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Brussels, 24 July 2002

Subject: Contribution to the joint working group of the CESR and the ESCB in the field of securities clearing and settlement

Dear Sirs:

The Euroclear Group is pleased to have the opportunity to contribute to the work of the joint working group established by the Committee of European Securities Regulators and the European System of Central Banks (the "Group").

Market-owned and market-governed, Euroclear is the worlds' premier settlement system for internationally traded securities, and the provider of choice among financial professionals for cross-border securities services. The Euroclear Group, as you may know, now includes Euroclear Bank, Euroclear France (formerly Sicovam), the primary provider of clearance and settlement services for the French market and, since April 30, 2002, Nederlands Centraal Instituut voor Giraal Effectenverkeer B.V. and Nederlands Interprofessioneel Effectencentrum NIEC B.V., which are the primary providers of clearance and settlement services for the Dutch market. In 2004, it is anticipated that the Euroclear Group will merge with the Belgian central securities depository. Euroclear has also assumed responsibility as CSD for Irish government bonds.

As a result, Euroclear now serves as a single access point to debt, equity and fund markets for clients across 80 countries, and provides low-cost, multi-currency, real-time settlement for securities transactions in both commercial bank and central bank money, with simultaneous DVP (BIS model 1) and immediate finality. Euroclear has substantial interaction with a large cross-section of the world's

exchanges, clearing organisations, settlement systems, depositaries, custodian banks and users of all of these entities.

In this context, we respectfully submit our responses to the questions raised the call for contributions of 15 March 2002.

We would be happy to discuss the enclosed comments further with the Group should it so desire, or to provide any other information that the Group would find useful to the Group's work. Please do not hesitate to contact us if we can be of further assistance in this regard.

Sincerely,

Diego Devos
Deputy General Counsel

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Assistant General Counsel

EUROCLEAR GROUP

CONTRIBUTION TO THE JOINT WORKING GROUP OF CESR AND ESCB IN THE FIELD OF SECURITIES CLEARING AND SETTLEMENT - RESPONSE TO CALL FOR CONTRIBUTIONS DATED 15 MARCH 2002

2.1 and 2.2 Nature of the recommendations; Addressee

Euroclear would like to caution the use of binding legal instruments in the area of securities clearing and settlement. It is an area, which currently is undergoing significant change, both in terms of market structure (through consolidation and linkages) and in terms of the services offered by the different market players. It is the view of Euroclear that any binding legal instrument aiming at regulating the types of services to be offered and the manner in which to structure such services could very well become an impediment to rather than a facilitator of further integration within the EU.

On the other hand, it should be recognised that some of the risks and barriers, which exist in today's environment, can only be successfully addressed by way of legislation. Typically, binding legislation will be needed where legal uncertainties are the cause of inefficiencies or risks. Please refer to Section 2.6. for a discussion of the areas where we believe that legislative measures would be useful in order to eliminate such uncertainties.

In the area of prudential supervision, Euroclear favours the adoption of recommendations agreed at EU level. For reasons of consistency (that should result in a level playing field) and transparency, we believe it is important that the principles for supervising providers of securities clearing and settlement services be agreed between European regulators. However, the manner in which to transpose the recommendations into the national supervisory framework should be left to each Member State so as to allow them to take into account the specifics of the clearing and settlement industry in their country. Therefore, we believe that such recommendation should best be addressed to national supervisors who

would, amongst other things, determine the appropriate sanctions. We see several advantages in the use of recommendations: Firstly, the time frame needed for revising and up-dating recommendations tends to be significantly shorter than for the adoption of amendments to EU legislation. Indeed, the length of the legislative procedure at the EU level (or even at the national level of each EU Member State) could well prevent a regulator from providing a sufficiently rapid response to changes in the securities clearing and settlement industry. Secondly, if the process of adopting relatively detailed legislation at the EU level is initiated, there is a risk that the result will reflect the minimum common denominator, whereas recommendations may provide a better framework for reaching agreement on high standards.

In addition, Euroclear believes that in cases where an entity or a group of affiliated entities within the EU providing clearing and settlement services is subject to the supervision of several regulators, it could add significant value to the supervisory process if the primary responsibility for supervision of the entity or the group were confined to one of the regulators in question (the so-called concept of a "lead regulator"). The introduction of a lead regulator would not only clarify the role of the regulators and thereby contribute to ensuring that adequate supervision is performed at group level. It would also be a way of avoiding duplication of the efforts made by the regulators and the regulated entities as part of the supervisory process. Taking this point even further, moving towards a structure with a single regulator at European level could be considered. It would, in addition to increased clarification and efficiency, bring the benefit of suppressing any "regulatory shopping" and would thus contribute to ensuring a level playing field amongst providers of clearing and settlement services in Europe.

