FEDERATION OF EUROPEAN SECURITIES EXCHANGES (FESE)
Rue du Lombard, 41
B-1000 Bruxelles
T (0032 2) 551.01.80
F 512.49.05
www.fese.org
B1576/3 (final) – 04 Nov 03

Brussels, 4th November 2003

Comments by the Federation of European Securities Exchanges (FESE) on the CESR-ECB Consultative Report:
Standards for Securities Clearing and Settlement Systems in the European Union

A. Introduction

The Federation of European Securities Exchanges combining all cash equity markets, derivative Exchanges and other regulated financial markets as well as clearing houses in the EU, Switzerland, Iceland and Norway takes with pleasure the opportunity to comment on the consultation papers that the ECB/CESR Working Party (CESR 03/247) has put out for comments.

The comments below have the support of the entire FESE Membership and include comments by the CCP-based clearing houses that jointly form EACH, the European Association of Clearing Houses. As CESR and the ECB will be aware from earlier contacts and as is more fully described on the EACH Website, EACH is a group of clearing and risk management specialists. Most of the central counterparty clearing houses at which the specialists work are divisions or subsidiaries of European Stock Exchanges. Reflecting those links, EACH affiliated to FESE in 2001 and three independent clearing houses jointed FESE as a result of the affiliation. The technical comments of the EACH Group relating to issues of specific importance to CCP-based clearing houses will be sent to you separately.

We are indeed pleased to see the express reference to EACH's Standards of Risk Management Controls used by Central Counterparty Clearing Houses. As the Chairman of EACH has communicated to you, that group of experts is currently continuing its work on Standards for CCPs (beyond risk control) and on a paper defining CCP functions in the wider context of clearing and settlement. Beyond this conceptual work, EACH and its members will of course continue to take an active part in the discussion and look forward to involvement in the further work on Central Counterparty Standards.

Reference to other documents

As CESR and the ECB are well aware, the international discussion on clearing and settlement with an emphasis on cross-border EU business is not short of reports, studies, papers and proposals. We may refer to the earlier communication by the Commission to which both FESE and EACH commented as well (EACH and FESE letters of November 2002). We may also refer to the G30 Report which although of global focus has its applicability to the EU discussion. We finally refer to the own-initiative report by Mr. Andria MEP as approved by the European Parliament.

We notice the reference to the Giovannini Group's two reports. We may refer also to the comments by ECSDA, the European Central Securities Depositories Association. Furthermore, we make explicit reference to all comments submitted by individual FESE Members, either through their central offices or through their business units and affiliated companies engaged in clearing and settlement activities.

Clearing and Settlement in the context of the FSAP

The current discussions on the renewal of the Investment Services Directive as being held now in the European Parliament and in the Council also contain a number of important issues relating to clearing and settlement.

FESE and its Members would like to emphasise in the very first place that there should be a great degree of consistency between these various proposals and discussions, especially as more than one of them may lead to binding legislative regulatory and policy proposals.

With reference to the FESCO-drafted Standards for Regulated Markets, we would like to point out that any legislative or regulatory approach to clearing and settlement should take into account that technology and competition are currently the driving forces in the development of domestic as well as of cross-border clearing and settlement systems and approaches. Therefore, is it of the greatest possible importance – not to say it is crucial – that any legislation and regulation take into account and builds upon the flexibility that remains necessary.

EU-level legislation is as we know the product of a lengthy – and fortunately since Lamfalussy very open – consultative process, but it is also a product that in the future can be changed only with the greatest possible difficulty and dare we add delay. This again, is separate argument to plead for flexibility. Flexibility we would also like to stress is not in contrast to legal clarity, which especially in clearing and settlement is a crucial element for all participants.

Clearing and Settlement and the regulatory scene

In view of the above, we would like to repeat to ECB and CESR that these issues will have to be taken further into account when elaborating and finalising the CESR-ECB standards. We do not

object to developing these standards further and therefore we do accept the regulators in Europe move from the phase of non-binding recommendations to binding standards.

We note however that under the current institutional and legal set-up, such standards will have to be implemented by all market participants and by the regulators within their national frameworks and on the basis of existing national formal and substantive legislation and regulation.

B. General comments

Before commenting on the individual 19 proposals for standards, we would like to make a few further general points:

The CESR-ECB proposals relating to the scope of application the standards will need further discussion and elaboration. Read jointly with the paragraphs on the objectives of the standards, we do feel that occasionally the inner logic and consistency leaves to be desired. By way of illustration, we believe that the standards partially are based on systemic risk and contagion issues and partially – and not always clearly distinguished – on considerations of efficiency and effectiveness, of investor protection (especially of the retail investor), of rights of access, and on prudential and other systems requirements etc.

Especially in the area of applicability or scope, we believe that all standards will have to be reviewed carefully, so as not to omit institutions that should be brought under certain standards and to delete institutions that upon second consideration should not bear the applicability. Overall, it is a functional approach that provides the best chance to address the right targets and their risks with the appropriate set of standards. We recall and support the comment made by Mr. Wymeersch at the hearing in Paris that existing market structures should not be meddled with in the absence of stringent necessity.

