



**EPDA PRELIMINARY RESPONSE
TO THE EUROPEAN COMMISSION'S
CLEARING AND SETTLEMENT ADVISORY AND
MONITORING EXPERT GROUP
(THE "CESAME" GROUP)
ON
CLEARING AND SETTLEMENT
WITHIN THE EUROPEAN UNION BOND MARKET
FEBRUARY 2006**

The EUROPEAN PRIMARY DEALERS ASSOCIATION (EPDA) addresses specific primary and secondary market issues arising across Euro government securities markets and recommends best practice across those markets. The members of the EPDA comprise government securities dealers officially recognised in numerous primary and secondary markets. The EPDA is a division of the BMA.

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EXECUTIVE SUMMARY

The EPDA sees the following measures as necessary in removing the major barriers/impediments to efficient, stable, secure and cost effective clearing and settlement within Europe for fixed income instruments:

1. Fragmentation of clearing and settlement along local requirements/practices needs to be removed, whilst at minimum retaining the current settlement efficiency rates and protection against systemic risk provided by existing systems. To a large extent, these barriers have been set out in Annex A to this paper under the various headings.
2. Harmonization and adoption of technical standards/protocol between market infrastructures and participants in order that any service provider may offer clearing and settlement services by providing access to market users to the system.
3. Real-time processing between ICSDs and CSDs and the development of effective bridges between CSDs and Agent Banks in order that a seamless integration of clearing and settlement services maybe provided throughout Europe to market users.
4. We support the consolidation of European CSDs in order to provide for a harmonized market. Such consolidation will allow economies of scale, in particular the concentration of the collateral into a single pool which will take advantage of its proximity with the cash liquidity in the European System of central banks System (Target 2).
5. As the ICSD business model bundles banking with infrastructure services, such consolidation involving ICSDs would require the separation of banking activities and these services to be strongly ring fenced from infrastructure services so to avoid credit risk concentration and to preserve competition in banking services. This consolidation process will have to follow the current domestic best practices including use of central bank money and, finality of settlement given by the national central banks,.
6. Adoption and utilisation of harmonized automated pre-matching processes which eliminate among other things telephone matching, manual submission, and dependency on intermediaries which thereby needlessly driving up costs and risks and undermining remote settlement.
7. Harmonisation of settlement periods, settlement and funding deadlines, re-alignment and buy-in provisions, based on domestic best practices where there is no justifiable local reason for the difference
8. Legal/Fiscal treatments including legal treatment of securities, netting as well as withholding tax and different methods for relief (source vs. reclaim)

With respect to barrier 10 - national restrictions on the activity of primary dealers and market makers, we have not specifically listed these separately but have included them within the list set out in Appendix A to this paper:

I – GENERAL

A. Fixed Income Markets and Clearing and Settlement

The focus on trying to make cross-border clearing and settlement as efficient, safe and cost-effective as at national level within Europe has been discussed for many years. The Giovannini Group in its first report entitled “Cross-Border Clearing and Settlement Arrangements in the European Union (2001)” listed 15 barriers to such an efficient, safe and cost-effective pan-European system back in 2001. This work was incorporated by reference into a more comprehensive report into a common EU financial services market entitled “Final Report of the Committee Of Wise Men on the Regulation of European Securities Markets” and the removal of which was included in the timeline for the completion of the “Financial Services Action Plan” set out therein by its Chairman, Professor Alexandre Lamfalussy.

It is not our purpose here to outline the history of the various developments and the many papers and important contributions to this issue but we will mention that the initial report was followed up by the Giovannini Group with a second entitled “Second Report on EU Clearing and Settlement Arrangements (2003)” which outlined the progress to date on addressing the barriers and set out a suggested timeline to remove them. Following that report, the European Commission set up in April 2004 the Clearing and Settlement Advisory and Monitoring Expert group (the “CESAME” group) to advise on market-led initiatives to remove the barriers as it saw cross-border clearing and settlement as “crucial to a real single securities market in the EU”.

