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Euroclear response to the consultation by CESR and ESCB on recommendations for securities clearing and settlement systems and central counterparties in the European Union

Euroclear is pleased to be given the opportunity to give its views on the new version of the ESCB/CESR recommendations. As a provider of securities clearing and settlement services[1], we will only provide comments on the recommendations relevant to CSDs.

Below you will find our generic comments, as well as specific comments on some recommendations and their assessment methodology. Please note that our comments on the assessment methodology are more extensive than those on the recommendations, as it is the first time that the methodology is consulted upon.

Generic comments

We welcome the new consultation of the ESCB/CESR recommendations and appreciate that an acceptable compromise on their content has been reached. The efforts of ESCB and CESR to adapt the recommendations and take into account elements from MiFID, SFD and the work on the removal of the Giovannini barriers are highly appreciated. As pointed out below, we believe that the references to the Code of Conduct could be more consistent.

We urge ESCB and CESR to finalise and implement the recommendations swiftly so that the EU post-trade industry can benefit from the much needed harmonised supervisory and regulatory environment that will contribute to achieving a level playing field amongst CSDs. In this respect, we stress that it is crucial that supervisors and regulators make a strong commitment to use the recommendations as the basis of their assessment of CSDs and CCPs and to use such assessment as the basis for mutual recognition of the CSDs and CCPs. We support the idea of ESCB

[1] Euroclear group comprises the international central securities depository Euroclear Bank, based in Brussels, as well as the national central securities depositories (CSDs) Euroclear Belgium, Euroclear France, Euroclear Nederland, Euroclear UK & Ireland and NCSD, the CSD for Finland and Sweden.

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and CESR to establish a task force that will seek to find common implementation guidelines and that CESR foresees that regulators will use the recommendations on a "comply or explain" basis.

We do expect however that further amendments to the recommendations may need to be envisaged in the medium term.

- First, in view of the experiences from the management of the financial crisis, to adapt them, where necessary, in some areas of operational risk or crisis management.

- Second - as pointed out in our response to the CESR call for evidence on the identification of regulatory arrangements for post-trading infrastructures in September 2008 – we believe that once CESR finalises the mapping of national regulatory requirements, it should perform a gap analysis to see which of those national requirements are not covered by the agreed ESCB/CESR recommendations. Thereafter, if required, the recommendations could be modified or completed.

While we understand the ECOFIN decision to limit the scope of application to CCPs and CSDs, we wish to point out that some recommendations cannot and should not be addressed to these entities alone. In most recommendations, there are aspects that should be addressed to (or complied with by) public authorities, regulators, market participants, central banks, issuers, settlement banks, etc. For instance, major parts of recommendations 1 (legal framework), 2 (trade confirmation and settlement matching), 3 (settlement cycles and operating times), 4 (central counterparties) are effectively addressed to other parties than the CSD. The same is true for many of the other recommendations.

We therefore urge ESCB and CESR to review the assessment methodology in such a way that it becomes clear which requirements apply to CSDs and which ones apply to other entities. This should ensure that the assessment rating given to a CSD by its regulator only refers to the CSD's own compliance with the recommendation. An additional advantage is that it would become more transparent in which areas further progress may be needed and by which entities this progress should be delivered. E.g. for recommendation 5 (securities lending), key question 1 relates to the legal and regulatory environment supporting securities lending. This question is addressed to public authorities and we believe it should not appear as an element in the assessment rating of the CSD.

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Also with regard to the assessment methodology, we would like to highlight that in some instances the key questions and/or criteria for the assignment of an assessment category are different from, or more restrictive than the text of the recommendations themselves. For instance, in recommendation 12 (protection of customers' securities), the explanatory memorandum states that segregation or identification of customer securities in the books of the custodian is one way of protecting customers' securities against the insolvency of the entity holding the securities in custody. Section 1.c. of the criteria for assigning an assessment category however implies that such segregation is the only compulsory solution. Below are a few additional (non-exhaustive) examples of such discrepancies. We request ESCB and CESR to bring the wording of the assessment methodology in line with the recommendations.

