

COMMENTS BY THE CNMV ADVISORY PANEL REGARDING THE "CONSULTATION ON CESR/ESCB DRAFT RECOMMENDATIONS FOR SECURITIES SETTLEMENT SYSTEMS, AND DRAFT RECOMMENDATIONS FOR CENTRAL COUNTERPARTIES"

1. INTRODUCTION

The Committee of European Securities Regulators (CESR) and the European System of Central Banks (ESCB) have published a document entitled "Consultation on CESR/ESCB draft recommendations for securities settlement systems, and draft recommendations for central counterparties".

The first part of the document contains 19 recommendations for Central Securities Depositories (CSDs) and the second part contains 15 recommendations for Central Counterparties (CCPs) with the goal of increasing the security and efficiency of securities settlement systems and central counterparties, respectively. The annexes set out the assessment methodology and a glossary of terms.

The recommendations are based on the recommendations made by CPSS-IOSCO for securities settlement systems in November 2001 and for CCPs in November 2004.

The work commenced by CESR-ESCB in this area was halted in 2005 in order to clarify some issues such as the scope, content and legal basis of these recommendations. In June 2008, the ECOFIN Council invited CESR-ESCB to complete the work, having regard to the following principles:

- The recommendations are addressed to public authorities and not to providers of post-trade services.
- Their scope should be confined to CSDs (including international CSDs) and CCPs. Custodian banks should be outside the scope.
- With regards to controlling credit and liquidity risks, the benchmark accepted by the G10 should be adopted.

Once completed, the recommendations will be used by public authorities to regulate CSDs and CCPs using a common tool. The authorities must promote implementation of the recommendations in their local markets, to which end regular assessments will be performed in accordance with the methodology set out in the annex to the document.

As a general comment, although the CNMV Advisory Panel believes the consultation document is positive, it would also like to raise the question as to whether some legislative action might not be required at European level on the issues or at least some of them which, because of their importance, may create serious distortions if a

minimum degree of harmonisation is not attained within the European Union. A good example, discussed later in our comment on Recommendation 6, is the question as to whether or not CSDs should be allowed to assume credit and liquidity risks and, if so, to what extent.

2. COMMENTS

The CNMV Advisory Panel broadly agrees with the recommendations set out in the CESR/ESCB consultation paper. But it would like to make the following comments about some of the recommendations regarding clearing and settlement systems:

Recommendation 2: “Trade Confirmation and Settlement Matching” (p. 22)

The recommendation is that trades between direct market participants should be confirmed as soon as possible and no later than the trade date (T+0). The goal is to reduce the costs and risks associated with settlement failure arising from errors or discrepancies in the instructions.

However, the key issues (B3) set out an exception to this recommendation for systems where free-of-payment transfers do not need to be matched.

Not requiring that free-of-payment transfers be matched may pose the same risks as any transfer vs. payment. On many occasions, free-of-payment transfers are associated with other transactions which are settled for cash through the system; therefore, a book-entry fault may lead to settlement failure.

Considering the goal being pursued by this recommendation, greater firmness and ambition should be shown in pursuing it; therefore, we propose removing the aforementioned exception unless it refers exclusively to transfers which, because of their peculiarities, do not need to be matched per se.

Recommendation 3: “Settlement Cycles and Operating Times” (p. 27)

The explanatory memorandum (C11) contains a brief list of mechanisms that can be used to reduce the risk of settlement failure. However, the list omits several important tools, such as centralised security lending, and purchases and sales in replacement.

Recommendation 5: "Securities Lending" (p. 33)

This recommendation contains an exhaustive analysis of securities lending on the grounds that it is a vital tool for avoiding settlement failures. The recommendation envisages that securities lending may be performed bilaterally or automatically on a

centralised basis by the System itself.

The explanatory memorandum (C5) states: "access to securities lending facilities should not be compulsory". However, we believe that CSDs should be allowed to impose centralised security lending as a last resort where all other voluntary instruments, including bilateral lending, have failed. Although the reference in that same paragraph to "the possibility of having facilities that can be automatically activated in some circumstances" may be interpreted as justifying centralised security lending facilities, the foregoing statement is too severe. Therefore, we suggest a more flexible wording to provide sufficient legal grounds for agile implementation on the part of the CSDs.

Recommendation 6: "Central Securities Depositories" (p. 35)

The recommendation states that securities should be immobilised or dematerialised and transferred by book entry in CSDs to the greatest possible extent.

We consider that only dematerialisation (i.e. elimination of physical securities) should be classified as a recommendation and best practice to be pursued by all CSDs.

Also, the explanatory memorandum (C4) states that "CSDs should avoid credit and liquidity risks to the greatest possible extent" while acknowledging that "most CSDs in Europe are prevented by their statutes" from assuming such risks. The asymmetries in the regulations governing the various CSDs give considerable advantages to those CSDs which can assume credit risks, albeit on a limited basis. CSDs that are not allowed to assume credit risks are confined to offering a much narrower range of services and, in a situation of open competition, they face severe difficulties that may jeopardise their very existence. Therefore, we recommend that the limits of the risks that CSDs can assume should be defined clearly, and that harmonised rules should be established so that all CSDs can continue within the established limits and can compete on an equal footing.

Recommendation 8: "Timing of Settlement Finality" (p. 42)

The key issues (B4) state that "the rules of the system should prohibit the unilateral revocation of unsettled transfer instructions late in the settlement day".

This recommendation seeks to eliminate the liquidity risk that unilateral revocation may pose. However, this risk is not eliminated if unilateral revocation is allowed at any other time after the instructions are matched, thus also creating uncertainty between the trade participants.

Considering the goal of minimising or eliminating settlement risks, Systems should not, in any event, allow unilateral revocation of instructions communicated by participants once they have been matched and are pending settlement.

Recommendation 12: “Protection of Customers' Securities” (p. 57)

The recommendation seeks to protect customers' securities by keeping them registered in the accounts of CSD participants.

However, the explanatory memorandum envisages several methods for recognising and separating customers' securities from those of the participating entity's own portfolio. We believe this recommendation is not deep or firm enough. A single model should be proposed in which customer securities are clearly separated from those of the intermediary's own securities in accounts at the CSD.

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