

Communication on Clearing and settlement in the European Union – The way forward.

Summary of the Responses

1 Introduction

In April 2004 the Commission published its second Communication on securities clearing and settlement¹. The Communication, a policy document for comments by all interested parties, describes the Commission objectives and proposed actions in this field.

The Commission received 82 responses in total. For practical purposes, the respondents were categorised by the Commission as follows: 4 asset management associations, 20 banking/investment firm associations and 14 individual banks/investment firms, 1 CCP and 1 association, 3 CSDs² and 1 association, 4 exchanges/regulated markets/MTFs and 1 association, 5 vertical silos, 25 governmental authorities/central banks/supervisory authorities³, 3 issuer associations, 3 representatives of the legal community, 1 registrar, 1 provider of matching services and 1 private individual.

73 responses have been made public⁴. This has the express approval of their authors. A small number of respondents did not provide authorisation for such publication (7) or expressly refused it (2). These responses have been considered by the Commission and included in this analysis but will not be made available to the wider public.

The present document summarises the responses received and provides some clarification on issues that have created confusion in the market. The summary seeks to represent the broad balance of views contained in the responses. However, it does not constitute a complete overview of all the opinions expressed by respondents. It has been drafted on a “best-effort” basis and highlights only the more significant issues raised by respondents. Readers are invited therefore to access the full text of these responses on the Commission web site.

The information contained in the responses and that gathered by Commission staff in many discussions with interested parties in recent months will feed into the policy-making process that is on-going within the Commission.

2. The broad Commission position in the Communication

The Commission set out its broad policy guidelines which will determine its involvement in the securities clearing and settlement sector and made concrete proposals as to the measures and actions that it considered appropriate to adopt in this field. The Commission suggested that it should adopt policies pursuing:

¹ “Clearing and settlement in the European Union – The way forward”, COM(2004)312final, 28.4.2004, available at http://europa.eu.int/comm/internal_market/financial-markets/clearing/index_en.htm#com

² In this note the term CSD refers to both CSDs and ICSDs.

³ These authorities submitted 19 responses in total; a number of responses were submitted by more than one authorities.

⁴ These responses are available at http://europa.eu.int/comm/internal_market/financial-markets/clearing/index_en.htm#com

- the *liberalisation and integration* of existing securities clearing and settlement systems. This will be achieved through the elimination, by the joint action of private and public sector bodies, of the barriers identified by the Giovannini group of experts. In addition, the Commission intends to complete the process, already initiated by the Investment Services and the Markets and Financial Instruments Directives, of introducing comprehensive access rights at all levels of the clearing and settlement structure so as to facilitate and increase the choices available to market participants;
- the consistent application of *competition rules* to address restrictive market practices and to monitor further industry consolidation;
- the adoption of a *common regulatory and supervisory framework* that ensures financial stability and investor protection. This framework will lead to the mutual recognition of systems and their effective integration; and, finally
- the introduction of certain specific *governance arrangements* to be implemented by clearing and settlement infrastructure providers in order to address ex-ante competition and safety concerns.

The Commission viewed the pursuit of these policies as a means to provide the markets and market participants with an environment which would enable them to adopt their business strategies and policies without the distortions occasioned by inconsistent cross-border technical, regulatory, legal and fiscal underpinnings.

At the same time, this environment should promote the efficiency and safety of systems, the protection of investors and should prevent or caution any anti-competitive activities by markets and market participants. The Commission considered that, at least at this stage, it is not necessary or advisable to impose any specific market structure or clearing and settlement model. For the Commission, markets are best placed to decide on the precise structure of the industry and on the combination of consolidation and integration that best meets their needs. In that respect, the Commission actions should aim at enabling things to happen in an orderly and safe way rather than imposing exactly how things should happen. On this basis, the Commission stated that, subject to the introduction of the necessary safeguards, it should be neutral as regards the degree and form of the integration and consolidation between market participants (either horizontal or vertical) and the opportunity for securities settlement systems and Central Counterparties to offer intermediary and/or banking services to their participants.

In order to meet the objectives mentioned above, the Commission suggested that it needs to:

- *Set up an Advisory and Monitoring group* to advise on, promote and monitor progress of the market-led actions to bring down those of the Giovannini barriers for which action by private sector bodies is the most appropriate way of handling them, and to promote the overall integration and liberalisation project.
- *Propose a Lamfalussy-type framework Directive on clearing and settlement* to complement the market-led removal of the relevant Giovannini barriers with a secure legal framework ensuring the freedom to provide securities clearing and settlement services throughout the EU on the basis of common requirements. Such a framework will ensure that restrictions and barriers as to the location of clearing and settlement are lifted, that there will be mutual recognition of the various national systems and that

regulation/supervision/oversight of systems is based on the home country principle, adapted as necessary to address the specificities of the clearing and settlement environment. The adoption of more detailed measures could be envisaged as further level 2 measures under the Lamfalussy process.

- ***Address the complex legal and tax issues*** that constitute effective barriers to cross-border clearing and settlement. The Commission proposed to set up two expert groups to consider these issues and, if required, to assist the Commission in the preparation of methods of harmonisation of national law and/or procedures.
- ***Ensure the effective implementation of competition law***. The Commission, in close cooperation with national competition authorities, should closely monitor the possible creation or reinforcement of dominant market positions and sanction any anti-competitive actions by, and/or agreements among, market participants in this vital sector for financial markets.

3. General remarks on the Commission objectives and approach

Overall, the Communication was well received. The respondents were generally appreciative of the Communication and felt that the Commission addressed the securities clearing and settlement issues in an articulate and consistent way.

The respondents agreed with the overarching objectives of the Commission, namely the need for an integrated, efficient and safe clearing and settlement environment in the EU which ensures a level playing field among the different providers of relevant services. Some respondents representing the legal profession and Member States authorities stressed, however, that it is important not to limit the whole effort to a purely internal EU exercise but also to consider the relations with third countries, given the importance of global trading and the convergence of capital markets world-wide.

Most respondents also agreed with the multi-pronged approach adopted by the Commission in tackling the various inefficiencies and barriers. They agreed with the express intention of the Commission to promote the co-operation of private and public sector bodies as the most efficient way to proceed. There was also support for the Commission playing a major role in providing the political impetus, coordinating actions and, at least for an important number of respondents, for eventually creating a legislative framework in which improvements to pan-European clearing and settlement systems will be set.

Nonetheless, some respondents, including Member States authorities and one silo, complained that “*cost-reduction*” in cross-border clearing and settlement no longer seemed to be one of the primary aims of the Commission.

The Commission does not share this view. In fact, the generic term “efficiency” used by the Commission in its Communication includes innovation (dynamic efficiency), cost-reductions (technical efficiency) and appropriate price levels (allocative efficiency). That the Commission continues to consider cost reductions as one of its primary aims stems also from the fact that it fully endorsed the Giovannini reports which established that dismantling the identified barriers is crucial for, among other things, cost-reduction.

The Commission's suggestion that integration and consolidation should be market-led and that it should refrain from imposing any specific market structure or clearing and settlement model divided respondents. The discussion centered mainly on the effects and desirability of allowing securities settlement systems (mainly CSDs) to incur credit risk and to compete with their participants in the provision of settlement intermediation and credit-related services. A detailed analysis of the various arguments and positions has been inserted in the appropriate sections below.

Certain related statements could, however, be mentioned here. One central bank remarked that although consolidation should be market-led, it should stop where it threatens innovation and competition. Any gains should be channeled to the benefit of end-investors and issuers, while competition could further be sustained by ensuring direct participation in the infrastructure for smaller players.

An association of issuers argued that the Commission approach on integration and consolidation would put CSDs in competition with each other. This will allegedly result in further fragmentation of the market and will not promote integration. In addition, it may result in a further compartmentalisation between the wholesale and the retail markets, which is contrary to the interests of the issuers.