2.3 Scope

Euroclear supports a regulatory approach based on the *nature* of risk as criterion, not only on the *magnitude* of risk or the *status* or *legal form* of the entity. While the nature of risks are obviously cumulative (for instance, if there is some credit risk there is also some operational risk and quite unavoidably custody risk), the services may not be cumulative. For instance, settlement in commercial bank funds can be offered by providers that do not offer settlement in central bank funds.

	Nature of risk involved	Main service	Typical examples (not exclusive)
Level 1	Custody risk	Depository vaults (certificates) Register or similar records of rights (dematerialised)	Local CSD
Level 2	Operational risk	Settlement	Local SSS
Level 3	Credit risk (on a non-central bank)	Settlement in commercial funds, incl. across DvP links with other CSDs, securities servicing and other value-added	ICSDs
Level 4	Market risk	Position taking for own account (execution, FX, derivatives, lending…)	Local agent banks, Global custodians, CCPs

We believe that regulatory action should be best structured around a layered approach that applies to all systemically important service providers:

- Systemic risks are by definition not specific to any particular level (nature of risk) but rather to the *size* and importance of the entity within its own level. Hence measures to minimise systemic implications from credit risk should apply to all *sizeable* entities in levels 3 and above, and not focus exclusively on entities with a specific status ("CSD", "ICSD", bank…) to ensure adequate risk mitigation as well as fair and equal treatment of all providers. An efficient deployment of regulatory resources could be ensured by maintaining a list of the most *systemically important* providers in Europe, based for instance on the number of transactions, the value exchanged and the depot under management.

- Forcing a separation of the entities that provide services across levels would not address the crux of the problem, because:
  - it would not improve the situation from a risk perspective as it would *transfer or reject* risks to another entity but not eliminate them;
  - adequate risk-mitigation would require regulatory measures and resources fragmented over a large number of service providers;
  - yet it would penalise the markets and make it more difficult to achieve the longer-term key objectives of
    (1) higher efficiency, lower costs and lower risks through reduction of fragmentation in Europe;

(2) fair and transparent access conditions, and equally fair regulatory treatment of all providers;

- furthermore it may create room for competitive distortions between service providers that may be structured differently today, while they essentially compete on very similar services (in levels 3 and/or 4).

In any event if such a forced separation were undertaken, it should apply to all systemically important entities, not just to those with a specific status.

- Euroclear recommends a layered approach with specific rules and controls to minimise systemic risk *at each level*, applicable in a *cumulative manner* to infrastructure providers as they provide services spanning across levels 2, possibly 3 and beyond.

2.4 Objectives

Euroclear concurs with the objectives expressed by the Working Group.

2.5 Access conditions

First of all, Euroclear recommends that access conditions be assessed and reviewed for all service providers involved in the settlement of cross-border transactions. This includes domestic CSDs, of course, but must also include parties dealing with the cash side of transactions (central bank, multilateral cash netting system…), as well as providers of instruction routing and matching services that form an integral part of the securities settlement infrastructure in some countries. It is only when all these providers have objective and publicly disclosed criteria for participation that we will see fair and open "remote access" in Europe.

Secondly, we urge the Group to strengthen its position against anti-competitive behaviour among settlement competitors. We believe that CSDs should be held to a high level of scrutiny when denying access to core settlement and safekeeping services to competitors. Euroclear recommends that any departure from standard access, service level and pricing conditions – for instance, but this is not restrictive, those agreed between CSDs in the framework of ECSDA – be justified

on objective grounds, and in any event do not depend on the status of the parties such as “CSD”, or the affiliation of the client to any association.

Finally, we suggest that the recommendation of objective and publicly disclosed criteria and fair access be applicable not only to the participation to, and use of existing service providers, but that it also applies to the ability of new providers to start offering services and compete with the current service providers. For instance we suggest that the Group examines in detail any discriminatory rule – by stock exchanges or clearing houses – that prevent fair and equal competition at the settlement level other than for clearly justifiable grounds, and that the justifications for such discriminations be periodically re-assessed.

