy procedure).

To solve this issue, the French legal environment mitigates systemic risks through article L431-3 of the Monetary and Financial Code (known as the 47ter provision, law of 3 January 1983).

"With respect to a delivery-versus-payment of financial instruments, failure to pay or to deliver on the date and in accordance with the conditions specified by applicable market rules or, if none exist, as agreed between the parties, automatically discharges the non-defaulting party of any obligation towards the defaulting party, notwithstanding any legal provision to the contrary.

When an intermediary acting as custodian or in whose books securities are registered settles a delivery-versus-payment transaction by substituting itself to its defaulting customer, it can avail itself of the provisions of this article; it then acquires full ownership of the cash or financial instruments received from the counterparty. The provisions of this Article apply notwithstanding the provisions of the law of Insolvency (n° 85-98 of January 25, 1985). Creditors of the defaulting party are not entitled or make any claim on such financial instruments or cash."

- Definition at European level of CSD and Custodian Bank status, governance and supervision

A distinction between the “public utility” role of a Central Securities Depository⁵ (CSD) and the commercial role of a Custodian Bank⁶ should be ensured. We also recommend that Custodian Bank activities (clearing, settlement and custody) are considered as core banking activities.

The CPSS/IOSCO definition for a Securities Settlement System covers “the full set of institutional arrangements for confirmation, clearance and settlement of securities trades and safekeeping of securities”.

A clear segregation of the SSS missions performed by CSDs and Custodian Banks should be applied, to allow the definition of roles and responsibilities, as well as standards and rules:

- CSD role: maintains the accounting balance of issues deposited with it, ensures the finality of securities book-keeping in the appropriate jurisdictions and operates an SSS in Central Bank Money to provide core settlement and custody functions,
- Custodian Bank role: maintains the clients accounts, delivers access to the CSDs and operates an SSS in commercial bank money to provide value-added clearing, settlement and custody services.

As a consequence, the role of SSS operator should be governed by either a CSD status or a Custodian Bank status.

b) Scope of standard rules

Standardisation of market infrastructure and procedures is as important as harmonisation of legal frameworks. We believe that common European rules are most needed: they should be defined by CESR in close cooperation with market practitioners and their endorsement would remain under the supervision of national authorities.

In particular, we suggest that a common set of rules applies to market participants, by taking example on the Conseil des Marchés Financiers General Regulations (CMF Title IV and Title VI), which set detailed rules for:

- central counterparties
- central securities depository
- custodian-account holders
- securities settlement systems. Areas where standard rules may apply are:
 - definition of Real Time Gross Settlement
 - matching and settlement deadlines
 - use of central bank versus commercial bank money.

This framework must be combined with a formal assessment process, as well as periodic review procedures, all monitored by the regulator.

⁵ For a definition of Central Securities Depository, please refer to page 11

⁶ For a definition of Custodian Bank, please refer to page 13

c) Market-led practice

Finally, BNP Paribas Securities Services supports the Wise Men Committee's assertion that, beyond the minimum regulatory harmonisation, any restructuring in the field of securities and settlement should be governed by the market.

In particular, market practices should dictate:

- Choice of settlement location
- Choice of DVP settlement
- Use of standards, such as Swift formats (15022), ISIN codes (securities) and BIC codes (counterparties)
- Trade confirmation deadlines
- Settlement cycles
- Repurchase agreement, buy and sell back, and securities lending and borrowing practices.

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?

We suggest that the regulators are the addressees of the standards or recommendations to be drawn by the Group, in order to issue binding regulations.

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?

We agree that the scope of the Group's work includes any entity providing clearing and settlement services or associated aspects; we also agree that central securities depositories (CSDs), international central securities depositories (ICSDs), CCPs, custodians and registrars are included.

Nevertheless, as a first step, we recommend that the Group clarifies the definitions used within this domain. We recognise 2 statuses relevant to the provision of SSS services: Central Securities Depository (CSD) and Custodian Bank, and we suggest here below a definition of these terms.

a) Central Securities Depository (CSD)

This is typically a non-banking and not for profit utility⁷, owned and governed by its participants, whose status is granted by law.

The CSD is essential in the financial stability of the Eurosystem. The CSD maintains accounting balance for the issues deposited with it (which is by definition a pseudo-monopolistic role) and ensures the finality of securities bookkeeping in the appropriate jurisdictions. As non-banking entities, their liability is limited in terms of financial responsibility.

They traditionally provide core securities transactions, related cash movements and custody services, for a wide range of participants: retail and wholesale, domestic and remote, central depositories, banks, broker-dealers including primary dealers, treasurers, specialised credit institutions, issuers including State Treasuries. Admission of new participants is subject to the approval of the local authorities.

As stated by the CMF (General Rules, Title VI, Custody and Account-Keeping of Financial Instruments, dated 18 January 1999):

"The functions of a central depository (of financial instruments) are:

- 1- *record in a specific account the entirety of the financial instruments making up each issue accepted for deposit by the depository,*
- 2- *open current accounts for custody account-keepers, other central depositories and French and foreign institutions that the depository has accepted as members under the conditions set by its operating rules; in the case of institutions from a country outside the European Economic Area, their membership must not have been opposed by the CMF within one month following the date at which the CMF was notified by the central depository;*
- 3- *ensure the circulation of financial instruments by book-entry transfer from one account to another;*
- 4- *verify that the total amount of each issue accepted by the depository is equal to the sum of financial instruments recorded on member accounts,*
- 5- *take all steps necessary to enable the exercise of rights attached to the financial instruments,*
- 6- *transmit registration information regarding holders of financial instruments between members and issuers,*
- 7- *issue certificates representing French-law financial instruments for use abroad.*

A central depository may accept for deposit financial instruments for which it does not hold the account of the issue. In such a case, it must at all times make sure that the quantity of financial instruments deposited with it is equal to the sum of financial instruments recorded on the accounts of its members."

CSDs operate Securities Settlement Systems in Central Bank Money (for Euro settlements), which allow secured settlement.