As CEBS is finalising its gap analysis between the recommendations and the banking regulation, we would like to understand how the CEBS conclusions will apply to CSDs with a banking license. In particular, we believe it would be beneficial to see a reference to the banking regulation in the recommendations, such that CSDs that have a banking license can refer to their compliance with the banking regulation, rather than having to comply with a similar, overlapping assessment under the recommendations. For example, recommendation 11 on operational reliability and recommendation 17 on transparency should refer to the CRD framework for operational risk management and the risk disclosure under Pillar 3, respectively.

With regard to the Glossary in Annex 2, we refer to the comments made by ECSDA to the ECB consultation on terms related to payment, clearing and settlement.

Detailed comments on recommendations

Euroclear welcomes the recommendations and only wishes to highlight a limited number of concerns on certain recommendations:

Recommendation 1 – Legal framework

In our view, the reference to "links between [securities settlement systems] or interoperable systems" or "links and interoperable systems" may be confusing, especially in view of the definition of "interoperable systems" as set out in the

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glossary (which includes links). It would be useful to illustrate with examples what is meant by "interoperable systems" in the frame of these recommendations.

Key issue 1: We propose to delete the words "the rights, liabilities and obligations arising from" as the need for publicity and accessibility relates to the laws, regulations, rules and contractual provisions themselves and not to the rights, liabilities and obligations arising from them. This is also the wording used in point 3 of the explanatory memorandum. This comment also applies to point E.1.1 and E.2.1. of the assessment methodology. We suggest to add the word "to system participants" after the terms "public and accessible" to make the wording consistent with the wording used in the assessment methodology.

Explanatory memorandum C 4: We propose replacing "CSDs should, … provide market participants with information" by "CSDs should, …, provide **their** participants". The use of the term "market participants" is too vague and too broad. The same comment applies to the related key question of the assessment methodology.

Explanatory memorandum C 6 fourth sentence: "The claims of a securities settlement system or the system participants against collateral posted" should become "The claims **of the operator of** a securities settlement system"

Explanatory memorandum C 8: We do not agree with the statement "that it may prove advisable that only one legal system is chosen to govern contractual aspects of the relationship between the system and each of its participants" and that "ideally the law chosen should be identical to the law governing the system." Designated systems should be able to choose several laws to govern certain specific services. We would appreciate more clarity on what is meant by "the law governing the system".

We believe the text should distinguish between:

1. The law governing the account (i.e. the rights in or in relation to the deposited securities which are evidenced or constituted by a credit to the account) and the validity and effect of securities transfers orders which enter the system. There can only be one law governing these matters in a single designated system. As a matter of fact, an operator may choose to have a single set of rules and to subject it to different laws in which case the operator is effectively operating as many systems as there are governing laws;
2. The law governing other services or matters unrelated to the execution of transfer orders: the system's operator and its participants should be free to choose the law governing such matters and services and to choose as many laws

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as there are such matters or services. An example of such a service would be collateral management services (valuation, substitution etc) allowing participants to better manage their collateral transactions involving securities deposited in the system in question. For such services, there is a strong business rationale for choosing, for example, English Law, irrespective of where the securities system is located. This would mirror English law as the law that generally applies to the documentation governing the underlying collateral transaction that is being serviced (GMRA market standard repo agreements with EU counterparts; or any other law selected to govern the EBF European Master Agreement).

The law chosen for each of 1 and 2 need not be the same.

Recommendation 6 - Central Securities Depositaries (CSDs)

Key issue 3: We disagree with the description "As CSDs uniquely combine the provision of final settlement with the recording of changes in legal title resulting from securities transactions,...". First, because not all CSDs perform or combine such functions (as demonstrated by the ECSDA survey in 2005). Second, because there are other entities (notably banks) that combine such functions. We would therefore appreciate that the text be redrafted and that at least the word "uniquely" be removed.

In the Explanatory Memorandum 1 and 4, the text mentions the notion of core and non-core activities of CSDs. Seen the controversy this terminology has brought in past public policy discussions, we find it very unhelpful and unnecessary that these terms are included in the text.