2.6 Risks and weaknesses

We concur with the view that legal, custody, settlement and operational risks are four important factors to risk in a securities settlement infrastructure. We would however insist on two additional factors that are generally implicit in the above risk factors for purely domestic infrastructures, but that take a much higher importance in the European context because of the diversity and fragmentation of the current settlement infrastructure:

- The first factor relates to the ability of the infrastructure as a whole to sustain volume growth in a scaleable manner. This scalability issue obviously applies at the level of individual domestic settlement systems, for the majority of domestic transactions that they process, but we contend that it is even more critical for the growing share of cross-border transactions in Europe. Focusing only on each of the four previous risk factors for each settlement system will not highlight this scalability issue for the infrastructure as a whole to cope with cross-border transactions.

- The second factor relates to the completeness of supervision of the infrastructure as a whole, in light of the large number of its constituencies in Europe, especially for cross-border transactions. More specifically we note that there are various arrangements to support cross-border settlement in Europe, some based on links between CSDs (and already subject to supervision for these activities), but more importantly also others based on local agents expanding their geographical scope to become regional providers

and therefore provide the same settlement services as CSDs, hence be the source of the same risks. Our view is that risks and weaknesses in the European settlement infrastructure can only be adequately mitigated if all significant providers are supervised in the same way, i.e. according to their function as opposed to their status.

Euroclear has consistently supported legal reforms to further modernisation and improvement of national laws in the area of securities settlement. In June 1993, Euroclear published a white paper, called "Beyond the G30 Recommendations", which recommended the modernisation and improvement of national laws with respect to securities ownership and transfers of securities with particular attention paid to securities pledging laws and procedures, in a cross-border environment through use of multiple-tiered holding systems. Several jurisdictions have adapted their national legislation in line with these recommendations, in order to ensure legal protection of investors' rights and the enforceability of collateral, including in case of insolvency, whether such collateral is taken under the form of pledge (or of other kind of security interests) or under the form of transfer of title (repurchase transaction, margin transfers). One example of these efforts is the EU Directive on settlement finality in payment and securities settlement systems.[1]

There are, however, substantial legal uncertainties that remain in many jurisdictions. We encourage the Group to consider making more specific recommendations that national laws be enacted, revised or interpreted to reflect the following four principles:

- Interests in securities held through a financial intermediary should be defined by legislation or otherwise interpreted either as (1) a type of interest in a pro-rata portion of the pool of securities or interests in securities held by the intermediary with whom the interest holder has a direct contractual relationship, evidenced solely by the interest holder's account with the intermediary, or (2) as a property right in the individual securities, but in no event as a mere contractual claim or as a traceable right in underlying securities which may be sub-deposited elsewhere.

- The pool of securities or interests in securities held by a financial intermediary to satisfy the entitlements of its interest holders should be protected against the claims of the intermediary's general creditors, either by defining the

[1] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998.

interest as a type of property or co-property right or by amending existing insolvency laws for financial intermediaries to give explicit effect to this policy.

- Conflicts of laws rules should be interpreted or modernised to reflect the development of the system for holding, transferring and pledging interests in securities by book-entry to accounts with financial intermediaries so that the selection of the law governing the characterisation, transfer and pledge of such interests is determined by reference to where the office of the financial intermediary maintaining such accounts is located or otherwise by reference to the intermediary's jurisdiction.

- Procedures for creating and enforcing a pledge of interests in securities credited to accounts with intermediaries are still very complex. It is indeed still the case that some formalities, such as public filing or registration requirements (as in the U.K.) or notarial deeds (as in Spain) must be fulfilled in order to achieve perfection of a pledge of interests in securities (even for a pledge governed by foreign law on securities held with an intermediary located abroad), which are very burdensome and tend to discourage the collateralisation of credit exposures, increasing the cost of credit. The recent EU Directive on financial collateral arrangements[2] should, upon final adoption at EU level and subject to proper implementation in the Member States, substantially improve the situation with respect to these issues.

In addition, Euroclear urges the Group to expressly support international initiatives dedicated to achieving greater legal clarity and support for cross-border settlement on a multinational level. In particular, we note the work currently underway to agree a Hague Convention on the law applicable to dispositions of securities held through indirect holding systems, to which Euroclear has contributed with noted experts from a range of countries. Express support of this initiative by the Group would provide additional incentive for the reform of national laws that hinder the efficient and legally robust settlement of international trading activity.

We also note that, in addition to seeking clarity in relevant laws, it is equally important for issuers and lead managers to put in place robust issue documentation. Settlement systems are typically not permitted, under their contractual arrangements with participants, to take actions that are not in

[2] Common position adopted by the Council of the European Union, 26 February 2002.

conformity with underlying issue documentation. If such documentation does not provide clearly for the rights of beneficial owners and participants in the settlement systems to pursue claims in case of an issuer bankruptcy or other default, it is not possible for the settlement systems to provide such rights. As a result, beneficial owners that have invested funds in an issuer can be effectively prohibited from exercising their individual judgement regarding the way to proceed against a bankrupt or defaulting issuer.