As a user of CSDs, BNP Paribas Securities Services has a strong preference for:

- the settlement of debt (government bonds) instruments to take place in Central Bank Money (real time gross settlement), with intra-day collateralisation,
- the settlement of equity securities to take place in central bank money (gross or net settlement).

Central bank money allows real time finality, which is of the utmost importance for transactions such as fixed-income instruments. Gross settlement requires intraday liquidity, whereas this is not the case for net settlement.

⁷ The exceptions in Europe are Clearstream Bank AG Frankfurt and SIS Intersectle in Zürich

CSDs also provide a diverse range of services.

Management of issuers' accounts

- Holding of specific accounts to deposit the issues, under various forms and laws (dematerialised, immobilised): we favour the book-entry of dematerialised securities
- Codification of new issues
- Management of shareholder information
- Management of corporate actions

Custody

- Asset segregation (by type of account, by sub-account),
- Automated corporate actions processing
- Management of issues: bearer, registered, occasionally registered

Wholesale transactions

- Grey, primary, secondary markets for all types of instruments. The placing of new issues on the same value date requires intra-day settlement finality and DVP cross border links.
- Bilateral transactions: buy/sale, free of payment, repurchase agreement, securities lending and borrowing, mutual fund subscription and redemption
- Placing of new issues

Retail transactions

- Mass transactions
- STP processing

Treasury operations

- Market transactions
- Operations with the National Central Bank
- Treasury transactions require excellent settlement rates and intra-day settlement finality
- Collateral optimisation and automated links with payment systems

Communication means

- standard communication facilities based on Swift 15022 formats, standard communication protocols and Internet access points,
- use of standard ISIN codes for securities (instead of domestic or internal codes) and of BIC codes (instead of internal codes) for counterparties.

b) Custodian Bank

A Custodian Bank is a for-profit organisation, which enables the holder of securities to have access to central securities depositories:

- either directly through the direct clearing and custody model,
- or indirectly through the global custody model.

Custodian Banks offer specialised services linked to the clearing, settlement and custody of securities (and associated cash), including banking and value-added products: the traditional and current scope of services offered by Custodian Banks is therefore different and broader than those provided by CSDs.

As banks, custodians provide credit lines and manage all the risks associated with their activity: legal, credit, liquidity, and operational risks. Hence, they need a quality balance sheet and rating, in order to attract and support clients and to develop their business.

The clients served include financial institutions and corporates, for instance:

- broker-dealers,
- investment firms / banks,
- global custodians,
- retail and private banks, e-brokers, e-banks,
- investment and pension funds (and asset managers),
- insurers and re-insurers,
- large corporates.

For all clients, an extensive credit review is performed and lines of credit are implemented in accordance with the services provided. Custodian Banks offer settlement in commercial bank money. As users of CSDs they have access to central bank money, but services to their customers are only provided in commercial bank money. We do not see how a Custodian Bank, in other words a commercial institution, could offer settlement in central bank money.

It is also worth noting that as a Custodian Bank, BNP Paribas Securities Services is liable to its customers for the assets safe-kept on their behalf. According to general French law, BNP Paribas Securities Services is normally under an absolute obligation to segregate its clients' assets and to return the assets to the owner.

Custodian Banks provide a diverse range of value-added services, which complement the CSD services.

- clearing / settlement (cash and securities),
- custody services (including tax reclaim),
- cash and securities financing management, such as tri-partite collateral services
- collateral services,
- depository bank,
- other fund and value-added services like electronic reporting,
- issuer services (e.g.: holding of registrar, financial services, corporate trust, trustee),
- insourcing of middle and back-office related functions.

This generic definition of a Custodian Bank applies to the various entities listed in the CPSS/IOSCO report (custodians, global custodians, international central securities depositories, local agents) which perform similar operational functions but adopt different marketing positions in terms of target clients, scope of instruments, geographical presence, range of services and organisation model.

c) Recommendation

In summary, we recommend to regulate on the basis of the CSD and Custodian Bank definitions indicated here above.

We also recommend strictly segregating the two roles and not allowing a party to combine both roles. BNP Paribas Securities Services believes that a given institution cannot play a “public” utility role and, at the same time, a banking private role. This justifies in itself a difference in legal status and supervision between Custodian Banks and CSDs.

d) Securities Settlement Systems (SSS)

Having defined the CSD and Custodian bank roles, it is worth noting that they operate SSSs, under their respective non-banking and banking statutes, which are relevant to such operation. **The term SSS itself describes a range of services, as such it does not define a legal status.**

In agreement with the line of the CPSS-IOSCO recommendations, BNP Paribas Securities Services considers that SSSs include the “full set of institutional arrangements for confirmation, clearance and settlement of securities trades and safekeeping of securities”.

As indicated above, Custodian Banks are de facto part of the Euro SSS infrastructure: there should therefore be a definition of SSSs, that would consider custodians as part of it and not only users.

It also seems essential that a common set of rules apply to SSSs, which involve an initial assessment and a periodic compliance review performed by an independent supervisory body.

Stating the CMF (General Regulations, Title VI, Custody and Account-Keeping of Financial Instruments, dated 18 January 1999):

“The CMF shall verify that the rules submitted to it comply with the provisions of these General Regulations governing payment and settlement systems for financial instruments. The operator of a payment and settlement system appoints a supervisor responsible for ensuring compliance with the operating rules approved by the CMF.

The operator of a payment and settlement system for financial instruments shall engage in no other activity that may create a conflict of interest with the operation of the said system.

A payment and settlement system for financial instruments must have appropriate risk management procedures to safeguard the rights of system participants in the event of a default on delivery or payment by one or more participants.

The operating rules of a payment and settlement system for financial instruments shall establish the conditions, including the time, under which an instruction in the system is considered to be irrevocable.”

e) International Central Securities Depository (ICSD)

Historically, ICSDs are not CSDs, hence the definition given by CPSS/IOSCO⁸ is misleading.

CPSS/IOSCO indicates that “ICSDs are CSDs”: in effect, they are Custodian Banks, “that settle trades in international securities and in various domestic securities, usually through direct or indirect links to local CSDs”.