The Commission did not specifically promote competition between CSDs as such. It suggested that CSDs should be able to be used by market participants as intermediaries to obtain direct or indirect access to foreign Securities Settlement Systems. This will increase competition in the market for the provision of access to foreign systems.

A criticism was also leveled against the Commission, mainly by certain central banks and Member States authorities, that it seemed not to consider, or not to take fully into account, direct holding systems, such as those operated in the Nordic countries, in Slovenia and in Greece.

Although it is true that the Communication did not clearly distinguish between the various types of holding patterns in the EU, these systems have always been at the heart of the Commission's consideration, as any other holding pattern in the EU. The distinctive features of all these systems are being fully considered by the Commission in the development of its policy and in the work of the Legal Certainty Group and of CESAME.

4. Specific issues

4.1 The need for a Directive

Commission position: The Commission expressed the view that the market-led removal of the relevant Giovannini barriers should be complemented by a secure legal framework ensuring the freedom to provide securities clearing and settlement services throughout the EU on the basis of common requirements. In view of the uncertainties of relying on voluntary action by Member States and national regulators and supervisors, the Commission felt that this should be a matter for an EU legislative proposal, in the form of a framework Directive. The Directive should only set general principles in conformity with the Lamfalussy process.

The Commission tentatively suggested that the Directive should provide for comprehensive rights of access and choice, a common regulatory and supervisory framework and appropriate

governance arrangements. The Directive should ensure the mutual recognition of the various national systems based on the home country principle. The detailed comments on the proposed contents of the Directive will be considered in the following sections. This section only deals with the respondents' view as to the desirability of the adoption of a framework Directive, as suggested by the Commission.

In addition, the Commission invited interested parties to comment on the relevance, for the EU, of the US model for clearing and settlement. Comments were provided and will be dealt with in this section.

Comments received:

Most of the respondents either approved the Commission's initial assessment that a Directive on clearing and settlement seems to be necessary or did not specifically reject it. In fact, the majority of respondents (47) requested the adoption of a Directive (even with diverging views as to its exact contents), while an additional 9 respondents were also generally in favour of, or not opposed to, a Directive but at the same time advised caution. On the other hand, only 6 out of the 82 respondents to the Commission Communication were explicitly against a Directive, while 7 other respondents have expressed a rather negative view. Finally, 13 responses did not take position or were unclear on this point. Thus 56 respondents were generally in favour of, or rather positive for, a Directive, while only 13 were against, or rather negative for, such a Directive.

Some of those that expressly approved the adoption of a Directive insisted on the necessity for the Directive to be subject to two conditions, namely that (a) it is a framework, Lamfalussy-type, Directive dealing only with high-level principles, as proposed by the Commission, and that (b) it is tested against a cost-benefit analysis or regulatory impact assessment.

On the first point, an interesting comment was made by a system of central banks. They agreed that the Directive should set-up high-level principles to be concretised by level two implementing measures, in line with the four-level approach embodied in the "Lamfalussy procedure", but they remarked that within the current comitology structure, no group or committee comprises representatives of both securities commissions and central banks. However, any group or committee that will be mandated to define the level two implementing measures on this area will require the combined efforts of securities commissions and central banks. For this reason, they suggested as a possible solution that a joint mandate could be given to the ESCB and the CESR.

On the issue of the regulatory impact assessment, the authorities of one Member State also requested the Commission to evaluate any market and/or regulatory failures before proposing a clearing and settlement Directive. It was also not a surprise that respondents who adopted a negative view on the Directive have also requested that the Commission conducts an impact assessment before finally deciding on this issue.

Suffice it to say that since the publication of the Communication, the Commission has clearly indicated that it is committed to preparing a regulatory impact assessment before deciding on a formal proposal for a clearing and settlement Directive⁵. Indeed the whole of 2005 will be

⁵ For example, please refer to the CESAME group 2nd synthesis report at http://europa.eu.int/comm/internal_market/financial-markets/clearing/cesame_en.htm

taken up for that purpose. The issue of market and regulatory failures will also be part of the overall assessment conducted by the Commission.

Two respondents representing a silo and a national supervisory authority felt that although a Directive is necessary, it might be preferable to amend the newly adopted MiFID, even extensively, rather than introducing a totally new piece of legislation.

However, respondents' opinions differ as to the possible contents of a future Directive.

The majority of supporters of a Directive agreed with the initial assessment of the Commission that governance rules should also be included in the Directive, in addition to access rights and a regulatory and supervisory framework. Another strand of responses maintained that the Directive should usefully tackle only access rights and a common regulatory and supervisory framework. The combined effect of these two groups of responses, which represent the great majority of the proponents of a Directive, is that (a) access rights and (b) a common regulatory and supervisory framework are considered to be indispensable elements of any future Directive.

A couple of respondents suggested that the Directive should simply provide for a common regulatory and supervisory framework; rights of access and choice should be addressed through the use of existing mechanisms and particularly the implementation work of the Directive on Markets and Financial Instruments.

A number of respondents suggested additional contents for the Directive. Thus, a number of banks, banking associations and Member States authorities wanted the Directive to introduce additional structural measures, such as a clear separation of "banking" and "infrastructure" activities. Another respondent wanted the Directive also to address the legal and the fiscal compliance issues which it considered as the most important areas where the EU can proceed effectively and produce real efficiency. Some of these comments will be discussed at more length further below.

Finally, a few respondents suggested that the Directive should not cover certain functions/activities, such as confirmation and matching, collateral management (except for CCPs) and asset servicing (when provided by banks), while another respondent wanted the assurance that the Directive will cover both domestic and cross-border activities.

On this last point, it is worthwhile to remind that the Commission has never suggested that a future Directive, if any, should operate such distinction.

As already mentioned, six respondents mainly investment banks and their associations felt that a Directive is not really necessary. Their arguments can be summarised as follows. Generally, the case for legislation has not been adequately made as yet. In addition, the costs of adopting an appropriate text (namely the period of regulatory uncertainty, the risk of sub-optimal political compromises, the costs of compliance with inappropriate legislation and the diversion of resources and management time), clearly outweigh any expected benefits. Others fear that there is a danger that new legislation may damage current efficient structures (e.g., the Eurobonds markets).

Seven other respondents including a Member State authority, 2 silos, a CSD and an issuer association, expressed a rather negative view as to the necessity for a Directive, without however rejecting it outright.

An issue that was raised by a great number of respondents was the relationship of any future Directive with the recently adopted ESCB/CESR standards on clearing and settlement. For some respondents, mainly representing infrastructure service providers, the Directive should be consistent with the ESCB/CESR standards. A national authority noted the non-binding character of these standards and welcomed the Commission's initiative as a way to provide certainty in the market. A greater number of responses, however, mainly banks and their associations were opposed to the ESCB/CESR standards being adopted before the Directive. They suggested that ESCB/CESR work should be put on hold until the major policy issues have been decided at the legislative level and then move with their adoption.

The Commission has followed, as an observer, the ESCB/CESR work to draft these standards. However, the adoption of any standards by national regulators and central banks will not put into question or institutionally constrain in any way the legislative responsibilities of the EU institutions. In this respect, the main policy decisions which might be enshrined in any future level 1 measure (i.e., in a Directive to be proposed by the Commission and adopted by the European Parliament and the Council) or any level II measures, will take precedence over any existing standards. In case of discrepancies, the affected standards would have therefore to be adapted, or even repealed, as appropriate.

As regards the relevance of the US model for the development of the EU markets on clearing and settlement, the consultation demonstrated that very few respondents propose or express a wish for the establishment of a single European CSD which would operate as a credit-risk free utility, similar to the DTCC. However, a substantial number of respondents (mainly individual custodian banks and their associations) suggest that, while it will be very difficult to introduce a single CSD in the EU, certain aspects of the US system, namely the utility nature of CSDs and/or their credit-risk free operation, should be introduced in any EU legislation on securities clearing and settlement.

