1. INTRODUCTION

The Intesa Group is the largest first Italian banking group and one of the main players at European level.

Banca Intesa is the most important Italian securities services’ provider, offering a full range of transaction products to support the activities of a diversified client base worldwide.

Banca Intesa would like to contribute with this paper to the debate of the Commission’s second Communication on securities clearing and settlement.

This paper aims at demonstrating that post trading facilities should be defined and regulated as “financial utilities”. Post trading facilities represent a unique combination of issues related to banking and financial markets and those connected to infrastructures. According to this view, two questions need to be addressed:

A. The integrity and stability of financial markets, as core unquestionable principles of the banking and financial sectors; and

B. The need to grant by virtue of law free and equal access to clearing and settlement infrastructures, according to the same principles applied through Community law and regulation to gas pipelines and electric cables.

The outcome of this paper will be the suggestion of a possible legal framework for governing the most sensitive topics related to post trading activities in the European Union.

2. ROLE AND IMPORTANCE OF CLEARING AND SETTLEMENT

Clearing and settlement play a critical and pivotal role in the smooth functioning of financial markets, as they allow for the factual endorsement of securities against payment and the transfer of proprietary rights to securities.

A sound post trading system fulfils a general public interest of the European economy as a whole, in which it promotes the **integrity of financial markets**. In fact, only a well functioning post trading system allows for a perfected trade in securities, which is
an essential component of investment, financing and savings in the market economy. For this reason post trading activities should be adequately safeguarded against a variety of risks. Consequently post trading infrastructures should be insulated\(^1\) as much as possible from the risks entangled with the activities performed by other actors in this sector.

Clearing and settlement also play an essential role in the **stability of financial markets**, inasmuch as they act as a conduit for the implementation of the monetary policy of the European Central Bank (ECB) and of national central banks. In its Monthly Bulletin the ECB remarked that “central banks have an interest in ensuring the smooth functioning of securities clearing and settlement systems, because of the potential impact of a major disruption may have on two of their key responsibilities: the smooth implementation of monetary policy and the smooth functioning of payment systems”\(^2\).

### 3. THE MAIN PLAYERS IN CLEARING AND SETTLEMENT

The main players which providers of clearing and settlement services are the following: the central securities depositories (CSDs), the international central securities depositories (ICSDs), the central counterparty clearing houses (CCPs) and the custodians.

**Central Securities Depositories**

CDSs perform essential core functions: they are primarily set up to immobilize or to dematerialise physical securities, in order to facilitate the transfer of ownership between securities holders through the use of book entries in electronic accounting systems. In other words, they are public notaries for securities. Historically, individual CSDs have operated only at a national level and can be regarded as “natural national monopolies”\(^3\).

The main task performed by CDSs is the duly registration of securities issued, their transfer and all rights attached to them\(^4\). It is therefore an essential role played to the benefit of the market as a whole, a back office function, which needs to be carried on in the most efficient way.

**International Central Securities Depositories**

ISCDs were established as an infrastructure with the aim of providing clearing and settlement services in relation to Eurobonds. They perform the same activities as CSDs.

---

\(^1\) The concept of insulation of payment and settlement systems has been introduced in section IV of the Settlement Finality Directive, see infra.

\(^2\) ECB, Monthly Bulletin, August 2001, page 76


\(^4\) CSDs avail themselves of security settlement systems (SSSs) for the transfer of securities against payment. The ECB defined a SSS as “a system which permits the holding and the transfer of securities, either free of payment (FOP) (for example in the case of a pledge) or against payment (DVP). It comprises all the institutional arrangements required for the clearing and the settlement of securities traded and the safekeeping of securities. Settlement of securities occurs on securities deposit account held with the CSD, ICSD or institutions in charge of operating the system. The final custodian is normally a CSD”. ECB, Monthly Bulletin, August 2001, page 69.
Central Counterparty clearing houses

Central counterparties are entities which interpose themselves as the buyer to every seller and as a seller to every buyer.

“A clearing house determines the obligations that result from debit and credit positions arising from the trading of financial assets and calculates the amounts which need to be settled, typically through SSSs.”

Custodians

A custodian is an entity, often a bank, which safe keeps and administers securities and other financial assets on behalf of others and which may also provide various other services, including clearance and settlement, cash management, foreign exchange and securities lending.

The consolidation of the securities industry occurred after the introduction of the Euro has lead to the blurring of the activities carried out by ICSDs and CSDs and to the commingling of risks of different nature incurred by these.

4. CLEARING AND SETTLEMENT SYSTEMS SHOULD BE REGULATED LIKE PAYMENT SYSTEMS

The ECB has repeatedly pointed out the interdependence between payment and securities systems.