ICSDs are intermediaries with a banking status

ICSDs were created initially to service the then emerging “eurobond” markets (homeless international issues, not to be confused with bonds issued in Euro). As they did not and still do not have a CSD status, they use the services of common depositories (commercial banks) to safe-keep the global notes.

Euroclear was created in 1968 as the securities division of the Belgian branch of Morgan Guaranty Trust Company of New-York to operate as a for-profit unit. When Cedel was created in 1971, as a for-profit company, Morgan Guaranty Trust Company of New-York sold the system to its users and Euroclear (the newly created company) became a for-profit utility competing with Cedel banking services, and nevertheless remained with JP Morgan until the end of 2000.

Both Euroclear and Cedel offered from their creation to today a true DVP service, requiring them to operate as banks, to allow the opening and use of cash accounts. As Euroclear continued to be operated (“Operator contract”) by JP Morgan, the cash accounts were left with JP Morgan. Cedel did not rely on a “settlement bank” and therefore opened and operated cash accounts on its books, as a bank but without a banking status (from 1980 to 1995).

In 1995, Cedel became Cedel Bank and created a first exception in Europe. In 2001, when Euroclear became Euroclear Bank, as a result of the termination of the operating agreement between JP Morgan and Euroclear, the second exception of a banking organisation was created.

ICSDs are intermediaries, who were established to provide payment finality in commercial bank money for the then homeless and largely physical “eurobond” market. They operate as a perfect duopoly and have proven their efficiency in automating the distribution of international “eurobond” issues. The model is based on the internalisation of trades on the ICSD books, by processing book-entries transfers between clients’ accounts. It proves efficient when a vast majority of transactions (the figure 75% was quoted by the LSE) are internalised, by opposition to delivering securities cross-border to CSDs.

⁸ CPSS/IOSCO Recommendations for Securities Settlement Systems issued in November 2001

ICSDs market share in EU cross border trades

It is totally wrong to assume that most EU cross-border transactions are settled by ICSDs. Over 50 Custodian Banks are active in the different European markets, serving local and/or international clients.

- Evolution of the “eurobond” market

At first, the ICSDs exclusively served the “eurobond” markets, in a perfect duopoly structure (a physical bridge at first, an electronic bridge thereafter eventually ensured an effective delivery versus payment mechanism between both ICSDs).

In a second step, the progressive harmonisation of domestic bonds with “eurobond” rules (issue, primary and secondary markets) shifted part of the “eurobond” business to the CSDs: for instance, in 1998 over 50% of the French Franc eurobond market was deposited with the French CSD.

A new step was taken in 1999, as the introduction of the Euro allowed the creation of a new domestic Euro-eurobond market, totally blended with traditional domestic issues. Indeed, the ICSDs’ model remains valid for the international “eurobond” market (non-Euro issues in USD, YEN, GBP and CHF for instance) which is a very active and valuable market.

- Domestic bond market

From servicing “eurobond”, ICSDs progressively expanded their services to domestic government bonds. This expansion was driven by commercial considerations and by the desire to attract new categories of securities, which their SSSs could process.

In fact, ICSDs gained some limited success on the domestic bonds: strong results were achieved on the German, Dutch, Portuguese, Danish and Irish government bond markets, but not so strong results were achieved on the other sovereign debt markets (for instance Italian, Spanish, Belgian, British and French).

- Equities market

Neither of the ICSDs has so far managed to play a significant role in the cross-border settlement of equity trades, which remain in the hand of Custodian Banks who act as general clearing members in the various markets and provide value-added services (including cash financing).

For instance, BNP Paribas Securities Services plays a major role in the field of equities: further to the purchase in 1995 of JP Morgan’s European clearing and custody network, BNP Paribas has become a leader in Europe. To illustrate, the total number of transactions settled by BNP Paribas Securities Services in 2001 (mainly equities) was equal to the total number of cross border transactions (mainly bonds) processed by both ICSDs.⁹

The reason for the ICSDs low penetration of the cross-border equity market derives from their centralised (global custody organisation) model, which proved inadequate to serve this market segment because of high processing costs and lack of market connectivity. Equities, unlike the homeless “eurobonds”, had a natural home in their respective home markets and remained served by a combination of CSDs and Custodian Banks providing direct custody services.

⁹ Source CEPS report December 2001

Merging ICSDs (Custodian Banks) with CSDs (utilities)

More recently both ICSDs started to acquire national CSDs, creating more confusion about the market infrastructure, their role and mission¹⁰.

Deriving from their historical role, ICSDs cannot be fully considered commercial organisations. A clear discrepancy exists between the mutualist role they ensure for some types of securities and the banking status they recently acquired.

This disorganised consolidation of the market place – largely driven by tactical considerations – leads to de facto monopolistic situations which do not suit the industry expectations in terms of level playing field. Granting credit is definitely a banking and a commercial function. The “blurring” of the borders between the Central Securities Depository function and other securities-related services such as lending and borrowing (of cash or securities) generates a risk for the market and leads to potential unfair competition between industry players.

Furthermore, the direct interlinking between ICSDs and CSDs as part of the Eurosystem foundation raises serious risk management concerns:

- systemic risk in case of the ICSD banks’ default,
- operational and settlement risks,
- credit risk exposure,
- intra-day and short term liquidity issues: intraday collateral optimisation, settlement in commercial bank money in the ICSD banks’ books, limited capacity (because of balance sheet and collateral stock constraints) to move the cash out through Target transfers,
- commercial banking liquidity cost: high spreads applied to cash debit balances.

Hence, we recommend that a clear distinction between the Custodian Bank and the Central Securities Depository function is preserved.

As a consequence, services provided by ICSDs must be split between the CSD function and the Custodian Bank role and the ICSDs must choose to retain either the CSD (non banking utility) or Custodian Bank (for profit) role, but not both.

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?

As stated above, we recommend that standards should apply on the basis of the legal status chosen by the parties: CSD or Custodian Bank.