An important number of respondents, on the contrary, clearly manifested their opposition to the transposition of the US model, or any of its components, to Europe. There are various statements in support of that position, such as that the EU should not introduce a monopolistic supplier of CCP and/or SSS services, it should not prevent certain entities from providing specific clearing and settlement services, nor should it impose a specific type of clearing and settlement operation (utility model).

Some other respondents simply suggested studying the US model with a view to consider the mandatory use of central bank money for settlement and the operation of credit risk-free CSDs. Others, although they also agreed in principle on the relevance of such a study, warned the Commission that this should not distract too many resources away from the most pressing need of removing the Giovannini barriers. An association of infrastructure providers suggested that, in any event, it might be useful to identify which conditions have allowed the unification of the infrastructures in the US (especially the legal environment) and then to find out whether those conditions are attainable in the EU.

4.2 *Rights of access and choice*

Commission position: Clearing and settlement service providers should enjoy effective freedom of access to, and choice of, their preferred clearing and settlement location on non-discriminatory terms. Existing EU legislation (e.g., the MiFID) already provides for certain rights of access and choice in that area mainly for markets and intermediaries. These rules, however, do not provide for rights of the CSDs and CCPs to access other systems and the conditions for exercising them. The Commission proposed to cover that gap by introducing such rights of access and choice in a future Directive so that, at the end, a coherent set of rights applicable throughout the whole chain of clearing and settlement service providers exist in the EU.

However, the Commission expressly mentioned in its Communication that access rights for the benefit of CCPs and CSDs will not imply that these entities should be obliged to request and maintain access to (all) other systems. If that were the case, the Commission would be imposing a specific market structure in the area of clearing and settlement, namely the spaghetti model, which goes against its stated intentions and objectives.

The absence of an obligation to exercise the right of access, as suggested by the Commission, necessarily affects the nature and the conditions for the exercise of the corresponding rights of choice. The right of choice could be exercised only when access is available, i.e., only when the right of access has been exercised by the entities concerned.

Comments received:

The comments received by the Commission on this issue fall within 2 broad categories, namely (a) the policy itself, and (b) the conditions for the establishment and the exercise of the rights of access and choice.

The policy elements

There were three main issues raised by respondents when discussing generally the Commission policy on access and choice. The first type of comments questioned the desirability of the policy itself. The second type of comments concentrated on the perceived lack of clarity as to the entities/functions these rights will be addressed to. Finally, some respondents expressed concerns on the implications that rights of choice may have for the markets and market participants. These will be considered in turn.

As to the *policy* itself, the majority of respondents were in favor. Respondents agreed with the Commission that rights of access should be as comprehensive as possible and that they should complement the relevant rights provided for under the MiFID.

As regards the method for implementing that policy, an interesting comment was made by two respondents who preferred a modification of the MiFID, even extensively, rather than the adoption of a clearing and settlement Directive. One respondent was also of the opinion that rights of access should only be offered to providers and participants within the EU.

A response from two national authorities focused on a particular issue on granting access; they wanted to ensure that the Commission policy will allow infrastructures to cooperate with each other and provide access to their respective participants through a common platform.

A number of responses drew the attention of the Commission to certain risks that this policy might entail; they invited the Commission to address them properly. For instance, a banking institution remarked that free access to other markets should be implemented in such a way as not create new operational risks or endanger the reliable function of clearing and settlement systems. The same respondent also stressed the practical barriers in the cash-side of securities settlement (i.e., access to central bank money) which, if not tackled, will also affect the exercise of the access rights.

As regards the effects that this policy will have on the competitive environment, some respondents stated that rights of access and choice will bring greater competition between the providers of clearing and settlement systems which would enhance efficiency. A banking institution also remarked that CSD-to-CSD open access and choice will frustrate potentially dominant positions as the exercise of rights of choice by participants to switch provider will reduce the potential for any overcharging.

However, for some other respondents representing issuers and market professionals the approach consisting in “give access to everyone, for everything, anywhere” is questionable per se. According to this line of thought, providing access to all infrastructures would entail colossal costs and will be too long to put in place. In view of that, only the biggest infrastructures will be able to do it and this will increase concentration. At the same time, this policy will also raise serious competition issues between CSDs and their participants. In fact, the CSDs concerned enjoy network effects that no intermediary can hope to achieve. As a consequence, the access policy at the level of infrastructure pushes towards an oligopolistic market. For this reason, the model to be pursued has to be detailed first before actually taking any such far reaching policy decisions.

Another respondent worried that granting rights of access for SSSs and CCPs at European level could lead to undesirable consequences especially if CSDs use such rights to establish links without reference to the business case to them. Such links should therefore be governed by commercial considerations.

This last comment demonstrates a possible misunderstanding of the Commission position as expressed in its Communication. The Commission proposes the introduction of rights and not of obligations, a policy which is consistent with the approach of the MiFID. In that respect, the request of a given entity, e.g. a CSD, for access to another CSD will obviously depend on commercial considerations and the business case of the requesting entity.

The *lack of clarity* as to the addressees of the rights of access has been raised by a number of respondents. Some of them considered that the Commission did not clearly state which institutions/persons will receive these rights. On that issue, it was also suggested that access rights should be defined with regard to functions or specific services rather than aiming at institutions.

Another respondent considered that access rights should refer to the right to hold a membership/member account or designation within a settlement system. Access to such memberships or accounts should not be restricted by law or regulation.

Other respondents asked that direct participation in the infrastructure should be ensured even for smaller players.

A consistent number of respondents raised the issue of the *right of choice*. A number of respondents stressed the importance of providing for the broadest possible access of intermediaries and markets to clearing and settlement systems, and the ability of allowing them to choose the location of settlement.

Some respondents were worried, however, that the effective exercise by intermediaries and by retail and wholesale investors of a right of choice will oblige clearing and settlement service providers to provide access to other systems irrespective of any objective business and cost considerations. They indicated that if the Commission intends to provide a right to intermediaries and investors to use the clearing and settlement system of their choice, this would imply that the intermediating institutions would have to maintain and offer to their clients several routes for clearing and settlement, even against their business plans. This would imply heavy costs and is not an appropriate solution in the EU context.

The right of choice is to be available to whoever has a right to access a system, but not to its clients. As is already mentioned, the right of choice could then be exercised only when access is effectively available, i.e., only when access has effectively been exercised by all the entities concerned. Thus a market participant may exercise its right to choose between the clearing and settlement locations it has access to, provided also that all the necessary links are in place and operational.

Conditions of access

All respondents agreed that the conditions for access to infrastructure providers should be (a) non-discriminatory and (b) transparent.

However, a multitude of views was expressed as to how these two general and widely accepted principles should be translated into practice.

For some respondents, conditions of access to CCPs and CSDs should only be risk-based. Others were more flexible. Thus, limitation of access on objectively justifiable grounds (including risk-related grounds), consistent with applicable competition law rules, in order to assure the safety and soundness of the system has been suggested by a number of respondents.

Some respondents argued that refusal of access should be allowed also for commercial reasons. Close to this argument, a participant stated that there needs to be a balance between the rights of access and the commercial policy of the entities to which access is requested. Another respondent felt that these rights should be examined on a case-by case basis regarding their technical feasibility, legal framework and commercial viability. Market demand and commercial criteria should be decisive with regard to the establishment and maintenance of links.

A respondent suggested that, in general, access requirements should be harmonised, with a view to prevent system operators from imposing additional requirements and thus recreating unequal conditions of access. However, these issues should be solved at level 2 and only certain general principles should be included in the level 1 Directive.

The practical aspects of the implementation of the access rights and the grounds for refusal were also discussed. Thus, a respondent was of the opinion that grounds of refusal have

allowed abusive denials of access in the past. For this reason it suggested that although the grounds for refusal should be limited, they should also be subject to oversight by the appropriate authorities. Close to these considerations, a respondent warned that it is one thing to have a right of access and another thing to give it commercial reality. For this reason it proposed that consideration should be given to the provision of a quick, cheap mechanism for resolving access disputes.