From an operational point of view two strong links between securities and payment systems can be drawn:

i) overdraft positions are often secured by a collateral in securities and

ii) market participants have often immobilized funds in securities which they may need to make payments at a later stage.

In both scenarios, should any problem in the securities systems occur, “the risk of bottlenecks in the payment systems would be very large.”

We believe that clearing and settlement facilities should be assimilated to payment systems for the following reasons:

a) Factual:

• Transactions in securities have a cash leg, since the “delivery versus payment” practice involves a cash payment;

• Collateral can be provided either by cash or by securities and in this respect cash and securities can be considered as fungible;

7 Euroclear and Clearstream, which were set up as the facility in charge of clearing and settlement for Eurobonds, have been granted a banking licence, thus departing from their original nature as an infrastructure to become at the same time also commercial banks, providing banking services, like i.a. securities lending and custody, credit facilities.
9 Not only for transactions among private undertakings, but also for transactions carried on by National Central Banks for monetary policy’s purposes.
• Evidence of the sensitivity of clearing and settlement, as for payment systems, can be found a.o. in the Bankhaus Herstatt case\(^{10}\).

b) Legal:

• According to recital 2 of the Directive 98/26 on Settlement Finality in payment and securities settlement systems\(^{11}\) it is explicitly stated that "it is of the utmost importance to reduce the risk associated with participation in securities settlement systems, in particular where there is a close connection between such systems and payment systems";

• The same concept can be found in the Directive 2002/47 on Financial Collateral Arrangements\(^{12}\), where recital 12 mentions the link between the conduct of monetary policy, liquidity and securities related transactions\(^{13}\);

• Most of the securities are liquid and only exceptionally they are not fungible. In this respect debt securities represent a monetary claim towards the issuer and therefore strong analogies can be drawn between said securities and titles of credit like bills of exchange, which are settled within the payment system;

• The majority of the European Member states (e.g. Germany, United Kingdom, Luxembourg and Italy), provides for a regulation and supervision on clearing and settlement infrastructures and/or activities, in a way similar to payment systems.

If it is accepted that payment systems and post trading activities can - and in our view should - be assimilated and treated along the same lines, then:

i. **Post trading activities should be regulated in the same way as payment systems; and**

ii. **Art. 105 (2) 4\(^{th}\) indent of the EC Treaty applies, at least for the Eurozone, thus implying the promotion of the smooth operation of payment systems by the ESCB\(^{14}\).**

In addition, we should look at the nature of the securities entitlement. In all systems, investors’ personal rights in respect to immobilized and dematerialized instruments are embodied in the contractual claim they hold towards the upper tier intermediary and eventually the CSD. Such rights are represented by an electronic book-entry-

---

\(^{10}\) On 26\(^{th}\) June 1974, after the close of the German interbank payments system (3:30 pm local time), Bankhaus Herstatt's banking licence was withdrawn, and it was ordered into liquidation during the banking day. Some of Herstatt Bank's counterparties had irrevocably paid Deutschemarks to the bank during the day but before the banking licence was withdrawn. They had done so in good faith, believing they would receive US dollars later in the same day in New York. But it was only 10:30 am in New York when Herstatt's banking business was terminated. Herstatt's New York correspondent bank suspended all outgoing US dollar payments from Herstatt's account, leaving its counterparties fully exposed to the value of the Deutschemarks they had paid the German bank earlier on in the day. Other cases for the 'Herstatt' risk are the collapses of US investment bank Drexel Burnham Lambert in 1990, of Bank of Credit and Commerce International in 1991 and of Barings in 1995.


\(^{13}\) Also the doctrine has interpreted the Settlement Finality Directive and the Financial Collateral Arrangements Directive according to the above ratio, i.e. "to ensure both the efficiency and the stability of dealings among participants in recognised clearing and settlement systems", R. Goode, Legal Problems of Credit and Security, London, 2003, p. 227.

\(^{14}\) Defined by Art. 8 of the EC Treaty.
form registration in the CSD ledger. In some systems, but not all, the contractual right is coupled with a proprietary interest in the securities, but there is no uniformity whatsoever in this respect. Where securities holders have a merely contractual right toward the CSD via the financial intermediary, they are exposed to the bankruptcy risk of all the upper layer intermediaries, because their securities can become part of the intermediaries' bankruptcy estate. Thus they cannot have a direct claim on the security, both because of the rule of privity of contract and of the "nemo dat quod non habet" rule, according to which a creditor qua creditor cannot validly claim more rights than those owned by its debtor. The above reasoning leads to the conclusion that, in the absence of proprietary protection, the higher the tier of the intermediary, the greater the risk of loss for the security holder, in case of default of the intermediary.