To this end, the EPDA is submitting this preliminary report on the Giovannini Barriers and their current effect on the operation of the pan-European fixed income market and in particular, we have highlighted are concerns on Barrier 10 in relation to national restrictions on the activity of primary dealers and market makers as this was specifically requested of us by the European Commission as noted at meeting of the Cesame Group on 10 June 2005.

This being said, the EPDA does not consider Barrier 10 to be particularly burdensome in itself and we have therefore, preferred an approach where we have set out the particular principles that should be applied in any market-led (or regulation-led) approach to the removal of the barriers and then identified what we believe are the major remaining barriers/impediments to an efficient, safe and cost-effective cross-border clearing and settlement system for fixed income markets within Europe. In doing so, we have concentrated mainly on the barriers related to technical requirements and market practice (ie. Barriers 1-10) and have only occasionally commented on the fiscal and legal barriers. This is largely related to the expertise of our working group but also to the fact that these are already being addressed by the experts on European Commission’s Legal Certainty and Fiscal Compliance group

Finally, we have not focused at all on the economic benefits or cost savings of market harmonization within the clearing and settlement landscape in Europe as these have been outlined by many other parties in great detail and forms part of the Financial Services Action Plan which derives from the Economic Reform Agenda agreed by the EU Member States at the Lisbon European Council in March 2000. We will take as given that where barriers or domestic preferences exist, these should be removed in order to further market harmonization and progress towards the cross-border integration of financial markets which forms the Lisbon Economic Reform Agenda. We also take as given the importance of an efficient, secure and cost-effective clearing and settlement system within Europe and as integral to harmonisation of financial markets, and will not

repeat here the many studies, papers, and speeches that have elaborated on this basic principle.

B. EPDA Clearing and Settlement Working Group

The European Primary Dealers Association (EPDA) was formed in 2004 to address specific primary and secondary market issues arising across Euro government securities markets and recommends best practice across those markets. The members of the EPDA comprise government securities dealers officially recognised in numerous primary and secondary markets and include the following institutions as Executive Members:

ABN Amro	ING Bank
Barclays Capital	J.P. Morgan
BNP Paribas	Lehman Brothers
Calyon	Merrill Lynch
IXIS CIB	Morgan Stanley
Citigroup	Nomura
Credit Suisse	RBS
Deutsche Bank	Société Générale
Dresdner Bank	UBS
Goldman Sachs	UBM
HSBC	

The EPDA is a division of the Bond Market Association.

The EPDA was asked by the European Commission by letter in May 2005 for a response on the existence and explanation of any restrictions linked specifically to primary dealers' settlement activities (ie. barrier 10). This request and clearing and settlement more broadly were discussed at the EPDA bi-monthly meeting in 20 September 2005. It was agreed that EPDA should respond and a working group was formed.

At the first meeting of EPDA Clearing and Settlement Working Group on 2 November 2005, Mr. Mario Nava updated the members on the work of the European Commission, the Cesame Group on clearing and settlement as well as set out the timeline for the completion of the impact assessment analysis for a possible directive on this matter. For these reasons, the Working Group agreed unanimously that time was of the essence if the EPDA was to present to the Cesame Group by the end of February and therefore, adopted a streamlined governance for this project. The EPDA would not over burden itself with external consultation at this point in time (even if that was our preference) as adopting such an approach would risk us losing the ability to report within the timeframe. For that reason, the Group agreed that we would only extend invitations to institutions who are current members of the EPDA and therefore are PDs (or equivalent) in at least 4 eurozone member states including Germany and one of France or Italy. This group would issue a preliminary report to the Cesame Group in February with a final version to come after more extensive consultation.

The approach in drafting this report we have used from the beginning is both a bottom up approach (to map out the European Clearing and Settlement landscape which forms Annex B to this paper) and a top down approach by asking our respective members to identify the existing barriers within the fixed income markets for clearing and settlement

within Europe (an aggregation of which forms Annex A to this paper). From both those documents, we then identified the remaining major impediments to market harmonization whilst still providing an efficient, robust clearing and settlement infrastructure in Europe.