Another respondent discussed the connected issue of equivalent treatment. It stated that any Directive should ensure that where identical access is not possible (e.g., because different participants have different costs - e.g., for technical reasons - in different situations) equivalent access should be achieved on the basis of a reasonableness test.

Another respondent raised the issue of the differing dimensions of participants. It agrees with the need for transparent and non-discriminatory access rules based on objective criteria but warns against discriminations simply on the basis of the participants' sizes; exclusions merely on the basis of size should therefore be prohibited. As a corollary to that, it also suggests that any access rules aimed at establishing maximum acceptable risk levels should be formulated in terms of ratios of capital to risk rather than of absolute amounts of capital.

A number of respondents also focused on the differences between CSDs and CCPs in that context. They suggested that access by CCPs to other CCPs would require individualised considerations concerning the degree of access and the eligible products. Another participant also discussed the particularities of CCP access to each other and links between CCPs. It considered that although access of a CCP to another as a general clearing member should be covered in the Directive, the question of links between them raises completely different issues (e.g., linking different risk management methods or harmonising admission requirements) and should not therefore be enforceable on a regulatory basis. It should be left out of the scope of the Directive.

4.3 Functional approach

Commission position: In line with the work undertaken by the CPSS-IOSCO and the ESCB/CESR in this area, any future Directive should be based on a risk-based functional approach, i.e., the same activities are subject to the same regulatory treatment, provided the risk is the same. This will ensure consistency of action and avoidance of regulatory conflicts.

This approach entails two distinct steps, namely the definition of the functions/activities and the analysis of risks. The definitions to be developed should be based on appropriate segments of the value chain and not on the “intermediary” or “infrastructure” status of the service provider. However, the “intermediary – infrastructure” dichotomy will be important as a proxy for deriving the level of risk associated to the different functions and in order to deal with two other issues, namely the selective imposition of certain **governance** requirements (they will only apply to infrastructures) and **access** (intermediaries and infrastructures have rights of access while only infrastructures have obligations in relation to access).

The Commission also considered that the degree of detail in the definition of functions will depend on how the different activities relate to the prudential and investor protection requirements that will be considered appropriate, in particular with respect to the various categories of risk – credit risk, operational risk, custody risk, etc – that such requirements are intended to tackle.

Comments received:

The various respondents commented on the functional approach as such, on the risk considerations and on the definitions to be used.

Most of the respondents agree with a functional approach to regulation. However, their views as to the exact contents of such an approach differ.

For a category of respondents, any legal framework should be based on a *pure functional approach* which takes no risk considerations into account. In essence under this approach “same activity” equals “same regulation” so that any legislative requirement will apply similarly to all institutions performing the same function irrespective of any risk related considerations. A respondent agreeing with the adoption of a pure functional approach also considered that the only functions that need be defined are simply “clearing” and “settlement”.

The second, and most numerous, category of respondents agreed with the Commission that the *functional approach* should be *risk-based*. It was felt that all entities performing a common function or activity should not be regulated in exactly the same manner, subject to identical detailed obligations. The functional approach should take account of the risk profile of entities concerned and the competitive environment in which they operate.

In that context it was suggested that the Commission should not only consider risks in isolation but that it should also assess the combination of different risks or that the Commission should take into account the overall risk impact of the entity carrying out the function before determining the type of regulation necessary. The Commission was warned, however, not to lock together specific combinations of activities and entities in a way which would reduce levels of innovation

In any event, within this family of responses several variations were discernible with respect to the effect that the “intermediary-infrastructure” dichotomy might have on this approach.

A number of these respondents approve a risk-based functional approach while considering that the “intermediaries-infrastructure” issue is a contradiction to the approach and detrimental to the markets. Two respondents even remarked that the irrelevance of this dichotomy in this context is further demonstrated by the Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary of December 2002 which treats both CSDs and banks as intermediaries.

Another category of respondents remarked, however, that in order to implement a risk-based functional regulation, the risks arising from a particular institution undertaking a particular activity should be assessed. In that context, the dichotomy between intermediaries and infrastructure providers is relevant; it helps to derive the level of risk associated with the performance of functions since if, and only if, the same risks are faced by different institutions does a risk based functional approach require that the same regulation be imposed on different institutions.

On the same line of thought, some respondents stated that a functional approach cannot work in isolation and that, in some cases, it has to be combined or overlaid with an institutional

approach, as certain functions are currently subject to different regulation depending on the institutional status of the entity that performs them.

These arguments ultimately raise the question whether a risk-based functional approach where “institutions are relevant” could be transformed into an institutional approach. Even if institutions are relevant in terms of risk, would that justify different definitions of the same activity?

Finally, for a small number of respondents, a straightforward *institutional approach* is preferable. Thus, respondents suggested that CSDs and CCPs should be subject to institutional regulation. For this line of thought, the dichotomy between intermediaries and infrastructures should serve as the basis to identify the status of these entities, to apply to them the relevant body of rules and eventually to submit them to the competent supervisor. These entities, namely CSDs and CCPs, should therefore be single purpose entities providing functions on a reserved basis.

Irrespective of the positions expressed in relation to the functional approach as such, the majority of respondents recognised *the importance of definitions* in any future legislative framework.

A great number of respondents expressed reservations on the definitions used by the Commission in its Communication. A central bank even noted that while the Communication adheres to the functional approach, the definitions it uses seem to suggest a more institutional approach.

A number of respondents provided their own views and proposals on definitions but no single set dominates the responses. The present document will not provide a synthesis of the definitional variations provided by the respondents. Certain general trends/points, however, need to be mentioned.

A consistent number of respondents, representing all types of entities, called the Commission to rely on definitions/glossaries already compiled and used in other fora, e.g., by CPSS-IOSCO and ESCB/CESR, either in their integrality or as a starting point for the development of more precise definitions.

Those who adopt a more institutional approach argue, as a consequence, for the necessity to apply in the definitions the distinction between the function of intermediaries and infrastructures or between entities whose main function is to assume banking risk and those who should not assume such a risk. The distinction between core and non-core or value-added activities will also need to be reflected according to the same type of approach.

Others were totally opposed to such differentiation. The argument was made that one should not be overly prescriptive in defining functions, or to distinguish "basic" from "value-added" services. In essence, this discussion closely follows the lines between the entities which would like the functional approach to adopt a strong institutional flavor and their opponents.

On a different line, a consistent number of respondents suggested that there is a need to distinguish between CCP activities and other clearing and settlement activities, mainly on the grounds that the risk profile of the CCP activities are different.

4.4 Initial and on-going prudential and investor protection requirements

Commission position: In order for securities clearing and settlement systems to be able to provide services freely in other Member States it is necessary to establish a new legislative framework. At the same time, a number of entities involved in the provision of these services represent an important source of counterparty and systemic risk to other market participants. For these reasons, the Commission considered it necessary to propose the establishment of common initial and on-going prudential and investor protection requirements with a view to achieving mutual recognition of systems within the framework of the internal financial market.

Comments received:

As a general point, a number of respondents acknowledged that a policy initiative based on harmonised minimum standards and mutual recognition in this field is essential. However, one of them would be concerned if the effort in producing such harmonisation and mutual recognition of systems, which would require considerable time and legislative effort, would ultimately delay the implementation of comprehensive rights of access which are considered as more important.

In adopting the position it expressed in its Communication, the Commission considered not only the benefits of establishing a common regulatory or supervisory framework as such, but also the fact that the provision of rights of access may not be effective without such a framework.

The most hotly debated issue was the question on whether the proposed legislative framework should allow CSDs/SSSs to incur **financial risk** at all and, if they do, whether they should be obliged to **legally separate** the entity incurring such risk.