¹⁰ Cedel Bank (ICSD) and Deutsche Börse Clearing (German CSD) merged in October 1999 to form the Clearstream Group; Euroclear Bank (ICSD) was incorporated in May 2000 and merged with Sicovam SA, CIK and Necigef (French, Belgian and Dutch CSDs) to form the Euroclear Group

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?

We consider that clearing (in the sense of being a member of a Central Counterparty), settlement and custody refer to 3 different ranges of services, which involve different capital requirements, risk management procedures and operational organisation.

A Custodian Bank may perform any of the three services, either separately or combined in a global offer. When Custodian Banks provide settlement and custody services, but no clearing facilities, we refer to their clients as “self clearing“ participants.

Do particular considerations apply where custody and safekeeping services are provided by credit institutions or investment services firms?

As stated previously, we recommend that custody and safekeeping activities are considered as core Custodian Bank activities subject to common European rules.

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?

When considering legal harmonisation, we agree that all securities instruments are covered, but this does not include derivatives. Derivatives are not securities, they are OTC contracts which are not covered by securities laws such as the payment finality directive. In addition, settlement and margin call procedures are specific to this type of instrument.

Considering securities, differentiation will be necessary according to the instrument, to reflect varying rules and market practices, in particular:

- Interest based instruments: private debt, negotiable debt instruments
- Sovereign debt
- Equities, warrants, ETF
- UCITS.

Should some standards/recommendations be specifically addressed to cross-border transactions? If so, which ones?

The legal harmonisation of securities finality, settlement finality, collateral and transfer of ownership rules will solve issues on cross-border transactions.

Please refer to section 1.1 Nature of the recommendations, where we detail the scope of legal instruments, which require a European harmonisation.

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?

BNP Paribas Securities Services confirms that risk mitigation, efficiency, creation of a level-playing field between service providers having the same legal status, and promotion of integration of the EU securities markets infrastructure are appropriate objectives.

When considering cross-border activities, we agree that efficiency is a valid objective, but we suggest that cost issues depend merely on the Custodian Bank's organisation model. We believe that cost reduction will be best served by market-led competition and progressive consolidation of market participants, rather than by regulatory intervention.

For clarification purpose, a cross-border trade is applicable to a trade executed by a broker-dealer on a "foreign" market.

Hence, prior to stating¹¹ that:

- transactions within the European economy that occur across Member States are far more complex, are hindered by a number of significant barriers and are much more costly than domestic transactions,
 - the additional cost that is associated with this fragmented infrastructure (19 CSDs and 2 ICSDs) represents a major limitation on the scope for cross-border securities trading in the Union,
- we should first wonder about which model of Custodian Bank is being discussed.

As indicated in section 1.2 of the present document (comments on Giovannini Group Report), a direct custody operation allows the Custodian Bank to process cross-border transactions with similar efficiency, processing flows, operational cost and indeed pricing, as domestic trades. Local connectivity allows the use of very cost-efficient and secure settlement procedures (for instance netting at the CCP and Central Bank Money settlement at the CSD). Hence, costs are not driven by the nature of the trade (cross-border or domestic), but by the volumes of transactions generated by the client.

This set-up is widely used in Europe: BNP Paribas Securities Services alone processed over 22 million cross-border trades in 2001 (which equals the total number of cross-border trades processed by both ICSDs), but also in the United States (e.g. JP Morgan Chase, BONY, BBH, Citibank services for brokers or foreign custodian banks).

On the reverse, for an ICSD, there is a significant difference between a cross-border trade and a domestic one, they are not processed the same way and hence the costs vary dramatically. According to the Giovannini Group report, the cost of a cross-border trade raises to 33 Euro per transaction, which compares with the internal settlement cost of 0.5 Euro announced by Euroclear Bank Brussels for equities. The reason for the ICSDs low penetration of the equity market derives from their centralised (global custody) model. This model adds to the costs by replicating the processing at the global custody level, it does not provide the same level of market connectivity and is not adequate to serve this market segment.

¹¹ Giovannini Group Report on the Cross-border clearing and settlement arrangements in the European Union, dated November 2001

Overall, Europe is very efficient and will become even more so as markets and regulations converge.

As stated in the JP Morgan – McKinsey report:

- the total cost of a wholesale cross-border trade is 1.3 times the domestic cost of wholesale,
- cross-border trade pricing is already under significant pressure in the EU owing to the introduction of the Euro and the growing centralisation of dealing desks at the largest institutional investors,
- clearing and settlement in Europe is already remarkably efficient,
- margins in Europe remain higher than in the United States owing to smaller overheads and back-office costs.

As a consequence, the influence of CCP or CSD consolidation is rather small and rather than “a ‘big bang’ DTCC of Europe”, the report recommends “a ‘Leaning Tower of Pisa’ outcome, i.e. vertical structures which gradually become more horizontal as regulations become more harmonised”.

In summary, we believe that the market consolidation will be driven by the creation of multi-market hubs at Exchange level, leading to the consolidation of CCPs, CSDs and Custodian Banks serving these hubs.

2.5. Access conditions

Are you aware of access conditions to specific service providers which could be considered discriminatory?

Within the EU, access is not an issue because we use a single currency and we have laid the appropriate legal framework (Investment Services Directive, Payment Finality Directive), allowing both direct and remote accesses to market infrastructures.

BNP Paribas Securities Services has experienced no difficulty in gaining access to Central Counterparty (clearing) or CSD (settlement and custody) systems.

- In most cases, we use a direct presence through a branch or a subsidiary.
- In certain cases, we have established remote links operated out of Paris to access non local CSDs (Portugal, Netherlands and Belgium).

Each membership requires:

- submitting an application file,
- complying with a rule of conduct guide,
- in most cases testing and validating the technical infrastructures (systems and interfaces).

The objective is to ensure that:

- the applying member has the professional standing required,
- its systems do interlink correctly with the CCP or CSD systems, to avoid the risk of disrupting the whole infrastructure upon their live connection.

Finally, some Central Counterparties (EUREX in particular) express capital adequacy requirements, which are valid but restrain access to members beyond a certain financial size.

If so, where do the main problems lie?