C. General Principles

Much has been written on the benefits of consolidation versus competition as the ideal business model for clearing and settlement within Europe. However it is important to highlight that the optimal market infrastructure solution for clearing and settlement across Europe should address the following key objectives:

- * Cost of service - the cost of post trade services should be as low as possible so that the market continues to remain competitive and buoyant;
- * Stability, Scalability and Security - no new systemic or operational risks should be introduced;
- * Transparency of governance - there should be balance between user and shareholder objectives
- * Removing barriers to entry - promotion of "free trade" (e.g. removal of exclusivity arrangements)

If consolidation is favoured; especially the creation of a single European bond clearing house/central counterparty that would process the trades from all major bond markets within Europe; then such consolidation would have to come with at minimum, strong user governance and with limited scope for participants to influence such change, the market should focus on the harmonization of market and technology standards and practices and interact with the Member States for the removal of barriers and preferences in the member states.

If a more competitive model is the preferred option then this should be without barriers or preferences in order to be able to choose one access point from one or more service providers for clearing and one access point from one or more service providers for settlement for ALL bonds it trades with ALL counterparties in Europe whereby technology and market standards have been agreed amongst ALL service providers and market participants in order to reduce costs, provide for seamless integration and prevent any market distortions being created by the clearing and settlement system.

The competition/consolidation aspect may also be further differentiated. The optimal market structure could be a consolidated model for functions that are most efficiently carried out centrally, for example clearing and settlement through a single European CCP and a single European CSD. Functions that have so far benefited from competition, for example at the custody and banking level, may remain competitive. Competition and consolidation could therefore be both appropriate at different stages along the value chain.

In a nutshell, participants from a clearing and settlement perspective should be able to view the European market as one and not a series of regional or product specific platforms. If the US experience provides a good example, the one way to encourage consolidation (without the regulators mandating it), is by removing the barriers to competition and agreeing market and technical standards (and this will be elaborated on below), as well as implementing a common regulatory framework for central providers of

clearing & settlement services (CCPs and CSDs) to ensure safety and good governance as well as focus on core utility functions (cf: “The future of clearing & settlement in Europe”, Corporation of London, December 2005, pp. 47 to 56).

D. Basic Principles

1. Open Competition and Removal of Barriers and Preferences - Encourage competition and consolidation by removing ALL barriers and preferences as this is the best tool to drive down costs and allow for innovation; however, if consolidation occurs and dominant or monopolistic positions develop or are favoured by the regulator(s), such a clearing and settlement institution needs to be owned and efficiently governed by the users in order to sufficiently safeguard the user from abuse. As a minimum requirement, transparency and shareholder participation rules for market infrastructures should be equivalent to those compulsory for publicly listed companies as suggested by the ECB in its recent paper “Governance of Securities Clearing and Settlement Systems” (October 2004)
How to do this?
 - i. Address vertical integration of clearing and settlement within trading venues – separate ownership of clearing and settlement institutions from trading venues is strongly preferred and may in certain cases imply a structural interference, as it prevents any trading venue (where by reason of factors such as the “stickiness” of liquidity, trading may be heavily concentrated) from benefiting from privileged treatment or favouring a given clearing and settlement platform and ensure equal access for all market users whilst guaranteeing market efficiency. Where vertical integration exists, any such clearing or settlement operations must be very strongly ring fenced from any trading operations, pricing should be transparent, and an open tender must take place in order that no preference is given to its own clearing and settlement operations over any other entity.
 - ii. Choice of clearing and settlement entity by trading venue or auction procedure – trading venue’s should not select the clearing and settlement institution for fixed income instruments but should allow any of its users to select any provider including both settlement/clearing institutions and agent banks offering this service to clear and settle on its behalf for any bond traded on that platform. This principle extends to auction procedures used by debt management offices whereby such systems should not domestic settlement and should allow the participant to choose any major provider for settlement purposes.
 - iii. Where dominant positions exist, such central Service Providers cannot deny clearing and settlement services to trading venues or market users other than for sound market, technical or commercial reasons. Such non-discriminatory access should also be extended to those users that compete with central providers in commercial areas.
 - iv. Fragmentation of clearing and settlement along local requirements/practices need to be removed as this defeats the purpose of an integrated European market as articulated within the Lamfalussy Report (eg. National legislation, Primary dealerships, Settlement preferences, Exchange requirements, Trading platform requirements)
 - v. Whilst national legislatures may require that book-entry utility services be undertaken by one entity (provided such central securities depository services are subject to open and transparent tendering), this service must be stringently ring fenced from any commercial operations offered by the same entity/ownership group. This is to ensure transparency of costs in order that banking/custody

services can not leveraged and/or bundled with clearing and settlement infrastructure operations. Therefore, a CSD must offer the book entry service for cost plus reasonable mark up and on the same terms to all participants (including to its own ownership group and those market users of its clearing and settlement services).