Views were polarised on this issue. For a great number of respondents, mainly banks, issuer associations and some Member States authorities, any future EU legislation should provide that CSDs and SSSs do not engage in financial risk taking activities. In addition, it was argued that if a CSD is part of the same corporate group as a credit institution, custodian or any other entity authorised to take banking risks, there should be a strict segregation between these entities. In addition, the relationship within the group between the CSD and the entity authorised to take banking risks cannot be a parent/subsidiary relationship; the two entities must be sister companies.

The reasons put forward by these respondents in support of their arguments relate to the systemic importance of these institutions and on competition law considerations. In that context, a number of respondents refuted the adequacy of less intrusive measures, such as the ones proposed by the Commission in its Communication. Thus it was said that accounting separation and Chinese walls cannot guarantee financial stability. For this reason, the legal segregation of the entities carrying out activities involving risks of different nature should be imposed.

Other respondents simply asked the Commission to explore ways to promote, but not to impose, a credit-risk-free infrastructure so that investors and collateral takers should not have to carry any material risks that would add to the original investment risk they have undertaken.

As was to be expected, a number of respondents were totally opposed to the imposition or promotion of credit-risk free infrastructures. These were mainly representatives of the infrastructure service providers and some other Member states authorities. Various arguments were advanced in support of this position. For instance, an association of infrastructure service providers interestingly remarked that the adoption of real time gross settlement systems in most European CSDs has increased the need for the operator of the settlement system to provide additional settlement liquidity (i.e., offer short term credit – securities lending facilities) to avoid “gridlock situations”. For this reason they felt that CSDs should not be restricted from expanding their services into settlement related banking activities, if the resultant risks are controlled within the framework proposed by the ESCB/CESR standards.

Others considered that CSDs should be allowed to incur a low level of credit risk, properly managed and totally covered. A system of central banks commented that it is essential to ensure both the neutrality principle as expressed by the Commission (namely that it will refrain from proposing or imposing any separation of the intermediary and banking activities eventually offered by CSDs) and the need for appropriate safeguards in order to address public policy concerns, in particular the need to maintain and protect financial stability. In this respect, it should be ensured, at a minimum, that risks are properly addressed.

Another issue that provoked a number of comments was the existing divergence on whether infrastructure services providers in the various Member States may obtain, or not, a **banking licence**. This was considered by a number of respondents as an issue of level playing field that needs to be addressed in any future legislative framework.

A respondent, a silo, remarked that the Commission expressed no need to segregate banking activities at this stage but that nothing was said about the possibility for CSDs that are not banks to perform banking functions. The respondent in question suggested that CSDs should not be prevented from turning into banks and that the CSDs decision to offer additional services should be based on business considerations and not by ex-ante decisions of the authorities. However, when a CSD wants to perform activities entailing credit risk, it should be subjected to appropriate regulations (e.g., Basel II).

In the same vein, an association of banking institutions felt that each firm providing clearing and settlement and custody services should be able to obtain a banking licence. But if such entities choose not to obtain a banking licence, they should not be entitled to offer banking services in the context of clearing and settlement.

Another respondent (a silo) wanted to ensure that, in any case, all institutions involved in the clearing and settlement sector and which already operate under a banking licence will be able to retain their banking status in post-trade markets. This suggestion appears to militate for the introduction of a “grandfathering” clause, in all events.

In their submission, two national authorities discussed the concept of **limited purpose banks**. They reminded that in cases where CSDs settle the cash leg of a securities transaction on their books, they extend credit which is limited to settlement and asset services related activities only. It was argued that with this limitation, the settlement function could not be endangered by risks that might stem from other banking activities. These respondents invited the Commission to analyse further this concept, for which at present there is no legal basis in the “acquis communautaire” for a possible use in the new EU framework.

Another related argument was that CSDs, whether or not licensed as banks, should be subject to **stricter requirements** than those applicable to banks. For these respondents, all CSDs, because of their systemic relevance, regardless of their specific legal status, should be submitted to the same set of prudential rules for the specific risks implicit in securities settlement - they should limit their credit activity to the provision of facilities and services which are necessary for the smooth functioning of the securities settlement; they should also fully cover their credit exposures (by means of collateralisation, immunisation or provision of free capital).

The question as to whether CSDs should be obliged to settle in **central bank money** also received differing responses. An important number of respondents consider a necessary requirement for the EU environment that CSDs should rely on central banks to act as cash settlement agents. A respondent introduced some temporal flexibility in this requirement. He suggested that CSDs and ICSDs are to be required to settle in central bank money after a reasonable period.

Another group of respondents, however, agreed with the position adopted by the Commission in its Communication. Thus a system of central banks welcomed the fact that the Commission considers that securities settlement systems settling in commercial bank money should at least provide a choice for their participants to settle in central bank money. A related view was expressed by other respondents who agreed that CSDs should give their participants the option to settle in central or commercial bank money, which should work alongside each other rather than being exclusive.

A respondent from the CSD community remarked that although settlement in central bank money is an essential risk reduction measure for the European securities markets, it can only be mandated by the authorities for the EU currency zone. The choice of commercial bank money remains essential for settlement in the wide range of non-European currencies that are settled in certain CSDs and ICSDs in Europe and for those clients that are unable to access central bank funds. This was echoed by a silo which remarked that unless the rules of the Eurosystem are changed and full multi-currency interoperability with non-European central banks is achieved, it should be recognised that commercial bank money remains a viable and essential means of settling cross-border transactions.

Another issue that was raised by some respondents, mainly banks and their associations was that CSD and SSSs should also be prohibited from providing **intermediation services** to their participants, in competition with them. Some of the respondents remarked that this suggestion mirrors the current situation in most Member States and in the US.

As regards **CCPs**, it was remarked by an association of CCPs that within the EU the authorisation or regulatory status of CCPs varies, ranging from a credit institution through many special clearing house recognitions. Thus, there is no CCP passport within Europe yet. This respondent concluded by stating that this omission should be rectified.

The possible repercussion of a future legislative framework on **custodian banks** was also extensively commented by the respondents. An association of banking institutions argued that custodian banks should not be subject to any clearing and settlement Directive requirements. The association stressed that no analysis has been made as to why custody and related

activities of commercial banks need a new regulatory framework, appropriate for clearing and settlement systems.

In any event, other respondents requested that the Commission should consider whether risks borne by banks are already covered under the existing banking Directives, so as to avoid over- or double-regulation. Thus it was felt that care should be had to the fact that where participants are already well regulated, they should not need to meet further regulations unless the new requirements (a) mitigate risks not dealt with elsewhere, (b) are justified on a cost/benefit grounds and (c) are consistent with those already in place.

A related issue was the Commission's suggestion that the future legislative framework should provide for **capital adequacy requirements**. The establishment of appropriate initial and on-going capital adequacy requirements would be based on the level of risk associated with the relevant functions.

Some of the respondents support the idea of establishing a full set of such initial and on-going capital requirements.

A number of respondents, including Member state authorities, associations of markets etc., provided strong support for the introduction of capital adequacy requirements. For some respondents capital requirements cannot be derived from the capital adequacy Directive, as this does not take into account certain relevant issues such as intraday credit exposures. In that respect it was argued that risk based capital adequacy requirements should apply to users of custody and settlement service providers. However, it was remarked that in setting capital requirements for custody and settlement, the legislators will face practical difficulties in quantifying risk.

An infrastructure service provider felt that the basis for the calculation of capital adequacy requirements for clearing and settlement must be thoroughly studied and discussed. He suggested that this task should be entrusted to one of the expert groups to be set up by the Commission.

It was also remarked by another respondent that the risk profiles of CSDs across Europe vary considerably as do the means by which they mitigate such risks. CSDs that have a banking licence must meet banking capital adequacy requirements, while others are required to hold the equivalent of a number of months operating expenses. The variety of services offered and risk profiles mean that constructing a comprehensive capital adequacy regime for all CSDs will be complex and time consuming. The same respondent suggested a possible extension of the Basel II regime to those settlement service providers that are not licensed as banks.

