



T2S PROJECT TEAM

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Answer to Euroclear comments on T2S User Requirements Documents

We are grateful for the considerable effort that Euroclear has put into its response to the public consultation on the User Requirements Document for T2S, as well as for its contribution to Technical Groups and the Advisory Group. We note that Euroclear supports the vision, and that it endorses the URD as “coherent and logical for the purposes of a core settlement engine”.

We emphasise that we recognize Euroclear’s achievements, and wish them well in completing the task of integrating 5 markets, which will (on their latest estimates) be completed in 2011. We think that all of Europe should have an integrated infrastructure promoting competition and embodying harmonisation, so as to reduce costs; we believe that T2S will provide a relatively rapid and highly effective means of accomplishing the **settlement** part of this vision. Euroclear’s experience indicates that achieving integration of settlement-related services adds greatly to the time to market; and such services are in any case better proved competitively. We acknowledge the progress Euroclear is making on harmonisation in these areas, and expect this to continue to be a considerable positive influence on the Europe-wide harmonisation progress.

Euroclear has expressed reservations about some significant details of the overall approach. We have thus prepared, and are publishing, this response in the interest of clarifying some important matters for wider debate, as input to the securities community’s decision on whether to provide commitment to T2S before the Governing Council’s decision in summer 2008.

We list below the 13 key issues that Euroclear has identified, and would like to comment on them:

- i. *“Significant and potentially detrimental effects on those markets which already operate on a single settlement platform”*. T2S aims to deliver for all of Europe the very benefits that caused Euroclear and its users to support a substantial and extended programme of investment for the five markets where Euroclear operates. We suggest that Euroclear and its users should balance any perceived “detriment” from the necessary adjustments in Euroclear’s strategy against the benefits of extending the single platform across Europe; we are confident that there is substantial

net benefit even for institutions that are very active in the five Euroclear markets (in particular for investments related to custody and asset servicing).

- ii. Euroclear suggests that there should perhaps be competition in providing settlement. We too believe that increased competition is an important element inter alia in reducing costs. We note that currently there is in practice little competition for core settlement, except perhaps in Eurobonds. Indeed, it is our belief that T2S promotes market opening since it unbundles core settlement from value-added services such as cash and securities liquidity provision, asset servicing and collateral management, it promotes competition in those areas where there is no material competition today. We see T2S as supporting the Code of Conduct since using T2S is a very effective way for CSDs to achieve efficient interoperability for core settlement.
- iii. Euroclear notes that a settlement system would have to retain its settlement platform if it wishes to offer settlement in commercial bank money, or in central bank money in currencies not available in T2S. So savings from de-commissioning would be small or zero for Euroclear. We take note of this point, but believe that each such system will have to consider with its users whether the costs of continuing with an internal settlement platform are justified by the user benefits it conveys. T2S will be built in a way to accommodate settlement in central bank money in other currencies and we note that e.g. the Riksbank has stated its readiness to provide Swedish Kronor in T2S, if there is adequate market demand. Other central banks responsible for other non-euro currencies may also adopt the same approach. Nevertheless, we accept that there will be settlement in commercial bank money, in ICSDs and through custodian banks. We believe that it is feasible for such entities to provide market users with choice, and right for market users to have choice.
- iv. *“T2S could actually increase, or at least maintain, the current levels of intermediation”*. We do not aim to reduce the amount of intermediation in the post trading area; instead, we aim to open the whole EU market to competition so that market users have a much larger set of practical options available to them. The workings of a more open market will deliver a more advantageous (in cost, efficiency and risk terms) pattern of intermediation. This process may well lead to partnerships and mergers; we do not believe that each CSD “must become a custodian ... across a wide range of securities”.
- v. Euroclear suggests that CSD re-shaping of custody and matching services would have “adverse effects” on clients. We spent considerable effort in discussing the concept and implications of re-shaping of CSD infrastructure and we have not seen any convincing explanation of why CSDs cannot adjust their techniques to maintain service levels. We have explained in detail how the tools available in T2S can be used to achieve good services in relation to corporate events and collateral management. In fact, we would anticipate that Euroclear, due to the consolidation and re-shaping having taken place within its group, should be in a position to reap benefits from T2S. Please see Annex 1 for a summary.
- vi. *“Direct connectivity introduces additional fragmentation”*.