In fact, the main issue is technical: connecting to a CCP or CSD system involves developing ad hoc interfaces, which form the major access barrier, given the size of the investment required (up front and in further maintenance), and the critical transaction mass required to make it worth.

Each CCP or CSD system has developed over time, on the basis of domestic legal frameworks and market practices. The fact that the fiscal and legal framework for the transfer of ownership, and even the form and legal rights attached to the ownership of securities, do still largely differ within the European Union, does not make the access to CCPs and CSDs any easier.

Problems derive mostly from the history of European markets: stock exchange markets traditionally “belonged” to stock brokers and were based on physical floor exchanges ; CSDs were established mostly to serve the banks (credit institutions) and were generally placed under public governance and supervision. In both cases, these institutions were domestic – in some cases even regional within one country – and often specialised by instrument types (in Germany, UK, France, Spain and Italy for instance).

In the late 80's, major deregulation moves allowed banks to gain access to stock exchanges, at national level in the first place ; in a second step, both banks and National Central Banks urged to improve the quality of market infrastructures: efficient and integrated systems were built, still at national level (in France, SBF and SICOVAM implemented RELIT in 1991 and RGV in 1998). As a result, regulation and supervision were organised at national level and technical investments concentrated on national infrastructures.

One important step was taken in 1993, as the Investment Services Directive introduced the European passport which granted access to all European markets, ended national monopolies and permitted the development of EU-wide competition amongst market players.

The switchover of financial markets to the Euro in 1999 was a further important step towards the development of a European market: all financial businesses including rating, listing, trading, investment, distribution, custody and treasury activities were impacted by the switchover.

Until now, Exchange, CCP and CSD infrastructures have remained largely domestic: the first example of a pan-European merger was the creation in 2000 of the EURONEXT Exchange, matched by the incorporation of CLEARNET as CCP.

Over time, legal and regulatory frameworks will converge and ease the access to Exchange, CCP and CSD infrastructures via a progressive drop of national rules and standardisation of technical and communication formats. Yet, we believe that efficient models will emerge and expected consolidation of technical infrastructures will take place mainly at the condition that we preserve competition and a level-playing field between the various market players.

In summary, market forces should drive the consolidation process, within a prescribed regulatory framework which prevents abuse in the case of monopoly situations.

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?

The recent consolidation of ICSDs with CSDs¹² has created a new situation, whereby the same company operates both a Custodian Bank (providing value added services such as cash and securities financing, securities borrowing and lending, custody services) and a CSD utility business, creating conflicts of interest.

This disorganised consolidation of the market place – largely driven by tactical considerations – leads to de facto monopolistic situations which do not suit the industry's expectations in terms of level playing field. The main issue lies in the fact that, being the owners of CSDs, ICSDs drive the abolition of the CSDs by totally integrating them within their structure.

Granting credit is clearly a banking and a commercial function. The “blurring” of the borders between the Central Securities Depository function and other securities-related services:

- generates a risk for the market,
- leads to potential unfair competition between industry players,
- gives way to future abuse by forcing the flows towards the ICSD banking platform, in order to gain critical mass.

To illustrate, Euroclear proposal for a Euronext settlement model¹³ aims at processing all blue chips on the Custodian Bank platform Next, based in Brussels. By ending the cross border links currently available to CSD members (Euroclear France, CIK and Necigef)¹⁴, these members are forced to opening an account with the custodian Euroclear Bank Brussels, which could result in:

- raising their custody, collateral and treasury fees,
- degrading the processing of cross border transactions¹⁵, which is particularly sensitive for arbitrage trades on multi-listed equities,
- distorted competition between Custodian Banks members of the CSDs and the ICSD bank itself.

To prevent such abuse, we recommend that a clear distinction between the Custodian Bank and the Central Securities Depository function is preserved and services provided by ICSDs must be split between the CSD function and the custodian role.

In summary, ICSDs must choose to retain either the CSD (non banking utility) or Custodian Bank (for profit) role, but not both.

¹² Cedel Bank (ICSD) and Deutsche Börse Clearing (German CSD) merged in October 1999 to form the Clearstream Group; Euroclear Bank (ICSD) was incorporated in May 2000 and merged with Sicovam SA, CIK and Necigef (French, Belgian and Dutch CSDs) to form the Euroclear Group

¹³ Euroclear client communication on Euronext Single Order Book – January / February 2002

¹⁴ Euroclear France Instruction n°196, dated 18 September 2001

¹⁵ A recent example for an equity listed in 7 countries and not deposited with a CSD (common depository set-up) indicates a shift in cross border deliveries from T+0 to T+1 (Spain) and T+2 (Belgium) for a Euroclear France participant.

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 suggested in this document (ref. Section 2.1 Scope of recommendations), we believe that the legal and tax harmonisation within the EU will solve the current 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?

National regulatory requirements can lead to different organisations of accounts in Europe:

- use of a single omnibus account opened in the name of the Custodian Bank at the CSD,
- segregation of proprietary and clients' accounts (Portugal and France for instance),
- opening of one account per customer at the CSD level (Greece, Spain, Denmark in particular).

In our view, a minimum standard should be the segregation of proprietary and customers' accounts in separate books opened by the Custodian Bank at the CSD. In addition, the Custodian Bank must maintain segregated client accounts within its own books and reconcile the total of these accounts with the accounts held at the CSD.

The following CMF rules (Extracts - General Regulations, Title VI, Custody and Account-Keeping of Financial Instruments, dated 18 January 1999) could be taken as reference:

"The custody account-keeper shall ensure the safekeeping and administration of the financial instruments entrusted to it.

The custody account-keeper has an obligation to return any financial instruments entrusted to it.

The custody account-keeper shall describe the organization of its accounting in an appropriate document.

For the purpose of ascertaining and monitoring the rights of account holders, financial-instrument accounts shall be kept according to the rules of double-entry book-keeping.

The terminology of these accounts and the operating rules applicable to them shall be determined by a decision of the CMF. For purposes of control, this terminology shall classify financial instruments belonging to UCITS, to other clients and to the custody-account-keeper itself into distinct categories."