A silo expressly made the link of capital adequacy requirements with the issue of prohibition on CSDs to take any credit-risk. It indicated that determining a capital adequacy requirement surely requires investigation of the concrete risks faced by different CSDs. Thus, establishing a risk-based capital adequacy should be sufficient to cover CSDs from credit risk without forcing them to avoid it.

A banking institution considered that in managing the systemic risks arising from the operations of a settlement institution, it may be more important to ensure appropriate backup and redundancy facilities for the institution than to require that it hold an appropriate amount

of capital, unless it is also a bank that engages in lending of cash and securities, in which case the Basel II capital rules will be applicable.

The differences of the systemic risks associated with operating a CCP and with operating a CSD was also raised in this context and need to be taken into account when devising any capital adequacy requirements for CCPs. A respondent was concerned with the current approach to capital requirements for CCPs, including the coverage of unmargined market risk using default or clearing funds. It was also concerned that regulators have not adopted to date a consistent approach to the capital treatment (risk weightings and definitions) of centrally cleared positions in various products and would urge that the opportunity is taken to ensure consistency.

An association of CCPs added that any assessment of a CCP's financial resources requires a holistic approach based on the totality of its financial resources, including any participant's collateral that may be used to offset CCP's losses arising from a default. There is a direct inter-dependence between collateral, defence lines as well as risk management and maintaining sufficient financial resources for possible losses in the largest exposure accompanied by complex economic trade-offs.

A number of respondents, including member states authorities, banking institutions, etc., disagreed however with the introduction of capital adequacy requirements. One respondent felt that the intention to eliminate all disparities as regards capital requirements between service providers licensed as banks and those that are not should not be followed. Another one disagreed because he felt that available supervisory instruments are sufficient.

Finally, a number of central banks remarked that the Communication underestimated their **oversight responsibilities** in this field. They stated that oversight arises from the need to prevent systemic risks from materialising and supports the conduct of monetary policy, as securities settlement systems are central to its transmission mechanism.

4.5 Supervisory cooperation

Commission position: In its Communication the Commission expressed the view that the introduction of comprehensive access rights, the removal of existing barriers to cross-border clearing and settlement and the introduction of a common regulatory framework are likely to bring about a greater degree of integration and consolidation in the *Clearing and Settlement* industry. For this reason, the regulatory framework needs to incorporate a model for supervisory co-operation, to avoid Securities Clearing and Settlement Systems operating cross-border being subject to the supervision of multiple supervisors, which would increase the cost of regulation and its complexity. The Communication suggested the adoption of the home country principle but also the need to take into account the specificities of clearing and settlement systems

Comments received:

Market participants by and large agree with the introduction of the home country principle. One of the supporters of this principle added that the host Member States should not be permitted to apply additional requirements to incoming service providers.

Some market participants proposed however the adoption of a model based on the concept of lead regulator. They argued that it could add significant value to the supervisory process if the primary responsibility for supervision of the group providing services cross-border were confined to one of the regulators in question (the so-called concept of a "lead regulator"). They also stressed the importance of the cross-border supervisory arrangements in the context of the regulatory impact assessment.

Public authorities and central banks, on the other hand, although they recognize the need for greater cooperation, substantially disagree with the home country principle. Instead they promote a more flexible approach to cooperation. They stress the importance of taking into account the systemic risk concerns of the host country; thus the host country authorities should have more competences on entities located in other Member States.

In this context it has been argued that while generally supporting the establishment of a common framework for the co-operation among national authorities, the new environment requires an explicit provision making it clear that the supervisory authority of a clearing and settlement system is committed to co-operate, by means of exchange of information, with the other relevant supervisory authorities having a legitimate interest in the operations of that system, in particular those authorities having supervisory responsibilities over intermediaries/markets/ infrastructures participating in, or being linked to, the system.

Another respondent felt that rules for cooperation between relevant authorities have mostly been established via MoUs, which are voluntary but legally unbinding commitments to joint action or joint decision making. It objects to the adoption of a cooperation based on the home country model and invite the Commission to seek novel solutions that take into account the fact that (a) a system may be systemically important in the host country and not in its home country, and (b) that it may also overly burden the resources of the home authorities. They also suggest that flexibility should be recognised since each institutional case may need different solutions ("one size fit all" -approach is not likely to be a viable solution). They also suggest that host responsibilities should include analysis of legal differences, the systemic importance of systems, their liquidity impacts, system governance arrangements, transparency and operational risks. They also suggest that the coordinating supervisor and overseer both need to be from the same country.

4.6 Governance

Commission position: The Commission felt that governance rules are an important complement of its approach. The Communication distinguished between two types of governance measures that might be usefully introduced in the future EU regulatory framework for clearing and settlement and which address different issues. These measures are independent on any particular governance structures that these entities might have adopted, i.e., for profit companies, or user owned/user governed.

First the Commission proposed the adoption of certain general governance measures for SSSs and CCPs which should mirror the equivalent requirements imposed on listed companies, banks and investment firms. These requirements include disclosure ones, e.g., shareholding levels, managers' salaries and incentive schemes etc, and control ones, such as the establishment of audit committees to deal with issues concerning risk-management policies, accounting, etc.

The Commission took also into account the fact that SSSs may compete with their participants in the provision of “intermediation” and “banking” services for settlement. For this reason, the Commission proposed that additional governance measures be introduced for SSSs and CCPs to increase transparency in the accounts and flexibility in the offering of services to their clients. The Commission proposed therefore that these entities should provide for accounting separation and unbundling of services.

Comments received:

On the *general corporate governance* issues, the picture is not very clear-cut. Banks mostly agree. Some of them even suggest that the measures proposed by the Commission, supplemented by the feedback during the consultation process, should be applied, as best practices, even before the adoption of the Directive.

Some of them, however, while agreeing in general, they make specific proposals or express reservations on particular issues.

The first important issue raised by respondents is the consistency of the Commission proposals on clearing and settlement with its wider policy on corporate governance. It was suggested that any principles and proposals should be consistent with the results of the Commission recent corporate governance action plan. Certain respondents even felt that the Commission action plan on corporate governance is sufficient; there is no need to adopt additional measures.

Authorities from a Member State raised the issue of the appropriate level of regulation. It was suggested that detailed corporate governance requirements should not be part of a Level 1 Directive, but, instead, they should be developed as level 2 measures. But even at level 2, there needs to be a degree of flexibility to ensure that arrangements are tailored to the circumstances of individual entities. Prescriptive detail will not be helpful.

An infrastructure provider felt that clearing and settlement systems already are subject to corporate governance requirements, as regards owners, group structure, composition of the board of directors etc. If, however, the Commission decides to propose the introduction of specific governance measures, they should be modeled upon the ones included in the MiFID (Articles 37 and 38).

A silo was concerned on the differential treatment between listed and non-listed entities in that area. It remarked service providers in the post-trade area which are listed companies already comply with such requirement. This is not the case with non-listed companies. For this reason it suggested that the corporate governance provisions normally applicable to listed companies could be made mandatory to non-listed ones in order to create a harmonised level of transparency and governance between service providers in the post-trade industry.

Another respondent mentioned that some SSSs are part of companies that are listed in regulated markets and are therefore subject to strict corporate governance arrangements already. Care therefore should be exercised had as to avoid the risk of overlapping regulation.

For a national association of banks, the Commission should consider imposing ownership caps to infrastructure service providers and to promote cooperative, not-for-profit governance arrangements.

On this latter point, a number of respondents expressed their views. The discussion centered on whether infrastructure service providers should be utilities or for-profit organisations.

A number of respondents were in favour of utility type of infrastructures. Other respondents, although sympathetic to the overall argument, declared that the creation of a small number of not-for-profit utility type, user owned and governed CSDs that should be risk remote should be industry-led and not politically driven.

On the contrary, other respondents, including infrastructure providers and Member State authorities, reject any Directive that would seek to or which in practice would tend to impose utility status on CCPs and/or CSDs.