Also we do feel that especially in the area of application within individual jurisdictions, an additional complexity has to be brought in the scope of the rules. Again as an illustration, is "systemically important" a relevant criterion only at the EU level or is it of relevance as well within a specific individual jurisdictions? A systemically important institution within one of our smaller economies would upon failure endanger the functioning of that economy, without however having much of an impact in terms of contagion or systemic risk to the wider EU community. This would be different for instance in a jurisdiction like Germany, France or the UK. In addition, there is the criterion of linkage closely bound to the contagion criterion that should be looked at further but that we do believe is an important one in view of the increasing importance of cross-border securities business.

The papers propose to focus on bond markets (public bonds and corporate bonds), equities and derivatives. It is unclear whether derivatives on commodities like traded on some of our Members' specialised markets fall under this description. We underline that commodities markets too have important linkages with cash equity and financial derivatives markets.

Monitoring ongoing developments and enforcement are two areas of consistent concern for Exchanges and related institutions. From the text of the consultation paper, it is however not clear to us, whether such processes including the assessments of methodology (as among others practiced by the IMF) are going to be a matter for public disclosure in the CESR-ECB proposals or only disclosure between the regulator and the assessed institution. We would advocate a relatively high degree of publicity in this context.

We miss in the proposals a clear reference to the need to avoid duplication and double regulation.

Finally, we believe that passporting of clearing and settlement services in the EU, and beyond on the basis of objective requirements and criteria, should be part of the total package. We refer to the discussions about the ISD in this respect.

With reference to the objectives of the standards, we believe there is an over-arching standard or goal that has not been mentioned and that is the establishment of an integrated set of securities markets and appropriate, sound, cheap, safe and effective and efficient clearing and settlement systems. Objectives 1 to 8 indeed flow from that over-arching goal. We also believe that more attention should be paid to suggestions of liberty of Member States to deviate from such standards in individual circumstances. We recognise that there may be arguments for that but at the same time we stress the need for a level-playing field.

FESE Members agree that mutual recognition is desirable. It is equally true that it is not clear how regulators would accept such very general "Standards" as the basis for mutual recognition. The answer may appear to be in the proposed three-level approach consisting of

- the CESR-ECB Standards;
- a "national" evaluation whether those standards are met; and
- a "supra-national" evaluation exercise to reinforce mutual confidence.

This approach could and should work; one of the crucial success factors will be, as so often, that national regulators and Central Banks are prepared to adopt and apply a truly cross-border single-market mindset. Moreover, we feel that the evaluation method is "work in hand" and the review process is not elaborated. We would welcome a few more comments by CESR-ECB on this issue.

In this context, some FESE Members argue that, if the CESR-ECB Standards are in fact intended as the basis for mutual recognition, their width of focus should be reviewed and emphasis should chiefly be given to core prudential capital and risk-related issues while topics like market efficiency etc. should receive less emphasis.

On harmonisation of settlement cycles, we believe they should not be forced upon the clients of Exchanges or of clearing and settlement service providers. We therefore would suggest that the first proposals for further work be indeed undertaken, a review and identification of costs and benefits, but that the recommendation about harmonisation should not be top-priority and should not be a given conclusion already at this time. With this argumentation we follow up to our

contributions to the work of the Giovannini Group and we see ourselves in the company of, among others, the European Banking Federation.

Before moving to comments on individual standards in the **annex** to this letter, we would like to note finally that the FESE Membership may return to the issue of the legal framework of the CESR-ECB proposals against the background of any forthcoming Commission communications and/or legislative proposals; we may wish to write anew to CESR and the ECB about such issues at a later stage. We would with what we wrote above also believe that CESR-ECB should consider a second round of discussion and consultation about the proposed standards after having reflected on the submissions received and having implemented any suggestions and proposals in such submissions as found favour with CESR and the ECB.

One of the other strategic issues that the FESE Membership would wish to consider further is competitive aspects between the EU services providers and the US American competition especially in view of the extraterritoriality that so often is part of US legislation.

The Federation, its Members and its Secretariat as well as the CCP experts forming EACH continue to be available for any further discussion on these issues and are looking forward towards good co-operation.

Yours sincerely,

Paul Arlman
Secretary General

Annex to the

Comments by the Federation of European Securities Exchanges (FESE) on the CESR-ECB Consultative Report: Standards for Securities Clearing and Settlement Systems in the European Union (Document B1576/3, dated 4th November 2003)

Standard 1, we can support but we would like to point out that the combination of paragraph 29 with standard 17 may impose a rather heavy regulatory and business burden, which we are not quite sure should be imposed in view of the current quality of clearing and settlement services in the EU.