The existence of different treatment and rights of security holders in Europe and the disruptive impact that it may have on the markets, call again for a uniform regulation of CSDs and ICSDs.

5. ARGUMENTS TO TREAT CLEARING AND SETTLEMENT AS INFRASTRUCTURES

The following main arguments points, partly drawn from the doctrine of essential facilities developed by the European Court of Justice, can be put forward to qualify clearing and settlement as infrastructures:

- Traditionally, the minimum optimal scale for these infrastructures is nationwide and they have been established to serve domestic markets. As any other device cannot substitute this back-office function, every intermediary needs to be in a position to access it on the same foot as its competitors. At European level, there is no rule guaranteeing indiscriminate access to them;

- It is economically not feasible (mainly for the high cost of investments in IT). Taking into account the prohibitive investments, mainly in terms of IT, needed to set up a CSD, it is not justified from an economic point of view to duplicate or create new ones CSDs;

- A duplication of a CSD is not even desirable for reasons of public policy, since these infrastructures were established to limit the risks for the marketplace as a whole and to provide for safety and soundness in case of errors or defaults. Moreover the efficiency of these infrastructures increases with the number of users.

These points arguments lead to one main consequence:

---


16 ECJ case C 7/97 Oscar Bronner Gmbh & Co. KG v Media Print Zeitungs – und Zeitschriftenverlag & Co KG and others, [1998], ECR I-7791.

17 Also a recent UK inquiry into bank competition ended up noting that each user of a payment system gains from the addition of new users, so pointing out the benefit of a larger system to customers.
Under Art. 82 (2) of the EC Treaty, operators of the clearing and settlement facilities are required not to hinder access of competitors to the relevant market, in compliance with Community competition law.\(^\text{16}\)

However, even the timely application of Community competition law would only result in the sanctioning of an abuse of a dominant position. We believe that clear and predictable rules should be drawn now in order to prevent abusive behaviours.

The sole application of Community competition law, in the absence of access regulation, would result in \textit{ex post} burdensome structural reforms of the companies involved, with huge impacts on their market-shares, client base, employment, etc. In addition, access granted as a result of an Art. 82 (2) procedure would not be extended to all market participants. The ECJ has clearly stated that any obligation to grant access to the service is imposed only on an exceptional basis.\(^\text{19}\) Therefore, the access granted would not be applicable outside the scope and beyond the parties of the Commission and ECJ decision.

The application of a specific set of rules on access and the \textit{ex post} relief provided by Community competition law are the two interdependent, but clearly separated, tools to make the market function.

\textbf{Competition law should not become an} \textit{ex post} \textbf{regulatory instrument. We believe that a new} regulatory framework needs to be adopted, in order to set predictable rules for market players.

\section*{6. A POSSIBLE LEGAL FRAMEWORK}

\subsection*{6.1. Rationale for a legal framework}

We believe that a legal framework governing clearing and settlement activities is needed for the following reasons:

\begin{enumerate}
\item See notice on the application of the EC competition rules to cross-border credit transfers, [1995] OJ C251/3, paras. 25-6. The ECJ has stated that “Business practices considered to be normal may constitute an abuse within the meaning of Article 82 of the EC Treaty if they are carried out by an undertaking which holds a dominant position. There must be an objective justification for any difference in the treatment of its various clients by an undertaking in a dominant position.” (Commission v Spain, C (2000) 2267, OJ L208 18.8.2000 p. 43). On the same line see also Decision 97/745/EC regarding the tariffs for piloting in the port of Genoa and Decision 95/364/EC in respect of the discounts on landing fees at Brussels National Airport (Zaventem). The concept has been further refined by identifying some precise examples of “difference in treatment”; in particular it has been said from the decision Hoffmann – La Roche v Commission (Case 85/76 [1979] ECRT 461, paragraph 91) on, that “... to bar competitors from access to the market, to apply dissimilar conditions to equivalent transactions with other trading parties or to strengthen the dominant position by distorting competition” (Case 203/01v Michelin v Commission, paragraph 60) are all factors to be taken into account to assess whether a behaviour is abusive or not. On the same line see also the recent decision British Airways v Commission, Case T 219/99, paragraph 270).
\item See Case law on essential facilities RTE and ITP v Commission [1995] ECR I – 743 (Magill Judgement), where the European Court of Justice held that an obligation to contract, to which an undertaking holding a dominant position would be subject, can be based on Art.82 (former Art.86) of the EC Treaty only in exceptional circumstances.
\end{enumerate}
• To complete the existing EU regulation on front trade activities and banks with post trade rules, in order to address the specific issues arising in the post trading context;
• To enhance the protection of primary interests such as the stability and integrity of European financial markets (in and out of the Eurozone) by identifying, managing and limiting risks arising in the post trading process;
• To address the issue of blurring of activities by some infrastructures, such as ICSDs, and the consequent commingling of risks of different natures incurred by them;
• To safeguard European investments and savings;
• To avoid ex ante any abuse of dominant position in the case of a facility constituting a natural monopoly;
• To ensure free and indiscriminate access to crucial facilities such as clearing and settlement ones on the basis of rules certain at law.