2. Market Standards – all market users and service providers for All bonds and All types of counterparties need to agree market standards for pre-matching processes, settlement periods, deadlines (funding and settlement), re-alignment, autoborrow availability and autolender requirements, and buy-in rules including auto-compensation, attitude to fails, and penalties (see Appendix A – Clearing and Settlement matrix) in order that counterparties may seamlessly settle across different entities and not be disadvantaged by their choice of point of access. To this end, the EPDA is considering endorsing the recent proposals of the European Securities Forum set out in their document of December 2005 entitled “Proposals to harmonise and standardise pre-settlement date matching processes throughout Europe”. Some examples:
 - a. Italy - it is a ‘market practice’ to conduct telephone pre-matching for all OTC trades and this is a major obstacle to the operation of an efficient market. Monte Titoli should consider making automated pre-matching mandatory for the entire market.
 - b. Germany - Free of payment deliveries do not require pre-matching which results in manual effort in cases where bonds have to be rejected
3. Technology Standards –
 - i. Technical formats, protocols and messaging agreed by and adopted by the whole industry (with market user participation) that allow for seamless “interoperability” in order that any service provider including agent banks may “plug” into the system in a fair, reasonable and transparent manner and offer services to the market users whilst at the same time ensuring a safety and robustness of the system. The debundling of the European telecommunication network from the national carriers maybe a good case study for a unified clearing and settlement system as well as the SEC order defining a set of principles to govern interoperability between Omgeo and a potential competitor in the U.S. Given the strong network effects, and even more in the instance of a single European utility, the entity owning this utility network should not be integrated within any commercial institution and should be owned by and managed by the market users; and must ensure a robust, fail-proof business continuity arrangements as it represents the single market infrastructure
 - ii. CCP Bridges –Where there exist more than one CCP for each bond, these institutions must by virtue of the agreed technical standards offer a CCP bridge between each other whereby there is no market impact on whether a market user trades with a counterparty that is a member of its own CCP or the one connected by the bridge. In practice, this means real-time or near real-time processing across the bridge, each CCP being a general clearing member of each other; the same method of calculating margins, and same capital requirements for membership. For example, there is an existing CCP bridge between CC&G and LCH.Clearnet on Italian bonds on MTS. Where the industry consolidates (eg. a potential LCH.Clearnet and Eurex Clearing merger), this should be accompanied by strong market user governance in order to ensure fair and transparent access as well as to control costs in order that the industry benefits from the economies of scale.

As user governance is not a panacea in itself, it is crucial to establish transparency and participation rules at least equivalent to those required of publicly listed companies.

- iii. ICSD Bridges – There is an existing bridge between the two ICSDs Euroclear Bank and Clearstream International but this bridge must become real-time (or at least every 15 minutes) including matching and turnaround as currently its multi-batch during the day which does not allow for an efficient turnaround of securities. These bridges must be extended on the basis of common agreed technical standards to all service providers including agent banks.
- iv. CSD bridges - the links between the ICSDs and CSDs must be real-time and not batch whereby all CSDs and ICSDs are members of each other and market users may hold their securities in the ICSD or CSD of their choice. This method was used in the U.S. in the 1970s and the arrangement was called “one account settlement” and was based on risk-free CSDs operating in central bank money. On the other hand, US government bonds always settled in a single system managed by the Federal Reserve and operated in central bank money: Market participants trading in US government bonds have the choice of direct or indirect access to central bank money, with two main commercial banks competing for the provision of commercial services (cash financing, triparty repos).. There are some steps in the direction of better cooperation between CSDs and at least central banks of other member states eg. between Clearstream Banking AG and central banks of Austria and Netherlands whereby participants make available liquidity by means of deposits in cash or securities at their national central bank, which submits a cross-border guarantee to the German Bundesbank. Target 2 will also improve this situation

