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Mr. Elias Karzarian
European Central Bank
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Mr. Christoph Crüwell
Committee of European Securities Regulators
Secretariat@europefesco.org

Dear Mr. Karzarian and Mr. Crüwell:

Re: Contribution to the Joint Work of the European System of Central Banks and the Committee of European Securities Regulators in the Field of Clearing and Settlement

Citibank welcomes and appreciates the call by the European System of Central Banks and the Committee of European Securities Regulators ("the Group") for contributions to their work on clearing and settlement.

Citibank provides securities clearing, settlement and custody services in 50 markets worldwide, including all markets in the European Union. We welcome the opportunity to work with government and regulatory authorities to improve efficiency and reduce risks in clearing and settlement. During the past twelve months, Citibank shared its experience and provided comments on settlement and clearing issues to other public bodies, including:

- European Commission, Giovannini Group - Questionnaire on Cross-Border Clearing and Settlement in the European Union
- CPSS-IOSCO - Recommendations for Securities Settlement Systems
- European Commission, Directorate General for Competition - Request for Information (relating to certain Clearing and Settlement issues in respect of CSDs)
- Group of Thirty – Clearing and Settlement Project

In addition, Citibank is an active member of major industry bodies such as the International Securities Services Association and the European Securities Forum.

Citibank would like to share its experience with the Group, as well as comment on our major concerns on issues related to our role as provider of settlement and custody services. In the following sections, we address in detail the issues specifically highlighted by the Group, in the order in which they appear in the call for contribution dated 15 March 2002.

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?

- Citibank, through its experience in being a securities services provider in all the securities markets in the European Union, recognizes that it is extremely difficult to reach unanimous conclusion on the harmonization of laws and rules across jurisdictions. Citibank does, however, consider that "best practices" can (and should) be established, preferably by a task force in consultation with interested parties. These best practices would be useful as formal guidance in establishing the basis for common (or at least complimentary) legislation and rules for settlement processes.

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?

- "Best practices", should naturally be addressed to all constituent parts of the clearing, settlement and custody community. A European Central Bank / Committee of European Securities Regulators certification for compliance with best practices should be considered as an incentive for systems, operators and service providers.
- Regulators should be made aware of the practical complexities of cross border clearing, settlement and custody and should look to those best practices as a practitioner's guide to the market.
- It is also important for the market to understand that CSDs and particularly ICSDs have developed into commercial undertakings with a profit-oriented business approach like any other commercial service provider. Accordingly, best practices should apply equally.

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?

- The Group's work should be associated with services, rather than with the type of service provider. The financial and securities services industry has undergone tremendous change in the last few years with mergers, alliances, and extension of services beyond traditional roles. The distinction between types of providers is blurring. Particularly subject to misinterpretation is the term "ICSD". An ICSD can be (a) a central depository, e.g. Euroclear Bank for Eurobonds, Euroclear France for French equities and (b) a settlement agent and custodian just like Citibank, providing settlement and safekeeping services for securities and markets where it is not the primary depository, e.g. Euroclear Bank settling Italian

securities. A distinction needs to be made between the services provided by the designated central depository of a market, and services provided which are identical to those of settlement agents to facilitate cross-border settlement. It is important for the Group to recognize that there is overlap in the services provided by clearing, settlement and custody agents and ICSDs, and for the Group to ensure that its recommendations support the conditions necessary for a level playing field.

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?

- There will probably be some standards that cannot be equally applied to all parties. Besides the scope of business, these entities also differ in regulatory regime. Central securities depositories, ICSDs, custodians and registrars may have different privileges or restrictions under their respective market rules and regulations, affecting their ability to comply with certain standards.

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?

- We view custody and safekeeping as the same service. In this document, we define custody/safekeeping services as an obligation to ensure the depositor, within the limits set by market practice and regulations, that his title to the securities is protected, that his access to the securities for sale or delivery is efficient, his rights to income and benefits duly advised and collected, his decisions on discretionary corporate actions duly executed, and that his receipt of information on his securities holdings and movements is timely, relevant and comprehensive.

  Some of the service elements described above are not normally provided by central depositories but are value-added services provided by service firms such as Citibank, which also provide customized solutions to fit the needs of individual clients or client segments.

- However, we view clearing and settlement as two distinct services.
  - We adopt the Bank for International Settlements' definition of clearing, which is, "*the process of transmitting, reconciling and, in some cases, confirming payment orders or security transfer instructions prior to settlement, possibly including the netting of instructions and the establishment of final positions for settlement. Sometimes the term is used (imprecisely) to include settlement*".
  - Settlement is the process of exchange of securities and payment.