6.2 Subjective and objective scope of a legal framework

A preliminary task is to identify the entities carrying out essential clearing and settlement facilities and to define their core activities.

As said in § 3 of the present paper, entities providing essential clearing and settlement facilities are CSDs, ICSDs, and CCPs. Conversely, custodians provide ancillary services to clearing and settlement facilities. Custodians enjoy a banking status and act in an open and competitive environment.

It can be seen that the activities carried out by CSDs, ICSDs, and CCPs are typically those of an infrastructure and are not provided in a competitive environment.

Financial utilities, as post trading facilities have been defined, can be compared to network industries. The European Commission has gained an extensive experience in this area. A whole set of legislation has been enacted by the European Commission in the telecommunication, gas and electricity, transport and postal sectors. The European Commission has acknowledged that “there is clearly no single ideal approach to the regulation of network industries. Choices depend on the characteristics of each industry”. Nonetheless it underlined that one of the crucial issues common to infrastructures lies in fair access, in particular for new entrants.

The issue of access should be addressed also for financial utilities.

6.3 Risk management, segregation, exclusivity and limitation of corporate scope

Risk management

The activities carried out by CSDs, ICSDs, and CCPs bear a variety of risks. The most significant type of risks are the following: liquidity risk, counterparty risk,
principal risk, legal risks, replacement risk\textsuperscript{23} and operational risk (i.e. the risk of system failure, human error, of fraud, giving rise to exposure and possibly loss).

These risks can have systemic implications and therefore should be mitigated.

This is particularly relevant since, as it was mentioned in § 2, these systems are essential to the conduct of monetary policy. There is therefore a strong interest in enhancing and eventually ensuring the stability of clearing and settlement systems and, ultimately, of financial markets.

In order to further improve the confidence of the system, the cash leg of transactions should be settled in central bank money.

As we mentioned before, this is a matter of concern of central banks in the first place. This is the reason why this paper advocates that post trading systems should be regulated and supervised by central banks, as payment systems already are. In particular, as far as the Eurozone is concerned, Art. 105 (2) 4\textsuperscript{th} indent of the EC Treaty should apply to post trading facilities.

This reasoning is in line with Art. 34, para 2, of the forthcoming Directive on Markets in Financial Instruments, where it is explicitly mentioned that national central banks are overseers of settlement systems.

\textit{Segregation}

One of the most effective and secure risk management techniques consists in the legal segregation of the entities carrying out activities involving risks of different nature. Other techniques, such as accounting separation and Chinese walls, do not guarantee the respect of general interests of major importance, such as the stability and integrity of financial markets worldwide. These techniques would not prevent that the bankruptcy of one department actually spreads also to the other departments of the same legal entity. In other terms only a strict legal separation can guarantee the maximum extent of bankruptcy remoteness of the infrastructure\textsuperscript{24}. In fact, the only risks that financial utilities should be allowed to bear are the operational ones. No commingling of banking risk should be allowed.

Therefore we strongly recommend that \textbf{post trading infrastructure activities are legally segregated from banking activities} carried out by custodians.

The concern of the stability of payment systems, as conduit of the Euro monetary policy, has already been addressed by the European legislator in the Directive 98/26/EEC on Settlement Finality. As Art. 9 states clearly, the aim of the directive is “to minimise the disruption to a system caused by insolvency proceedings against a


\textsuperscript{24} This principle has been first introduced by the doctrine on the bankruptcy remoteness of Special Purpose Entities (SPEs) and then implemented by the relevant legislation (e.g. Italian law 130/99 on securitisation Art. 3, Portuguese Decree-Law number 453/99 of 5 November 1999, Art. 39, French Decree n. 89 -158 of 9 March 1989 on Fonds Communs de Créances) and practice (e.g. Standard& Poor’s, “U.S. Legal Criteria in Structured Finance Transactions,” dated April 2000, chapter entitled Special Purpose Entities).
participant in that system”. It provides in particular for the insulation of the rights of holders of collateral securities from the effect of the insolvency of the provider.