In all cases, the contractual relationship with the client lies at the Custodian Bank level. To secure this relationship, the regulator may request (e.g. in France) the signing of an account holding convention stipulating the respective rights and duties of the parties.

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?

We agree but would suggest first that a clear distinction is made between Central Bank Money and commercial bank money.

BNP Paribas Securities Services acts as DVP agent in its books through its links to both local CSDs and National Central Banks, but only provides DVP in markets where the market infrastructure makes a linkage between the CSD and the National Central Bank possible. As a Custodian Bank, BNP Paribas Securities Services offers intraday finality in commercial bank money for settlement activities when the two counterparties to a transaction have accounts in our books.

Intraday settlement finality can only be provided by Central Securities Depositories since they have direct access to central bank money. This access allows more secured settlements and offers real time finality which is of the utmost importance for transactions such as fixed-income instruments. In addition, gross settlement requires intraday liquidity whereas this is not the case for net settlement.

As a user of CSDs, we have a strong preference for:

- the settlement of debt (government bonds) instruments to take place in central bank money (intra day settlement finality through real time gross settlement), with intra-day liquidity through the collateralisation of transaction flows,
- the settlement of equity securities to take place in central bank money (with settlement finality on a net settlement basis).

What specific impact could these issues have on clearing and settlement of cross-border transactions?

They would ease the cross border transfer of securities, as cross border deliveries should only take place on the basis that the final settlement of securities has taken place in the delivering CSD books. In addition, we recommend that cross-border transfers of securities take place between CSDs, on the basis of cross-border links duly validated by the regulators. Such rules currently exist for securities used as collateral in the Eurosystem monetary policy operations.

Finally, as far as operational risks are concerned, what are the main factors to be considered?

Controlling operational risks involves implementing the highest security and availability in terms of operation, systems and networks. This includes various measures like a back-up site and physical protections. All market participants are concerned, including Exchanges, CCPs, CSDs and Custodian Banks.

At CSD level, all measures must be taken to ensure the highest performance in transaction matching and settlement. At Custodian Bank level, the level of performance on services delivered to customers should be agreed in the contracts signed with the clientele.

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?

Harmonising the settlement cycles is a valid objective for regulated markets, but should be governed by market participants. Today, regulated markets in Europe operate with a T+3 rolling settlement cycle, with the exception of Germany, where the Xetra settlement cycle is T+2.

Reducing the settlement cycle to T+2 or T+1 for regulated market across the EU may prove very demanding:

- the United States are still committed to reaching a T+1 deadline, although they realise that it will bring little benefit; besides straight through processing,
- a T+2 settlement cycle will be difficult to achieve in markets, such as Spain, where the exchange of trade details is connected to the exchange of registration details. Hence, a first step towards harmonising settlement cycles would consist in harmonising the processing of registration details and disconnecting it from the exchange of trade details.

Over the counter markets (OTC) are not concerned, as the settlement deadline is agreed between both participants on a bilateral basis and forms part of the matching criteria. It is adjusted for each transaction and may vary a great deal, for instance:

- financing transactions need very short settlement deadlines, repurchase agreements or commercial paper issue and distribution trades are mostly processed on T+0 or T+1,
- grey market transactions are processed with a longer settlement deadline (T+7 or more),
- UCITS purchases and redemptions are generally processed on T+1 or T+2,
- deliveries of on-exchange transactions tend to be settled on T+3, to match the market settlement cycle,
- monetary policy operations have specific deadlines and cycles which differ according to the transaction (tenders, bilateral repurchase agreements, overnight repurchase agreements...).

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?

Consolidation is expected and necessary for an increased efficiency of European financial markets.

Yet, when consolidation is discussed, the sound functioning of a pan-European securities market is at stake, which raises the question of the principles governing clearing and settlement across Europe. As stated by the CEPS report, securities settlement systems form the backbone of the financial market infrastructure. Hence, the evolution of the industry should be carefully considered, by taking into account its potential impacts in terms of investors' protection, systemic risk and efficiency.

Therefore:

- (i) Public policy should ensure that this consolidation does not lead to any form of monopoly on the commercial activity,
- (ii) Public intervention is necessary concerning the governance and supervision of monopolistic utility activities.

Consolidation process

CCPs

Clearing services are mainly provided at national level in Europe (e.g. Clearnet in France and LCH in the UK) and still lack in a number of countries (Greece, Spain, Germany). The existing infrastructures have just started to develop pan-European clearing services (for instance Clearnet to serve the Euronext market) ; hence, the European challenge is not so much about consolidating the existing infrastructures, but more about developing the use of CCPs.

Creating a single European CCP remains a very theoretical objective, as the domestic markets are structured vertically (Exchange, CCP (when it exists), settlement and custody). Currently, Exchanges search an optimum valorisation of their technological investments by placing on the market their vertical silos (IPOs of Deutsche Börse, Euronext, and soon Spain, Italy and Greece).

This is a significant barrier to the creation of a single European CCP. In the light of this recent market evolution, we expect that at least 3 major vertical silos will remain in Europe (Euronext, Germany and Scandinavia), and potentially 4 if the UK infrastructure remains separate.

CSDs

The main advantage of a single organisation will be the consolidation of the settlement (SSS) process providing a single entry-point and standardised processes. From a client's point of view, this is already the case when Custodian Banks act as global custodians.

In addition, this would raise a huge competition problem if this consolidation was managed by a single entity benefiting from a banking licence.

Also, the emergence of a single CSD will require the harmonisation of both the European tax and legal frameworks. In effect, equities and UCITS are subject to regulatory, fiscal and legal constraints (company law, securities finality law, bankruptcy law, ...) which are specific to each country. Unless European harmonisation is implemented, the consolidation of settlement systems (to implement a centralised model) will either remain a utopia, or have legal impacts on the underlying securities.

The fact that the ICSD Euroclear Bank Brussels acquired the French, Dutch and Belgian CSDs (Sicovam, Necigef and CIK) will not change this situation. The technological and operational consolidation which was the objective of the merger (the objective stated was to save 300 million euros to European banks) can take place only on the basis of legal, fiscal and regulatory harmonisation of the countries involved.