- A third function, risk management, exists in some markets to protect the exposure of trading members from each other's default. This is most often achieved via the use of guarantee funds, collateral and/or a central counterparty.
- We believe that the Group should separate the accounting of obligations, the exchange of assets, and the management of risk as distinct functions in order to more clearly identify the standards that should apply to each function. These functions could conceivably be undertaken by three different entities, provided they communicate to each other the essential information in a timely manner.
- It would be difficult to segregate custody/safekeeping of the assets and the provision of settlement services as settlement involves receipt or delivery of assets.
- Along with settlement and custody services, settlement agents usually provide liquidity in the form of credit extension to clients, and risk minimization services, e.g. more stringent control over the exchange of assets than is possible through the standard procedures of the market infrastructures.
- The providers of settlement and custody/safekeeping services must be financially solid, have the appropriate technology, controls, and experience, and be adequately regulated in order to ensure the protection of depositors and ultimately investors.

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?

- Custody/safekeeping service requirements can differ by type of security, involving varying degrees of complexity in operations and risk control to protect the interest of the investors during the period of holding. Distinctions could be made regarding attributes that have material effect on service requirements and complexity, such as but not limited to:
    - Registered versus bearer securities
    - Physical versus dematerialized forms
    - Listed and publicly traded versus non-listed issues
    - Interest-bearing versus non-interest bearing debt obligations
    - Fixed versus variable versus indefinite duration
    - Choice, frequency and timing of action by issuer versus by investor

  Derivatives, furthermore, encompass many different instruments as diverse as financial futures contracts and warrants, and involve a very

high rate of innovation. As a consequence, we believe that although best practices would be helpful in defining broad standards, the actual standard of care to be exercised in the custody/safekeeping of a portfolio is best covered by commercial contract which has the required flexibility to accommodate business needs and the speed of innovation.

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

- Cross-border transactions involve elements absent in domestic transactions and standards / recommendations should be drawn up to address those specific elements. We believe the ones to be given priority are finality and open access of qualified intermediary service providers (such as settlement agents) to infrastructures (such as exchanges and clearing houses).
- Public bodies such as the Bank for International Settlements[1] and the Federal Reserve Bank[2] have conducted some extensive analysis on issues and risks specific to cross-border securities settlements. The Group may wish to review these studies and possibly use them to assist in establishing the scope and priority of standards and recommendations to be addressed. The Group of Thirty and International Securities Services Association also have an on-going clearing and settlement projects which also have recommendations for cross-border transactions.

2.4. Objectives: A priori, the objectives of central banks and securities regulators in the field of securities clearing and settlement systems could be summarized 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?

- We agree with the first two objectives and as mentioned previously, we are fully in support of achieving the third objective, a level playing field and the fostering of competition.
- The fourth objective, promoting the integration of the EU securities markets infrastructure, should be pursued if integration will lead to increased efficiency, reduced risks and reduced costs. However, caution should be taken so that achieving this objective does not sacrifice or compromise objective three.

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

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[1] Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries, Report on Cross-Border Securities Settlements, March 1995.

[2] The Payments Risk Committee Securities Settlement Sub-Committee, Report on Cross-Border Risks, March 1995.

respect? Do they relate to the access criteria of the system or to other conditions such as operational features? If so, which ones?

- Service providers need the flexibility to determine the market segment they wish to service. Certain standards can be objective (such as whether the customer is an individual or a corporation) but others are subject to judgment (such as credit worthiness).
- As such, there will always be a need for intermediaries who meet the requirements of the service providers and who are willing to provide an integrated means of access to non-qualified institutions or institutions who prefer to engage an intermediary for improved service. Institutions who wish to serve as intermediaries should be accorded appropriate conditions by the service providers to ensure a level playing field.
- Infrastructures which operate as a monopoly in a market – such as a CCP or CSD – could create obstacles to free competition by entering into exclusive arrangements with certain service providers (whether labeled ICSDs or CSDs) but not others who are equally equipped to deliver the service. As previously mentioned, Citibank views this as a major impediment to competition which if allowed, would hinder Europe's overall ability to compete globally.

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?