On Standard 2, we would like to know whose responsibility would be the duties imposed upon indirect market participants. Under key elements here, we believe that element 5 of automation is already a given; we therefore "support" this principle but wonder whether it actually needs much encouragement at this moment. Inter-operability, which also applies to trading systems, is indeed important and finds our support. The term in paragraph 43 "without delay" is open for interpretation and we may refer to the ISD discussion on a similar term that has created confusion.

Standard 3, we can support including a cost-benefit study for a shorter cycle. As we put to the Giovannini Group on this issue and underlined again at the hearing in Paris, we believe that shorter cycles are only one alternative in making further progress in terms of quality of the process. We are not quite sure that harmonisation of operating days and hours is a matter that should be regulated. We would also like to refer to the work done by a working party of ECSDA on operating hours and settlement deadlines.

On Standard 4, we would like to argue that it is up to market participants whether or not to set up a CCP and obviously in such circumstances the costs and benefits would be evaluated. We agree that a CCP should rigorously control the risks it assumes, which is current practice. Even more so: CCPs offer a superior risk reduction. Under key element 2, we believe that is not a standard.

On Standard 5, we would like again to argue that this is not a standard. If there are arrangements for securities lending, they should as a matter of course be sound, safe and efficient. The discussion under key element 7 is one that needs further elaboration. There are some who would argue that a CCP should not and never be a principal to securities lending that is to run various risks but only as an agent. Others may argue that a CCP should remain far from this and leave lending and borrowing to market participants. The same may apply even more to a CSD. We find interesting key element 8 about debit balances and securities creation. Some of us believe however that securities creation needs not necessarily be so categorically excluded, always of course under appropriate risk policies. In paragraph 75, mention is made of a principal who also operates the securities settlement system. This would also apply if the principal were to run a clearing system.

Standard 6, we believe here that the lines about minimising systemic risks for CSDs should be elaborated in terms of distinction between the various risks (financial, operating, credit, reputation

etc.). With reference to paragraph 79, we believe there should be no forced segregation of services (see point 33 of EACH White Paper).

Standard 7, we can generally support the proposals.

Standard 8, we can support.

Standard 9, we believe that the formulation here may create a discriminatory situation between CSDs and custodians (see also Standard 6). After the term whenever 'practical' we would suggest to add the words "and necessary". The three lines at the end of these Standards "operations of settlement systems" to "unable to settle", we believe is an illustration of a specific situation and not part of a standard and could therefore be deleted. We believe on key element 1 that this standard is also addressed to CCPs. We question whether "who" in the second line applies to the custodians only or to the CSDs and custodians.

Standard 10, we can generally support.

Standard 11, these standards also find a place in current banking regulation, but currently only to a limited extent. They will in all likelihood form part of the new Basle Capital Accord. The sometimes excessive detailedness of US prescriptions in this area ought to be avoided. We note in this context with concern the high level of detail in the Explanatory Memorandum to this Standard (e.g. par. 130 on, among other detailed issues, the geographical distance of back-up facilities). We also recall the questions raised at the hearing in Paris on the necessity of having back-up facilities within the EU.

Standard 12, we do not see that these standards should be limited to the protection of the customer's securities only; customer's money should also be appropriately protected. This protection by the way should also apply to derivatives clearing. We note that it is not in the first place accounting practices and safe keeping procedures that protect customers' securities but current national formal legislation and rules and that is we believe how it should be. We note that CCPs are not custodians and that any customer securities that they may hold represent collateral.

Standard 13, all financial services providers of any relevance also fulfil public interest requirements. Any organisation automatically promotes the objective of its owners; that is not a standard. On the other hand, what is or could indeed be a standard is also to protect the objectives of users and possibly other groups or stakeholders. We also add the comment that this Standard, as drafted, assumes a single-board company structure. Flexibility has to be introduced in its wording to reflect the coexistence (as underlined and reinforced in the European Commission's Corporate Governance Action Plan) of single-board and two-tier board structures in Europe.

Standard 14, it should be not only rules and requirements but also fees and margins and so and so forth. That they should be aimed exclusively at control and risk might be better phrased in saying they should be part of overall risk and commercial policies. We note under paragraph 56 the reference to EU competition rules.

Standard 15, we do not have objections against this standard but we believe that the first part of it is not a standard appropriate for regulators to impose, whereas inter-operability is an important objective and an important standard to be met in due time.

Standard 16, we do not have problems, although the call for timetables and deadlines in key element 2 can be seen as too prescriptive.

Standard 17, we wonder whether the limitation "with a dominant position in a particular market" should be part of this standard. With reference to earlier comments, we put a question mark at key element 3 about publicly accessible information. This will need further discussion.

Standard 18, a obvious question here is whether any measures by regulators vis-à-vis services providers should come in the public domain or remain under all circumstances with this specific regulator and the specific institution. This is an area that needs further private and public discussion. It was noted that there was no explicit reference to home country primacy or lead regulation in the "key elements".

Standard 19, we may refer here to the issue whether passporting and cross-system cross-border arrangements should be limited to the EU or under appropriate criteria also beyond the EU. While agreeing with key element 3, we believe that term 'if feasible' should be added.