Respondents also made comments on particular aspects of the Commission's suggestions. Most of them relate to the role of the independent directors and the audit committees.

An association of banks considered that the issue of independent Committees needs further evaluation and that the definition of "independence" needs to take into account the highly technical nature of the sector. It was also felt that the possibility of outsourcing certain tasks of the Committee would need to be made clearer.

Another bank objected to the fact that user owned SSSs and CCPs should be obliged to have Committees composed of a majority of independent directors as well as the fact that the board of directors should be composed of independent individuals to the extent that representatives of major users would not be considered as independent. It proposed therefore to adopt not an "independence-in appearance" principle but an "independence-in-mind" principle, which would mean that directors and members of committees would be obliged to decide in the best interest of the respective company. For for-profit entities, the same respondent proposed that they should be only put under specific governance requirements relating to clearing and settlement to the extent that they provide monopoly-like services. It also opposed to any extension of specific governance requirements to intermediaries for clearing and settlement activities.

These arguments echoed the position taken by infrastructure service providers who objected to the suggestion that independent directors should be a majority. They remarked that although in user-owned/user-governed entities there is value in having a number of directors who are not affiliated to the users, their number should be limited in order for the entity to give true value to the concept of governance by users. For this respondent, a more helpful approach would be to require all non-executives to be independent of management and free from any business or other relationship that could materially interfere with the exercise of their independent judgment.

It was also remarked that that the audit Committee should not automatically be entrusted with the management of conflict of interests. It should be left to the board of the entity concerned to decide to which Committee to delegate this responsibility.

An infrastructure provider raised the issue of independent audit Committees in consolidated groups' structures. They question whether independent committee members should always be on the level of the SSS or CCP. They propose that the independent members should be at the

group level board while the boards of the subsidiaries should be composed by executive members.

An association of listed companies considered governance rules as very important but invited the Commission to consider and promote also the interests of the issuers and not only of the intermediaries. For instance, existing "user owned-user governed" entities exclude from their board the issuers, in spite of the fact that issuers were actively participating in the governance of CSDs before they were acquired by these entities.

On the other hand, a number of respondents disagree with the adoption of corporate governance measures for clearing and settlement organisations in a Directive. One of the arguments used is that no such principles have been imposed on exchanges or payment systems and that no differentiation seems to be necessary for clearing and settlement organisations. Some of these respondents added, however, that if governance measures are introduced they should not promote or define the form of governance structure and should have sufficient flexibility for reasonable interpretation.

As regards the issue of ***accounting separation and unbundling of services*** the respondents were divided, as expected; banks mostly agree while CSDs, CCPs and vertically integrated entities disagree. From the remainder, the exchanges which do not belong to any vertical silo mostly agree, governments are split while a few securities regulators are in favor.

For a number of respondents the active implementation of existing competition law will be sufficient to address any anticompetitive behaviour that might be adopted by an entity in a monopoly situation. Ex-ante governance rules are therefore not necessary. In arguing that position and stressing the inappropriateness of any additional measures at this stage, a number of points were made by those respondents.

The first series of points centre on the lack of careful consideration by the Commission of the basis on which these rules could be applied. The vagueness of the Commission definitions between what might constitute "core" and "added value" services especially in view of different practices in Member States was put forward by an association of infrastructure service providers. Under that type of argument, the distinction between "core" and "value-added" services is misguided and inappropriate.

It was also mentioned that the Commission suggestion is based on a misunderstanding of the contestability of the core services. In fact, according to that argument, the Commission erroneously consider that certain types of services offered by SSSs are in a monopoly situation. Thus, the idea of SSSs/CCPs having a dominant position is not theoretically founded. The Commission fails to recognise or underestimates the role agent banks have in internalising settlement. In addition, looking forward into the future the Commission should not underestimate the actual application of the provisions on the *Societas Europea* which would in essence allow competition even for the issuers' accounts.

An argument which addressed indirectly the perceived inconsistency of the Commission's suggestion was that it was not clear why the ex-ante governance rules should only apply to SSSs/CCPs and not to exchanges, payment systems and foreign exchange service providers.

Coupled with the above, the opponents of the ex-ante governance requirements raised questions boiling down to cost/benefit considerations. It was argued that any such requirement

would require tremendous IT investments while they are intrusive in the internal organisation of the entities concerned.

It was also mentioned that technically it will not be correct to include in a Directive dealing mainly with supervision issues specific competition law provisions.

Finally, public authorities from one Member State remarked that in Europe there are two models for arranging the cash settlement, namely the outside settlement model where a CSD relies to outside banks, mostly central banks, and the internal settlement model which is performed within the CSD. In both models the settlement provider actually provides credit but only the internalised model would call for concerns in terms of unbundling and cross-subsidisation.

The consultation provided however also staunch supporters of these measures even though some of them considered these measures insufficient to address the competition and safety risks that need to be addressed.

For one participant, in order for these measures to be successful, there is a need to develop an industry-sensitive methodology on cost allocation, to have standardised accounts and to impose a regular internal audit. They also suggested that unbundling should apply to securities borrowing and triparty repo services.

Others agreed with the measures and the entities on which the measures would be applied but repeated that these rules should not apply to custodian banks. The suggestion was also made that the two specific proposals, i.e., accounting separation and unbundling of services, should be coordinated with the work of ESCB-CESR.

A Member State authority was worried on how could these requirements be enforced and how supervision should be organised.

A number of respondents also added that strict governance measures are needed also in order to ensure that systems do not use inside information obtained in their capacity of system operators to distort competition.

Finally, it was suggested by an association of custodian banks that segregation should also extend to governance itself. They believe that CSD expansion to intermediary services should have to lead to a functional separation of core services from intermediary services as an important means of containing systemic risk. Segregation requirements should therefore include separate governance structures for the separate activities and should be designed to ensure that the full range of risks to infrastructure services is taken into account before CSD service expansion proceeds.

4.7 Expert Groups

Commission position: In addition to its proposal for the adoption of a framework Directive, the Commission considered that certain issues should have to be addressed with the assistance of expert groups.

The Commission proposed, first of all, to set up an Advisory and Monitoring group in order to tackle all Giovannini Barriers for which the private sector has sole or joint responsibility, and

to promote the overall integration and liberalisation project. This group, which is called the “Clearing and Settlement Advisory and Monitoring Expert Group” (“CESAME”), has met three times. Its mandate, membership and the agendas and minutes of its meetings are available at the Commission’s web-site⁶.

The Commission has also proposed to set up two other expert groups to consider respectively the legal and tax-related barriers to integration. The role of these groups would be to consider the discrepancies in the various national legal regimes and tax procedural requirements, to evaluate their effects on cross-border clearing and settlement and, if considered necessary, to assist the Commission in devising methods of addressing these barriers.

Comments received:

There was unanimous support for the creation of both the Advisory and Monitoring group (the CESAME group) and the legal expert group (which has now been set up⁷ and should be referred to as the “Legal Certainty Group”). As regards the tax expert group (which should be referred to as the “Fiscal Compliance group”) the great majority of respondents were in favor. Only two respondents, both Member State national authorities, were against its creation. They both felt that tax issues remain the responsibility of the Member States: current arrangements are sufficient to consider these issues.

For some respondents, the removal of the legal and fiscal barriers through the action of the various expert groups will be the biggest single contributor to the reduction in the costs and complexity of cross-border clearing and settlement, coupled with a proper and harmonised regulatory framework.

On the **Legal Certainty project**, more particularly, a great number of respondents representing all types of institutions felt that it is a high priority task.

In tackling the legal issues, a number of respondents coming from Member States where a direct holding system is used strongly requested that the Commission and the expert groups consider these systems properly.

Respondents remarked that issues that need to be considered are (a) an appropriate framework for the treatment of interests in securities (review the obstacles to harmonised law of holding and transfer of securities), (b) the location of securities and of securities registrars, and (c) collateral issues for CCPs.