- Citibank has extensive experience in conducting analysis of different legal principles which apply to settlement and custody in specific jurisdictions. The most significant issues in our view are:
  - The definition and clarity of the agent/principal capacity of a broker, which has important implications on the settlement agent or general clearing member's right of retention and set off. Settlement agents and general clearing members are important liquidity providers to the market via the extension of credit to their clients. In the event of a client default, it is essential that the settlement agent has unencumbered access to the securities paid for through the use of credit.
  - The regulations governing certain types of liquidity management tools (such as repos), which are important to ensure proper protection of ownership rights and obligations. The lack of clarity in some jurisdictions deprives market participants of these tools or increases the risk of their use.

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?

- The proper segregation of assets is important and the appropriate level for the segregation of client and proprietary assets should be clearly defined. In our view, segregation of client and proprietary assets should not be required to extend beyond the books and records of the immediate contracting service provider.
- Custody is a complex service due to the myriad varieties of corporate actions and the significant financial loss which could accrue to investors if certain actions are not communicated correctly or processed in time. The decision on the acceptable form of corporate actions is in the domain of company law and the issuer community. Since innovations are often used to create enticements and rewards for investors, it will be difficult to achieve standardization. Nevertheless, standardization for core activities as well as best practices will be helpful in reducing risk.

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?

- We agree that these are crucial issues to be addressed for domestic transactions.
- Cross-border transactions give rise to the risk of conflict of law when investors, intermediaries, infrastructures and securities fall under different jurisdictions. When securities positions need to move from one settlement location to another, it is particularly important to ensure that finality is achieved prior to the transfer.

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

- Service providers for settlement and custody must have sufficient experience and thoroughly tested contingency plans in place to weather operational disruptions. Best practices and an appropriate level of disclosure should be established as formal guidelines.

2.7. Settlement cycles: What are the arguments for and against harmonized 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.?

- Shorter settlement cycles has been widely accepted as desirable to reduce the risks associated with the ability of a counterparty to settle a trade. However, there is probably a point of diminishing returns when a short

settlement cycle will create problems such as (a) a higher fail rate due to the inability for information to be exchanged in time, a particular challenge for trading across time zone differences; (b) a higher transaction cost due to the inability to move funds for cross-border trades efficiently through foreign exchange markets that do not synchronize with the settlement cycle.

- Harmonized settlement cycles is an issue which should be tackled when there is agreement on the optimal settlement cycle. There are two main areas of differentiation: settlement cycles of different securities traded in a domestic market (e.g. for equities and government bonds in the same country) and settlement cycles across borders.
- Harmonized settlement cycles should help increase liquidity, as the sales proceeds from one market can be used to settle the purchases in another. Banking intermediaries play a crucial role for market participants to realize this benefit.

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) centralized or decentralized structures for infrastructure and service providers; and (ii) the governance structure of infrastructure and service providers?

- The key issues on the structure of the industry include:
  - The need to differentiate different functions: trading, clearing, risk management, settlement, and custody.
  - The need to balance choice and competition with efficiency and risk management.
  - The need to differentiate some functions that benefit more from concentration, and to focus on those that are key, such as clearing and risk management.
  - The need to address governance of infrastructures that are virtual monopolies (exchanges, CSDs, CCPs) as a higher priority than functions in a competitive environment with multiple service providers (custodians, registrars).

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?

- The issue that is of the greatest concern to Citibank is the possibility that institutions providing similar services to users are not given an opportunity to compete on a level playing field. Specifically, the business Citibank is engaged in is similar to the two ICSDs Euroclear and Clearstream: we are for-profit organizations providing settlement and safekeeping services for multiple markets, and compete in providing

services to many of the same financial institutions. Because the corporate ownership of the ICSDs and equity CSDs in several European markets have merged in the last few years [3], we are concerned that the ICSDs may be given privileges in their roles as CSDs which will impede our ability to compete on a level playing field in the provision of clearing and settlement services. For example, a clearing house may decide to channel all settlement instructions exclusively to the ICSD-CSD and oblige all members to settle through it, even though settlement banks such as Citibank can also provide similar service, risk management and operations arrangements. We believe that giving users a choice will be ultimately be beneficial to the health of the financial market as service providers compete on the quality and scope of service, more efficiency and lower cost. Therefore, we ask that the Group takes into consideration competition issues between ICSD-CSDs and other providers of settlement and safekeeping services when formulating its recommendations and standards.

Does the same reasoning apply to the provider of trading services?

- We believe the necessity to provide choice to users and a level playing field for competitors applies equally to trading and other securities-related services.

Yours sincerely,

Raymond A. Parodi
Managing Director
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[3] Euroclear and the CSDs of France, Netherlands and Belgium; Clearstream and the CSD of Germany.