- a. First, T2S will allow CSDs to offer this service to their users; no-one will be forced to use it, and it is not core to delivering our objectives. A number of large users regard this option as valuable; if they use it, it is hard to see how this use would damage other participants who choose not to use it.
 - b. Second, we understand that CSDs will need to obtain data in relation to their clients' use of this service, to keep their own records consistent. We do not agree that clients will need to send messages both to T2S and to the CSD; CSDs should consider accessing T2S' records as described in the URD.
 - c. Third, we do not see any fundamental liability issue. Directly connected clients will only have a legal relationship with a CSD, there will be no direct legal relationship with T2S. Once received by us, messages will be treated in all respects (including liability) as though they came from the CSD to which they relate. As provided for by the liability regime of the CSD, the client may have a claim for damages against the CSD in relation to losses caused by T2S (whereby of course the CSD will have a recourse claim against T2S). To the extent that these clients will use a network provider for delivering messages securely and promptly to the T2S sites, clients may also have recourse to the network provider (just as they would do in relation to delivery of instructions to the CSD).
- vii. We fully understand that CSDs will need to add a mark-up to what they pay T2S. This is one of the areas where we believe (like Euroclear) that competition will provide useful discipline.
- viii. We agree that end-to end harmonisation including market practices is required to get the full benefits of T2S. We acknowledge the achievements of Euroclear in this area, and believe that Europe and users of its markets need to see further harmonisation extended all across Europe. The Eurosystem is well placed to add energy and influence to existing work on identifying and removing barriers; and T2S will provide an important means of focussing and concretising the adoption of new processes.
- ix. Euroclear notes the need for infrastructure to "*meet changing client needs*".
- a. We agree, and believe that T2S will, by stimulating competition outside core settlement, lead to a greater innovation and responsiveness in areas where it may be less than optimal today.
 - b. We understand the limitations of formal user governance models, especially for businesses which possess considerable market power (because of network effects, barriers to entry and bundling) but which are not avowedly "not for profit"; there can be real tension between directors' duties to the success of the company, and their role in promoting the efficiency and success of the market which it serves. Tensions will always exist, whatever the governance model. We believe that transparency, willingness to interact directly with market users, and a formal advisory process including all direct stakeholder groups have served T2S well so far; and intend to preserve these three key features into the future. The Eurosystem will next year consider governance for the period after 2009, including the option of a separate (not for profit) legal entity.

- c. We also understand that governance will need to ensure equity in charging, cost effectiveness and prudent operation, among other important matters.
- x. We understand that T2S will need to offer CSDs appropriate compensation for any direct losses, which its negligence may cause their clients, broadly in line with models offered by CSDs to their clients (the details of which will be subject to the contractual negotiations).
- xi. Future development will be determined in discussion with CSDs and market users, subject to commitment that T2S costs have to be recovered over time. The experience with the AG so far provides a good indication of how development requests may be dealt with in the future. Where a development is undertaken for a specific market segment, we will normally expect a firm commitment from those who ask for the change to underwrite our recovery via T2S charges of the costs we incur. Moreover, consistent with our single market objective, we would expect any change not valuable to the wider EU market to be undertaken by other providers (such as CSDs) to the maximum extent technically possible.
- xii. We will of course comply with competition law, and will welcome responses on any potential issues we should address.
- xiii. We re-iterate that there is and will be a “Chinese wall” between T2S and the regulatory functions in the ECB/Eurosystem. There will of course be regular formal and informal interaction, as is customary between CSDs and both central banks and regulators. An exchange of views has already been launched with the Committee of European Securities Regulators (CESR) which also participates to the T2S Advisory Group and the Task Force on contractual issues as an observer.

Annex: Some Miscomprehensions in the Euroclear response

1 Separation of settlement and custody

Euroclear argues that a T2S forces an “artificial” split between previously integrated services in a single platform, which it believes would lead to “considerable inefficiencies” for CSDs and their clients. We think this is over-stated.

There will need to be adjustments (and thus investment) in the direction of a modular architecture, where a CSD has not already adopted this approach. We assume that Euroclear has already implemented this modular approach: their paper on T2S User Requirements explains that the five local markets within the group have decommissioned their core settlement engines (page 20) but will continue to provide asset servicing (page 25). Once the modular approach is in place, it matters very little whether the settlement engine resides alongside the CSD’s other applications in one or more data centres belonging to the CSD, or in data centres provided by the Eurosystem, provided that:

- Appropriate enquiries/messages are available for interaction (since T2S is described as “coherent and logical for the purposes of a core settlement engine”, it is assumed that T2S has passed this test); and
- Interactivity is adequately real-time (we believe that this does not pose major technical issues, but look forward to more substantive debate with CSDs which have doubts).

In relation to **collateral management** by CSDs, we understand the need for them to reallocate/substitute securities. (Indeed, T2S itself has the same need in relation to auto-collateralisation of cash used for settlement.) We think this is perfectly possible using mechanisms described in the URD across high speed communication lines; as Euroclear say, their system will of course have to monitor and interact with settlement (at least during the latter part of the day) to avoid unnecessary fails. This seems to be the same need that Euroclear has in relation to its own settlement engine now.