The consolidation of both ICSDs - Euroclear and Cedel - was actually requested by the Securities Industry User Group in 1999. Cedel merged with Deutsche Börse Clearing, as it did not believe it had a viable future as an independent entity and felt this was a better option than merging with Euroclear. In particular, it allowed the further development of Cedel systems to launch the Creation platform. As a response and to keep up with the newly created Clearstream, Euroclear decided to start purchasing CSDs, who did not either believe they had a viable future as independent entities, namely Sicovam, CIK and Necigef. Further to Deutsche Börse's IPO and its purchase of Clearstream, the prospect of a consolidation between Euroclear and Clearstream now seems to have vanished for a long time.

Long and medium term prospective

In general terms, we believe that Europe will progressively converge towards "a *'Leaning Tower of Pisa'* outcome, i.e. vertical structures which gradually become more horizontal as regulations become more harmonised" *ope*", as indicated in the JP Morgan – McKinsey report ".

A "big bang DTCC of Europe" would be difficult to achieve, as even in the States 30 years of progressive convergence, have lead to a number of players acting at each horizontal level: trading platforms (Exchanges, ECNs and ATSS), CCPs (GSCC,.....), Custodian Banks (JP Morgan Chase, BONY, BBH, Citibank, State Street Bank Boston, Mellon Trust, Northern Trust, IBT) and CSDs (DTC and Federal Reserve).

The "One-all" objective (one European Exchange, one European CCP, one Custodian Bank, one European CSD) is not a reality in the United States today and will be an even longer term objective in Europe.

Therefore, in the medium term, we expect that:

- the regional consolidation of Stock Exchanges will drive the market consolidation process;
- we will see the emergence of Central Counterparties (playing a growing European role and either focusing on certain instrument types or combining them all) which will allow higher efficiency, lower cost and lower risks in the clearing process ;
- securities and cash settlement will be offered by different Regional Custodian Banks, including the ICSDs, operating in a level-playing field (in commercial bank money) ;
- finality of settlement and guarantee for the safekeeping of assets will remain the "raison d'être" of CSDs ; in that respect, we should promote the best model (such as the US and French systems) which consist of DVP final settlement of securities within a mutualist CSD (such as DTC), with a

cash settlement leg under close supervision by the Central Bank in order to ensure liquidity and prevent systemic risks ;

- cash settlement for government bonds in a system operated and managed by the Eurosystem would be an option to study (such as the Federal Reserve system).

Governance

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?

We believe that public intervention is necessary concerning the governance and supervision of monopolistic utility activities.

CSDs

Historically, these institutions are “utilities”, owned and governed by users or members and are not for profit operators. We believe that they should remain “utilities”, given their role of final registrar of financial assets in a given jurisdiction, which by essence is monopolistic.

CSDs should be regulated and controlled by an independant supervisory body and should benefit from a special and a non-banking status.

The appropriate legal framework for CSDs is the following:

- Public Utilities, not for profit, owned and governed by users or members
- Non-Banking status
- Regulated and controlled by an independant supervisory body
- Core services
- Settlement of all transactions in central bank money, either on a gross or net basis (depending on the instruments traded or the users' choice) to avoid credit and liquidity risk.
- + encouragement à tout metre dans CSD (UCITS, CP)

Custodian Banks

They should remain under banking supervision and their governance lies in the hand of their shareholders. They operate in a very competitive market and, as commercial organisations, they are client-driven and client-focused.

The appropriate legal framework for Custodian Banks is the following:

- Commercial banks (they may be specialised or limited purpose banks)
- For-profit companies, providing banking services & taking on board risk
- Governed by their shareholders and supervised by their respective banking authority
- Commercial bank money settlement provided to their clients, both on a gross and end-of-day basis
- Members of the CSDs.

ICSDs

The governance of both ICSDs has evolved recently: Clearstream advocates for a clear vertical integration model (shareholder governance) ; Euroclear advocates for a mutualist – horizontal model whilst combining both types of governance (shareholder governance at the CSD level and user governance at the bank level). In effect, both Clearstream and Euroclear develop similar vertical models, more or less fat at the horizontal level.

Without insisting on the high level of risks (credit, liquidity and operational risks) concentrated with both organisations, the ICSDs' monopolistic positioning on their respective markets (German Stock Exchange for Clearstream, Euronext Exchange for Euroclear) is particularly damageable as it is combined with a Custodian Bank role.

This monopolistic positioning requires a clear definition of the ICSDs' role and governance. Either they keep benefiting from a banking licence and retain a Custodian Bank role in a free competition environment (level playing field, shareholders' governance) ; or they seek to consolidate their « notary » role in Europe (to converge towards a European CSD, user governance) by retaining a CSD role, without a banking licence.

APPENDIX 1

Recommendation for a clear segregation
between CSD (non banking)
and custodian (banking) activities

prepared by European Custodian Banks

April 2002

This memorandum results from the work of the major European Custodian Banks, jointly expressing a recommendation for a clear legal framework and segregation between CSD activities and Custodian Bank roles, in order to support the development of the Eurosystem¹⁶.

A strong interconnection between cash and securities systems

As capital markets develop and securities are increasingly used as collateral, Securities Settlement Systems (SSS) have become a core element to ensure the stability of the Eurosystem.

- Multilateral securities settlement systems generate increasing outflows of cash positions (credit or debit) to the accounts held at the National Central Banks (NCB), which guarantee a transaction's finality in Central Bank Money. Given the amounts at stake, these outflows need to be closely monitored by both the NCBs and the banks' treasurers, in order to abide by the TARGET daily calendar.
- Securities have become a major collateral tool used in:
 - monetary policy operations
 - intraday liquidity provision for payment systems (both gross or net systems)
 - Clearing Houses' deposits
 - interbank financing operations (repurchase agreements, tri-party repos).