**Exclusivity and limitation of corporate scope**

To ensure the consistency with the existing EU banking and financial services regulation, the new EU regulatory framework should adopt a systematic approach, hence transposing also to this sector the approach adopted in the Second Banking Directive and in the forthcoming Directive on Markets for Financial Instruments. Consequently, Community regulation on the clearing and settlement area should be built upon the following two main pillars:

i) Only regulated entities should be allowed to carry out clearing and settlement activities; and

ii) Such entities can carry out only clearing and settlement services, because of the exclusivity of their corporate scope.

**6.4 Access to infrastructures**

Infrastructures should be made accessible to users, provided that some clearly defined criteria are met.

The European Commission has granted access in the network industries, according to the following rules:

<table>
<thead>
<tr>
<th>Sector</th>
<th>Directive</th>
<th>Article</th>
<th>Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tlc</td>
<td>2002/19/EC (television)</td>
<td>9 - 13</td>
<td>Operators with significant market power (SMP) are required to deal with reasonable requests for access to their networks; conditions of access were to be based on objective criteria, transparent - and published - and non discriminatory. Access to networks and services can only be restricted on the basis of essential requirements.</td>
</tr>
<tr>
<td>Energy</td>
<td>96/92/EC (electricity)</td>
<td>17 – 18</td>
<td>MS can choose between negotiated third parties access to the system (TPA), regulated TPA or the single buyer system.</td>
</tr>
<tr>
<td></td>
<td>98/30/EC (gas)</td>
<td>15 – 16</td>
<td>MS can choose between negotiated third parties access to the system (TPA) or regulated TPA.</td>
</tr>
<tr>
<td>Transport</td>
<td>96/67/EC (ground handling)</td>
<td>11</td>
<td>Access is granted by the airport infrastructure to ground handling operators upon public tender.</td>
</tr>
</tbody>
</table>

In our view, intermediaries meeting a certain number of predetermined criteria should be granted access to the clearing and settlement facilities.

In particular the regulatory body should:
• Draft the access criteria with the view of protecting the soundness of the infrastructure and thus of the market and to create equal conditions of competition among the users;
• Identify the conduct of business rules that clearing and settlement facilities providers should comply with;
• Supervise the compliance of financial utilities with the applicable body of rules;
• Establish cooperation links with supervisors competent in other jurisdictions.

Access criteria should embody the following principles\(^{25}\):

• Objectivity, non-discrimination and justifiableness;
• Transparency and public disclosure of the admission process\(^ {26} \);
• Refusal to provide a service possible only on justified objectives, technical or legal grounds and coupled with the possibility to challenge negative decisions.

Conduct of business rule should aim at:

• Non discriminatory prices;
• Provision of unbundled services;
• Client order handling rules (i.e. conditions other than prices applied in a transparent and indiscriminate manner).

Art. 34 of the forthcoming Directive on Markets in Financial Instruments follows this approach by stating that access of investment firms to CCPs and CSDs is made subject to “non-discriminatory, transparent and objective criteria”.

7. CONCLUSIONS

The Bankhaus Herstatt case\(^ {27} \) has clearly demonstrated that a material domino effect upon default of counterparty can be managed only by means of a stable system and arrangements amongst supervisory authorities.

The lesson to be drawn from the legal arguments and factual evidence provided is that post trading systems should be stable and regulated: the stability, the neutrality and bankruptcy remoteness of financial utilities are *sine qua non* conditions to allow the market deal with a possible default scenario, like the Herstatt one.

The only feasible and effective way to preserve financial utilities from risks that are not embedded with the activities they should carry out is to insulate the said utilities from any other player. A leading example of this model is provided in the US, where a single purpose entity has been created and entrusted with the management of clearing and settlement\(^ {28} \).

\(^{25}\) These criteria should be read as applying both to the infrastructure and to the users.

\(^{26}\) See Core Principle IX of the G10 report on systemically important payment systems.

\(^{27}\) See § 4 above for its description.

In this context, national central banks should be empowered to regulate and exercise supervision on clearing and settlement systems.

Since financial utilities are network industries, one of the core issues on which regulation should focus on is access. In order to establish a level playing field among users and to foster fair competition among them, regulators should establish objective, transparent and non-discriminatory access criteria and conduct of business rules.

* * *

For any further comment or question, please contact:

Alessandra Perrazzelli
Head of International and European Affairs
Banca Intesa
Square de Meeûs, 35
B – 1000 Brussels
alessandra.perrazzelli@bancaintesa.it

Francesca Passamonti
Responsible for EU Affairs
Banca Intesa
Square de Meeûs, 35
B – 1000 - Brussels
francesca.passamonti@bancaintesa.it

Brussels, April 2004