Euroclear also note that T2S will not provide complex repo services. This is partly because such markets are not yet harmonised; and partly because the Advisory Group thought it right to leave specific national processes for CSDs to manage. We expect that such CSDs will use T2S for opening, closing and perhaps margining repos, by sending us pre-matched settlement instructions derived by their existing functionality which supports complex repos. As in our assessment above of complex collateral management, we suppose that such CSDs already derive such instructions from repo functionality and need only to change their destination to T2S.

In relation to corporate events (also known as corporate actions), we do not advocate blocking in connection with dividends/coupons; it is an option for those markets which may require it. We are aware that complex events require very timely interaction and, as Euroclear recognise, T2S will provide CSDs and other market participants with tools to access T2S data in real-time either in push or in pull mode. We expect these tools to provide very efficient and timely interaction with T2S as required in the context of those corporate events.

Cross-border settlement is also seen as a problem by Euroclear. We agree that an investor CSD needs to connect in some sense to the issuer CSD, which handles the corporate event. It needs a legal relationship, and information flows. But it does not need to link for normal settlement, or for implementing even complex corporate events – see above. And T2S provides automatic realignments including in relation to events such as share splits, scrip dividends etc. So we do not believe there is an inefficiency here; indeed, T2S is **designed** to remove many of the barriers which stop CSDs servicing assets issued in other European CSDs.

We welcome the recent announcement of a joint venture of 7 CSDs (one of them outside the EU) to improve exchange of information relating cross border holdings, as a first step in this direction. And we note that Euroclear is also making significant steps for its 5 markets.

2 Direct connectivity

First, as noted in our main text, CSDs have to agree any such connections; if they view the risk or costs as unacceptable, they are at liberty to deny them, though this might have consequences for user loyalty.

We of course agree that users will need to connect to CSDs for complex services which T2S does not provide.

We however do not agree that users will be required to send messages to CSDs as well as T2S to benefit from all the services that Euroclear lists (and that other CSDs may also provide). Data for such issues as transaction taxes, registration and regulatory reporting can be included in users' settlement instructions sent directly to T2S for matching; we expect that CSDs will be willing to retrieve such instructions from T2S, using the high capacity communication lines they will in any case need. So directly connected users do not need to send data to both T2S and the CSD.

We do not agree that ALL instructions will need to be retrieved, though we accept that it will be required for instructions (and statuses) in securities subject to a corporate event where a CSD operates claims or transformations:

- We are concerned about the suggestion that one reason for so doing is that our validation may not meet a CSD's standards. If so and there is a sound logic, we will amend the URD. Euroclear is invited to provide details.
- A CSD will normally not intervene or amend an instruction of the directly connected user since the latter will undertake this under its own management. Should intervention be necessary (e.g. for legal reasons) a CSD will always be in a position to do so as it carries the responsibility for its participants.
- We do not think that a CSD needs to know the timestamp for a settlement to be protected by the Settlement Finality Directive; it will of course be able to obtain timestamps rapidly if needed to investigate a problem.

3 Cross border services

We broadly agree that T2S facilitates, but does not complete, achieving the very valuable objective of allowing users access to all securities through one CSD. Please note that it has never been our expectation that every CSD should provide this service. Some CSDs may choose to do so on a large or a small scale, and T2S will provide an incentive for this. Others may choose not to provide such services. The potential benefits of T2S do not depend on CSDs linking to each other but can equally be realised by existing intermediaries enjoying reduced costs or by banks connecting directly to more CSDs themselves.

We expect competition, facilitated by the Code of Conduct, to fill the gap. The need is clear, and CSDs will have incentives in the T2S world to fill it, perhaps in combination with others.

We are puzzled that the issuer CSD is seen as having material advantages which cannot be replicated by other CSDs. Euroclear offer registration as the sole example. However, we understand that registering securities in the name of the investor is not often regarded as important by international wholesale investors. It is near-universal practice for them to hold securities in omnibus accounts of custodians, even where the custodian could offer an account registered in the name of the owner. Retail investors in the country of the issuer may prefer to be registered, but are of course not forced to move to a foreign CSD.

Clarification on other misunderstandings:

Portuguese tax numbers (Page 18) can be passed to Interbolsa using a spare field in the settlement instruction sent to T2S by the counterparty which is not using Interbolsa.

We do not have a position in relation to internalisation (Page 19) of settlement within a custodian; our objective is to reduce the costs of moving to a single market in securities. If users choose settlement in commercial bank money in a custodian or ICSD, that option is open to them.

4 Decommissioning

We don't agree that decommissioning of CSD systems is the critical success factor; we see collateral savings, greater competition, and harmonisation as being more important. But of course we think that it is highly inefficient to duplicate investment in complex systems for real time settlement.

We take note of Euroclear's success in decommissioning; the objective of T2S is to extend this benefit to a European rather than to a regional level.