In the future, this situation is likely to develop even further, as EU member states gradually endorse real-time gross settlement systems (RTGS) and cross-border transaction volumes increase. As a consequence, the stability and smooth functioning of securities settlement systems are key to the stability of the Eurozone and securities settlement systems need a clear legal framework.

¹⁶ *Eurosystem* is the word chosen by the ECB to indicate the "ECB+11 participating national central banks", i.e. the central bank of the euro. It indicates the articulated entity which is for the euro what the Federal Reserve System is for the dollar.

Learning from the existing European Union infrastructures

Analysing the current infrastructures of the EU countries (e.g.: Crest, Iberclear, Montetitol, Euroclear France, Necigef, CIK), we have identified two widely shared principles which could form the basis of a standard European framework:

- **CSD:** Central Securities Depository, its missions are essential to the stability of the financial system.

The CSD maintains the register and the issuer's accounting balance, and ensures the final book-keeping of securities in the appropriate jurisdictions. CSDs perform core SSS functions: processing of core securities transactions, related cash movements and custody services, at a low-cost, for various types of financial institutions (retail or wholesale, domestic or remote).

The appropriate legal framework for CSDs is the following:

- Public Utilities, not for profit, owned and governed by users or members
- Non-Banking status
- Regulated and controlled by an independent supervisory body
- Core services
- Settlement of all transactions in central bank money, either on a gross or net basis (depending on the instruments traded or the users' choice) to avoid credit and liquidity risk.

- **Custodian Banks** (agent banks, global custodians and international settlement banks (ICSDs)) specialise in the provision of value-added services to both internal and external clients.

They operate in a competitive market and target various ranges of services, financial products and clients. These clients may be located outside the Eurozone; USA and Asia in particular. Often, clients are located inside the Eurozone, as their value creation model involves outsourcing the back-office functions. Custodian Banks perform value-added SSS functions: clearing, settlement, custody, cash and securities financing. Some have an SSS status, but all grant credit lines, manage credit and liquidity risks and require quality balance sheets and ratings to develop their business

The appropriate legal framework for Custodian Banks is the following:

- Commercial banks (they may be specialised or limited purpose banks)
- For-profit companies, providing banking services & taking on board risk
- Governed by their shareholders and supervised by their respective banking authority
- Commercial bank money settlement provided to their clients, both on a gross and end-of-day basis
- Members of the CSD(s): their overnight positions are posted in Central Bank Money.

In summary, the role of CSD (final registrar of securities assets, core SSS services) must be clearly separated from the role of banker (value-added clearing, settlement and custody services).

New risks deriving from the consolidation between ICSDs and CSDs

Consolidation of a fragmented European securities infrastructure is inevitable and Euro-wide competition will lead to the emergence of new regional hubs. Yet, the sound structural basis set-up by the European Central Bank in the creation of the Eurozone (RTGS systems, central bank money) may be swept away through the unmonitored evolution of securities infrastructures.

The ICSDs were established in the 1970's to process the homeless international «eurobond» market. They have proven their efficiency in automating the distribution of these issues. Since the introduction of the euro, a new domestic bond market has emerged, blending euro-»eurobond» with the traditional domestic bonds deposited with the CSDs. Indeed the international bond market itself (non-euro issues in USD, YEN, GBP, CHF for instance) has not disappeared and remains very active and valuable.

The ICSDs are banks¹⁷, in effect Custodian Banks that "settle trades in international securities and in various domestic securities, usually through direct or indirect links to local CSDs"¹⁸.

They are not CSDs, as misleadingly stated by CPSS/IOSCO. Yet, their recent consolidation with CSDs¹⁹ has led to the emergence of a new breed which:

- benefits from a banking licence and offers value added services: cash and securities financing, securities borrowing and lending, custody services, on the same model as Custodian Banks,
- owns the CSDs and operates SSS infrastructures both as CSDs and Custodian Banks,
- combines utilities with banking activities, creating conflicts of interests.

This disorganised consolidation of the market place – largely driven by tactical considerations – leads to de facto monopolistic situations which do not suit the industry's expectations in terms of level playing field.

Furthermore, it raises serious risk management concerns:

- systemic risk in case of the ICSD banks' default,
- credit risk exposure,
- intra-day and short term liquidity issues: intraday collateral optimisation, creation of commercial bank money trapped in the ICSD banks' books, limited capacity (balance sheet and stock of collateral) to move the cash out through Target transfers,
- commercial banking liquidity cost: high spreads applied to cash debit balances.

Today, the ICSDs combine both CSD and Custodian Bank roles, they operate SSS infrastructures under both roles: these roles must be clearly separated and the ICSDs must choose to retain either the CSD or Custodian Bank status, but not both.

Our recommendation for 2 strictly segregated functional levels

1) We recommend the identification of 2 strictly segregated functional levels:

-Non banking CSD functional level

- Registrar role
- Utility providing core services
- Settlement in Central Bank money
- Supervised by a specific authority and controlled by the EuroSystem to preserve the links between the cash and securities systems

-Custodian Bank functional level

- Banking licence
- Value added services, competitive business
- Settlement in Commercial Bank Money
- Supervised by the respective banking authority

2) We also recommend that **these activities are not combined under the umbrella of a holding company**. In our mind, a holding company is not sufficient to ensure an adequate segregation of risks and does not prevent conflicts of interest. As a consequence, it does not guarantee their resolution in favour of the members' interest.

3) Finally, we recommend:

- the harmonisation of legal environments in the Eurozone (including CSD and SSS status, securities finality)
- the transposition of the European Directives (e.g.: settlement finality, remote access)
- the establishment of a sound level playing field, driving cost reductions through competition and market consolidation.

¹⁷ Clearstream Bank Luxembourg and Euroclear Bank Brussels

¹⁸ CPSS/IOSCO "Recommendations for Securities Settlement Systems" issued in November 2001

¹⁹ Cedel Bank (ICSD) and Deutsche Börse Clearing (German CSD) merged in October 1999 to form the Clearstream Group; Euroclear Bank (ICSD) was incorporated in May 2000 and merged with Sicovam SA, CIK and Necigef (French, Belgian and Dutch CSDs) to form the Euroclear Group