One cannot claim that these principles are exhaustive. However, we would suggest that one cannot pick and chose the principles they like from those outlined above. Hard choices must be made as this is the only way a truly competitive market place can develop. Market users would strongly benefit from one access point to the system for all bonds trading with all counterparties and not be disadvantaged vis-à-vis fragmentation stemming from other counterparties using other systems. This system must be cost efficient, safe/secure and robust. And if the harmonization of standards is to increase cost significantly in order to create a competitive open marketplace, than consolidation should be preferred with one CCP and one CSD covering all Bonds of Europe. .

E. Consolidation/Competition Implementation Risks

Consolidation of the European Fixed Income clearing and settlement and thereby liquidity will allow economies of scale, in particular the concentration of the collateral into a single pool. This collateral pool will usefully take advantage of its proximity with the cash liquidity in the European central banks system (Target 1, and then Target 2). But if the intermediate situation is a fragmentation between domestic and international CSDs, it brings a risk of lowering significantly the security of trades by multiplying the number of "cross-border" movements. This would be detrimental to the market efficiency.

Furthermore, ICSDs use their own balance sheet to guaranty the settlements. This credit risk cannot ascertain for example the irrevocability of trades. This can threaten the system in case of big trades to settle (such as primary market new issues). So the

principles of safety (use of central banks money) and efficiency (definition of best practices) should come before the process of consolidation.

F. Further Work

As mentioned above, we acknowledge that this is a preliminary report and that due to the shortness of time required by the submission to the Cesame Group at the end of February we have not had the opportunity to provide a full report. As such, we plan to complete the following within 2006:

1. Actively engage other market users which may include European primary dealers, member state debt agencies, bank treasurers, central banks, investors (asset managers, hedge funds, pension funds, life assurance companies and other buy-side participants) on this issue in order to validate our initial research as set out in Appendix A and B to this paper.
2. Actively work with and seek consensus with other industry bodies and working groups on a market-led approach to these issues.
3. Work with other trade associations to ensure an effective and unified European wide voice on this issue
4. Consult with all major market provider clearing and settlement institutions and agent banks in order to encourage a market-led approach.
5. Issue a final report in early 2007 on progress on removing the barriers for fixed income markets.

G. Conclusion

We have focused on the technical and market barriers from a fixed income perspective (as oppose to an equity one) and have not extensively reviewed the legal or fiscal barriers that are being reviewed by the Legal Certainty Group and the Fiscal Compliance Group separately.

Whilst we have noted our principles for clearing and settlement harmonization and identified the remaining barriers, we do not support in principle the introduction of a directive at this point in time in particular for market and technical barriers. If a directive is to be introduced by the EU Commission, it should only encompass those legal and fiscal barriers where market participants cannot act alone. We believe the current momentum in the Cesame Group and related industry working bodies for finding a market led approach is positive and should be given more time to run its course. A directive may also slow down the process and bring unwanted provisions or side effects. And to this end, we note that others have presented arguments and reasoning against a directive, for example, as elaborated by the London Investment Banking Association in its paper published in July 2004 entitled “Guiding Principles for the Development of EU Clearing and Settlement Policy” or more recently the Corporation of London report published in December 2005 entitled “The Future of Clearing and Settlement in Europe” and do not deem it necessary to repeat or expand on such arguments here.

Nevertheless, EPDA will actively support a market led approach based on the principles set out in this paper through the further work identified above. By the end of 2006, we expect to complete our further work at which time we will comment in early 2007 on whether this momentum has begun to realise these technical and market standards and shown progress on the removal of the barriers and preferences. If there is not sufficient

progress, we may consider our position on whether a directive would be useful in galvanizing action. At this time, we should be wary of the “regulatory fatigue” experienced by our members in implementing the Financial Services Action Plan.

Annex A – European Clearing and Settlement Matrix

Annex B - EU - 25 Clearing and Settlement Paths