We understand that Euroclear faces a specific issue with the settlement of securities in sterling. T2S offers the possibility of settling other currencies in central bank money on the T2S platform. We are confident that participants in the UK market see the benefit of having sterling securities settled on the T2S platform and might enter into discussion with UK authorities.

5 Liquidity management

We do not agree that it is "*vital*" in achieving access to a single pool of cash and securities liquidity that market users can access all T2S securities "*from one CSD account*"; it is of certainly a desirable outcome which should be achieved in the longer term.

First, T2S allows a user to fund all its cash needs from one NCB account¹, even where it has multiple CSD accounts.

Second, harmonised settlement model and operating hours reduce the probability of a user finding its cash locked away (or, where it uses ICSDs, being in debt) overnight in one or more CSDs.

Third, it can arrange and settle real time stock loans and (reverse) repos directly with market participants whether or not the counterparty is a member of its CSD(s) – so long as the counterparty has an account in T2S through its CSD(s). If its CSD cannot provide asset servicing on some securities, that does not stop assets being held in accounts with the CSD; this will normally not be attractive for custody purposes (though the custodian may fill the servicing gap), but will often be adequate for short term collateral operations.

The user will perhaps not normally operate in this way where there is a need to accept an **optional** corporate event during the term of the loan. However, we think that mandatory events can be accommodated by modifying the terms of the loan/repo and (if needed) supplementary deliveries between the parties in T2S at the end of the loan.

We accept that long dated/undated loans will benefit from pan-CSD asset servicing. But we think there are big gains for short term activity.

Detail:

T2S will incorporate corporate events in its liquidity projections for users where instructions to implement such events are present in T2S. They will normally be present, especially if users make it clear to CSDs (and registrars, where relevant) that they need accurate forecasts.

Unexpected last minute instructions will of course not be reflected in anyone's projections!

We agree that market users which also settle in commercial bank euro money will need to construct their own projections. Many major users of collateral markets already do so.

Euroclear suggests, in relation to **settlement in central bank money provided in T2S by a commercial bank** on behalf of a user without a NCB account, that there would have to be a transfer into T2S from T2 for each such user. We do not agree. It will be one transfer at start of day for each commercial bank provider, to cover its estimate of its own and its clients' needs, with further automated or autonomous transfers according to parameters controlled by the bank.

We do not accept that a floating charge cannot be used to secure the payment bank; it is similarly possible as in Euroclear. We do not offer automatic "implementation" of the charge via repos through auto-collateralisation², having been told by banks that they do not regard this as necessary. We can re-consider if they change their minds.

6 Harmonisation

¹ Or one account provided by a bank, if it does not have a NCB account

² As we do between NCBs and banks

We do not agree that the investor CSD need incur “significant operational risks” in relation to its client owning assets with a different issuer. Asset servicing could practically be provided by the issuer CSD, or by a custodian with an account in the issuer CSD; either could download holdings data (with client and CSD consent) from T2S (or the issuer CSD if it duplicates records) and construct appropriate settlement instructions for sending to T2S and investor CSD as appropriate.

Euroclear notes the merits of its “multi-jurisdictional” model. Euroclear describes this term on page 25: “... looks like one account at a technical level, in legal terms it effectively represents many different underlying legal accounts”. This is at one level also a good description of a market user’s holding of accounts in multiple CSDs, all of which are available in T2S via a direct connection.

We suspect that this precise model can only be delivered for Europe by merging all the CSDs in Europe into one, which does not seem likely to be achieved in the next few years. We wish to explore with Euroclear experts whether it can be achieved while there are multiple CSDs.

However, the T2S world can offer³ market users (through direct technical connectivity) a single access point (i.e. a single BIC address at technical level) for an entity wishing to use this means of instructing all its CSD account(s) valid for T2S. This approach is available whether the user has account(s) with only one CSD (e.g. where that CSD is connected to all other CSDs); or accounts with more than one CSD.

In any case, however, we do not see a serious detriment in risk terms in our approach, which offers more flexibility; and we expect there will be legal progress which further improves the position by 2013.

As noted above, we do not believe a close relationship with issuers being on the register is highly valued by the owners of a large proportion of shares; and note that such owners can continue to hold accounts in the issuer CSD if they choose.

We do not understand why Euroclear cannot continue with its multi-jurisdictional approach in T2S; we will seek a deeper understanding.

7 Governance

Euroclear suggest that the governance structure under consideration for T2S would be a “significant change” for the markets. While it is true that the Advisory Group would have an advisory, rather than a direct decision-making role, the overall structure would be similar to that of the Euroclear group. We note that there are, in fact, almost no clients represented on the boards of the Euroclear CSDs, which consist mainly of Euroclear management and some independent directors. Clients are represented only on the board of the company that provides services to the CSDs, and on market advisory committees. In this respect, representation at the level of T2S, the service provider to CSDs, is similar to the representation they enjoy today.

³ Subject to each CSD’s permission