Recommendation 7 – Delivery versus payment

Explanatory Memorandum 4: we support the requirement that settlement systems should minimise the time between completion of the blocking of securities, the settling of cash and the subsequent release and delivery of the blocked securities. In this respect, we would like to understand why the last sentence of the Explanatory Memorandum gives an exception to night time batches. It is our view that even when there are night time batches, the time between blocking of securities and transfer of cash should be minimised.

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Recommendation 10 - Cash settlement assets

Explanatory Memorandum 3 states that "within the EU, in cases where the domestic CSD is not located in the country where the currency is issued, the CSD should liaise with the relevant central bank to offer the facility in that currency". Explanatory memorandum 6 states that "in particular, the use of commercial bank money should not be de facto compulsory, so that the participants are not in practice forced to use commercial bank money". We believe that these statements are unnecessarily restrictive and not in line with the recommendation itself, and what the recommendation aims to achieve. Moreover, given the full collateralisation requirement included in recommendation 9, we are convinced that the potential risk arising from settlement in commercial bank money is sufficiently mitigated.

The ongoing credit crisis is clearly demonstrating that the risk management practices employed by Euroclear Bank are robust. There is no indication that settlement in commercial bank money leads to increased systemic risk (at least when strict risk mitigation practices are employed). Further enforcement of settlement in central bank money does not seem warranted from a systemic risk viewpoint. Moreover, we do not believe it was the ECOFIN intention to include the ICSDs in the scope of the recommendations and thereafter make it impossible for them to comply with the recommendations.

Recommendation 11 - Operational risk

We appreciate that the recommendation includes requirements related to outsourcing and that these requirements apply to all providers of outsourcing services.

A reference to/recognition of compliance with the Basel II/CRD framework for operational risk would be very helpful.

Key issue 5: It is widely recognized that non *material* outsourcing should not be subject to approval or notification. We think the recommendations should reflect this, as otherwise any minimal or insignificant outsourcing would have to be notified. Obviously this implies that there need to be some guidelines as to what constitutes "material" outsourcing. In this respect, there are some regulatory guidelines (e.g. provided by BIS) that elaborate on this (the same comment applies to section 15 of the explanatory memorandum where we suggest to refer to "material" instead of "actual" settlement operations).

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We would welcome a clarification of the wording of the last sentence *"The relevant outsourcing entities should have the power to require adaptations of the outsourcing measures".* We assume it is referring to the outsourcing entity's right to control and approve changes to the outsourced services, and the obligation to have a process to allow for change management under the outsourcing entity's control. It would be worth clarifying this, since the word "measures" is ambiguous.

Explanatory memorandum 16: *"additional outsourcing must be duly authorized by the primary outsourcing entity and notified or approved by the relevant competent authorities, according to national requirements".* With respect to the control of the outsourcing activity, the recommendation seems to focus primarily on the initial and subsequent approval but does not foresee any ongoing reporting and control. In our view *"clear lines of communication"* are not sufficient if the CSDs "*remains fully answerable"*. We therefore suggest to add that *"there should be reporting, monitoring and other relevant measures contractually agreed that allow the outsourcing entity to control the outsourced activity".*

"The "relevant competent authorities" refers to the authorities in the jurisdictions where both the outsourcing and insourcing entities are located". We do not understand why the insourcing entity's authorities should be notified. This would have unhelpful extra-territorial impact, even outside Europe (e.g. would a CSD need to notify Indian authorities in addition to its local authorities in case of off-shoring to an Indian company? What would the Indian authorities do with this notification?).

Recommendation 13 - Governance

The new text of the recommendation provides that the governance arrangements "should promote the objectives of owners and market participants". In our view the use of the term "market participants" in this recommendation is too broad in scope and inappropriate. It is conceivable that there could be (competing) "market participants" with diverging objectives to those of the CSDs and we believe it is not optimal for the efficiency of markets that the governance arrangements of a CSD should be designed to promote such opposing objectives. We think the recommendation should refer to the objectives of "users" rather than of "market participants".

Explanatory Memorandum 2 mentions "many CSDs are the sole providers […] to the markets they serve". We believe it is unhelpful that the text seems to make an

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assessment of the competitive position of CSDs without agreed market definition. We suggest removing this sentence as it is not crucial for the recommendation.