Interestingly, a number of respondents have drawn a distinction between the legal category or nature of rights and their functional effects, and have tended to urge that the Legal Certainty Group should focus on the latter. Thus, an association of banks suggested that the harmonisation should focus not on the legal categorisation per se but on the legal implications of registration to a securities account. Thus the harmonisation should focus on the legal effects of book-entries (in case of insolvency or in conflict with other rights) rather than on the legal nature of book-entries. This was echoed by the comments of an association of infrastructure service providers which considered that the legal group should focus on the

⁶ Related documents and additional information available at http://europa.eu.int/comm/internal_market/financial-markets/clearing/cesame_en.htm

⁷ Related documents and additional information available at http://europa.eu.int/comm/internal_market/financial-markets/clearing/certainty_en.htm

harmonisation of how national laws treat investors' rights (whatever nature these rights have) in case of insolvency or in conflict with other rights.

Others, such as an association of professionals, felt that, in order to maintain compatibility of solutions world-wide, the legal certainty project should be limited to defining the nature of the rights themselves.

A central bank acknowledged, nevertheless, that their jurisdiction does not provide for an unambiguous protection when foreign securities are held via an intermediary. This respondent supported full harmonisation of the EU legal framework defining the entitlements and formal procedures in indirect holding of securities, but insisted that the investor's right to hold securities directly should also be confirmed.

Respondents also provided suggestions on more specific issues. Some respondents were of the opinion that investors should be able to choose the location in which their investments are registered. This could be achieved by the introduction of legislation to allow issuers to maintain sub-share registers in other EU jurisdictions. An association of banks insisted that Member States should repeal laws and exchange rules that deny issuers freedom of choice of central registers and CSDs.

Other national authorities stressed that greater priority should be given to the appropriate framework for the treatment of interests to securities than to issues relating to securities location. It was also remarked that the expert group should focus on the technical rather than the political issues. It should liaise with market participants and should strive to find a solution that should not be EU-centric.

For an association of banks, the group should also assess incompatible accounting rules that do not allow for cross-border netting, the issue of the costs of legal opinions and the impact of insolvency for remote participants in different member states.

For an association of issuers it is important that legislation should ensure that issuers have easy access to their investors irrespective of the number of intermediaries. In addition, proxy voting by ultimate investors should be facilitated. This coincided with the comments made by an association of representatives of the legal community that not only investors' rights in relation to the title but also other rights connected with securities must be taken into account, such as voting rights, the right to call a general meeting, the right to ask questions, to table resolutions, to obtain information and to obtain dividends. On voting rights most particularly, the solutions should be flexible, so as to allow the continuation of perfectly appropriate solutions in Member States.

A national supervisory authority was worried that with the intensification of cross-border holdings, authorities, issuers and investors could face additional difficulties in order to know the identity of shareholders (important to the authorities for exercising their supervisory duties, manipulation, insider dealing, fraud, etc) and for exercising proxy voting.

On the other hand, a stock exchange felt that the need for harmonisation in all areas, particularly in corporate actions, is not obvious.

Finally a banking association suggested that the group should provide clarity on the legal status of intermediaries and nominees.

On the *Fiscal Compliance group*, the comments were limited. With the exception of the two negative responses, most of the comments concentrated on the need to examine one or all of the following subjects: the harmonisation of tax collection and reclamation processing, withholding tax issues and the issues pertaining to stamp duty.

For instance, a national association of banks remarked that although taxation should remain an issue for national legislators, the identification of some of the more technical issues by a group of experts will be beneficial especially on withholding tax issues which may benefit from an approach that ensures equal treatment for domestic and foreign investors and their intermediaries.

Another banking association agreed with the Commission's proposal and considered that the priority should be the development of harmonised tax file information to discuss with the tax authorities in a process facilitated by the Commission.

As stated already, the Commission has already established that Advisory and Monitoring Expert group and the Legal Certainty group, while the Fiscal Compliance group will start its work in April 2005

4.8 Competition

4.8.1. Application of competition policy

Commission position: The communication confirmed that the normal rules of competition policy are applied to this sector both as concerns anti trust and mergers. An initial enquiry has indicated that market participants see issues of access and pricing as areas where competition regulators should focus their attention. In addition the exclusive arrangements between certain trading and post-trading infrastructures were highlighted as potentially limiting competition.

Comments received: All respondents who commented on this topic agreed that the application of competition policy is an essential element for ensuring a level playing field for the development of financial markets in the EU. As an example, some indicated that the actions already undertaken by DG Competition have already sent the right message to the industry that the sector is under scrutiny and that abuses will be attacked.

Most banks, infrastructures and national authorities proposed that this virile approach should continue to be applied by all competition authorities. They considered that this would be an adequate safeguard against any potential abuse, on condition that authorities are adequately staffed and trained, as there is a certain opinion that there is a high potential for abuse inherent in the market structure of this sector. A small minority of banks however, pleaded for new ex-ante measures such as guidelines for dominant companies to be introduced to pre-empt the possibility of competition abuses taking place.

Some concerns were expressed by individual respondents from all categories regarding national practises which are considered as de facto entry barriers either to service providers or to users. A number of non-EU based institutions pleaded specifically for DG Competition to take actions which prevent national interests interfering with the development of competition.

Consolidation in the sector is expected to continue. With one exception, respondents agree that the market should define the future shape of the industry. However, one infrastructure provider expresses concerns that cross-border mergers in the sector are not submitted to EU scrutiny and pleads for any major initiative between infrastructures to be automatically regarded as having a European dimension.

4.8.2 Issues for a possible directive

As these items have also been covered by the general summary of replies to the communication, the comments below are restricted to the role respondents considered competition policy should play in these areas.

4.8.3 Fair and open access

Comments received: There is unanimity that the principle of equal access rights is essential for sustainable competition. Apart from a minority view which calls for the introduction of common rules for the regulation of access to infrastructures throughout EU, respondents tend to see the role of competition as one of ensuring that any provisions for open access are effectively applied without discriminatory effects.

The topic of access is also linked to that of the choice of location of clearing and settlement which many respondents consider would contribute to promoting competition between intermediaries. A user representative however fears that in the long run such a policy might lead to less rather than more competition if only the largest services providers are able to effectively make use of their EU passport and several infrastructure providers comment on the potential inefficiencies of such arrangements. An issuers' interests group points out that by allowing choice in the clearing and settlement location, the Commission may introduce discrimination between wholesale flows (likely to move to ICSDs) and retail flows (likely to stay at local CSD) which might not be coherent with competition rules.

4.8.4. Governance arrangements

Comments received: The division of views on the questions raised in the communication regarding the need or not for the proposed directive to specify governance arrangements and in particular accounting separation for securities settlement systems is coherent with positions already expressed. The majority of banks, in the interest of more transparent competition, see a strong requirement for at minimum account separation between monopoly and value added services of infrastructure providers; the majority of infrastructures do not acknowledge the existence of monopoly services so do not either recognise the need for account separation; regulators focus their comments to the need to limit risk taking.

4.8.5 DG Competition position:

DG Competition will continue to work actively with the competition authorities of the European Competition Network in ensuring competition rules are enforced in this sector particularly in cases of potential serious competitive harm and/or strong market reference value. This could include issues relating to access, exclusive arrangements and possible exclusionary practices in both trading and post-trading activities.

Those respondents who have mentioned specific situations which they believe are in fact national barriers to entry or impediments to the smooth functioning of competition will be contacted bilaterally as part of our on-going market monitoring. DG Competition will then assess on the basis of the additional information, whether further action should be taken.

Concerning the regulation of mergers, as indicated in the communication, DG Competition will continue to reinforce its cooperation with national competition authorities particularly in this sector. It may also be noted that as for all other sectors, the parties may, if they wish, request that a merger be assessed at EU level.

In addition, DG Competition will continue to cooperate closely with DG MARKT in its regulatory initiatives, to help ensure that these are ex-ante pro-competitive.