Recommendation 14 - Access

We would like to point out that for some CSDs, access rules are included in local regulation and therefore not under the direct control of CSDs. The recommendation and its assessment methodology should recognise this.

We would welcome a reference to the Access and Interoperability Guideline linked to the Code of Conduct, e.g. in Explanatory Memorandum 7.

Recommendation 15 - Efficiency:

Here also, we would welcome a reference to the Code of Conduct.

Recommendation 17 - Transparency:

Key issue 3 states that disclosures should be done "in a language commonly used in the international financial markets as well as in at least one of the domestic languages (*in footnote:* if required in the respective domestic market)". However, the assessment methodology imposes disclosure in a domestic language and is therefore more restrictive than the recommendation. Though disclosure in a national language might be necessary for the CSDs (which have a strong link to domestic markets), this is not true for the ICSDs. The choice of the language in which the disclosures are done should be left at the discretion of the CSD, or of the stakeholders (including relevant regulators) interested in these disclosures.

A minor drafting comment: explanatory note 1 refers to "In the past decade", which are the exact words of the CPSS/IOSCO recommendations.... which were issued close to 10 years ago. We suggest this sentence starts with “in the past decades”.

We would appreciate a reference to/recognition of compliance with the Basel II/CRD framework, i.e. to risk disclosures issued under Pillar 3. A reference to the Code of Conduct's price transparency would be welcome.

Recommendation 18 - Regulation, Supervision and Oversight

We appreciate that the recommendation now includes a better framework of cooperation between supervisory authorities.

We regret that the text does not mention the instance of a transaction feed access between a trading platform or a CCP and a CSD. We believe that this situation

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should also be addressed in the cooperation arrangement between relevant regulatory and supervisory bodies, specifically seen the challenges experienced under the Code related to such access.

It is unfortunate that this recommendation does not recognise that there is no functional difference between standard access granted by a CSD to another CSD or to another participant in the CSD. Yet, in the case of a CSD to CSD link, stricter requirements are imposed e.g. with regard to DVP and finality.

Recommendation 19 - Risks in cross-system links or interoperable systems

Key issue 4 provides that "relayed links should be designed and operated in a way that does not increase the level of risks or reduce the efficiency of cross-system settlement". We would appreciate more clarity on what should be used as the point of reference to measure compliance with this recommendation (is it a reduction of efficiency in comparison with a direct or indirect link?). Moreover, we would like to understand why a similar recommendation does not apply to indirect or direct links (these comments apply also for the related key issues and assessment criteria in the assessment methodology).

Detailed comments on the assessment methodology

We refer to the comments made above on the need to revise/clarify the assessment methodology and rating assignment depending on the addressee of the requirements, i.e. distinguishing the requirements are effectively to be met by CSDs from those that have to be met by other entities such as public authorities, regulators, market participants, central banks, issuers, settlement banks, etc. In some instances, the assessment methodology differs from, or is more strict than the recommendation itself. This needs to be corrected. The comments made above on the recommendations themselves should obviously also be reflected in the assessment methodology.

We have the following further comments:

RSS5 – key question 5 includes a reference to full collateralisation of credit exposures. We believe that such mention should not appear under RSS5 but rather under RSS9.

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RSS6 - key question 3 mentions "non-core business": as explained above, we believe this terminology is unhelpful and unnecessary for the compliance with the recommendation itself.

RSS7 - assignment of assessment methodology 1b: the methodology states that 95% of transactions should be settled on DVP basis before the CSD is given a score of "observed": we do not agree with this statement as the CSD cannot and should not control the share of DVP transactions.

RSS10 – assignment of assessment methodology 1a and 1b: as mentioned above, the explanatory memorandum to the recommendation and assessment methodology are too strict when compared to the recommendation itself. As drafted, the ICSDs cannot obtain an "observed" rating even if they comply in full with recommendation 9 and are in line with the recommendation 10. We believe that this is not in the spirit of the ECOFIN conclusions.

RSS14 – Key question 3: We believe that the last questions in this section go far beyond the scope of the recommendation.

We are ready to provide further clarification on our comments.

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