In addressing legal and regulatory issues in the field of clearing and settlement, we believe it is of utmost importance that regulators avoid limiting customer choice and that they ensure that all asset servicing service components can be offered by any intermediary independent of its location.

As far as custody activities are concerned we concur with the view that the segregation of assets and the reconciliation of positions are the most crucial issues. As an additional measure towards fair competition and transparency, as well as the promotion of sound asset protection practices, we recommend that the Group considers measures to ensure full disclosure and transparency across all providers of safekeeping services – including CSDs, ICSDs, sub-custodian banks and global custodians – of any potential right, lien, interest or claim on clients' assets, be it for collateralisation or other purposes.

With respect to settlement risk and in light of the single European market in preparation, our view is that there should be minimal differences between measures for domestic transactions and measures for cross-border or cross-system transactions. This view is reinforced by the fact that a growing number of shares are more actively traded and settled on a pan-European cross-border basis than on a pure domestic basis. We agree that the definition of DvP and its timing, and the importance of a dual access to both central and commercial money are the most important issues related to settlement risk, but stress that effective risk-mitigating measures should cover both domestic transactions (currently a large proportion of the entire activity), and cross-border transactions (very likely to outnumber the domestic volumes in the longer term). Hence the importance of intra-day and possibly real-time finality in individual CSDs, as well as sound DVP settlement links between CSDs.

2.7 Settlement cycles

Euroclear's view is that settlement cycles should be harmonised across European markets, at least for each main asset class (shares, debt). We recognise indeed that a growing proportion of investors no longer trade on a pure domestic basis, but instead on a pan-European sector basis. They are gradually re-structuring their back-office processes and will achieve the highest savings if market practices converge across markets, and this includes settlement cycles.

We also recognise that securities financing markets differ among shares and fixed income (ranging from repo's, securities loans, collateralised loans, general collateral or settlement-integrated securities borrowing programmes), and the settlement periods of cash markets strongly influence and/or depend on these financing markets as well as on the world-wide FX market. We recommend that any change to the settlement period of cash markets be assessed in close collaboration with at least a pan-European sample of market players.

The above-mentioned dependencies are particularly important when considering the specific case of T+1 (they are even more important for T+0). Because of the much shorter timeframe, we suspect that the various financing markets mentioned earlier will either cease to exist in their current form, or at least cease to provide the same level of liquidity as required by market players to minimise consequences of settlement fails, and hence it will become critically important for markets to have automated securities borrowing services integrated with the settlement process in CSDs.

2.8 Structural issues

We are of the view that markets will take a number of routes, possibly simultaneously – including concentration, inter-operability and open access – to gradually integrate into an efficient European market infrastructure, and believe that market forces should remain the main driver for change. The speed of the process and the effectiveness of market forces depend however on the critical condition that market users (including infrastructure service providers themselves) must have a fair and transparent access to services across geographical boundaries, at equally fair and transparent prices.

The following practices or arrangements, generally inherited from past domestic structures, should therefore be closely examined:

- Exclusivity arrangements between infrastructure service providers, possibly across the trading, clearing or settlement levels, whereby users of a service provider are not only forced to also using an affiliated provider, but more importantly whereby no competing provider can even enter that market. Market practitioners often refer to “vertical silos”.

- Complex regulatory, tax and other de facto arrangements that lead indirectly to the same outcome as described above, even if the two linked providers are not affiliated. They include complex regulatory reporting requirements, tax reporting and collection requirements, peculiar membership requirements for the cash side of transactions … etc. These situations could be qualified as “de facto silos”.

- Membership criteria that may prevent users from a fair and transparent access to the same service/price package as others, for instance based on their location.

- Remove regulatory and de facto barriers, which prevent fair competition in the domains of trading, clearing and settlement. A major impediment for the smooth operation of cross-border settlement and beneficial consolidation is the maintenance of vertical silos whereby the actions of the settlement provider are controlled or unduly influenced by a related trading or clearing provider. These silos prevent consolidation on a horizontal level and, as a consequence, represent a major obstacle for the realising of centralised settlement. Similarly, certain legal regimes require securities traded on a stock exchange to be settled or deposited only with an affiliated settlement system.

- Remove regulatory and de facto barriers that prevent remote access to markets, clearing and settlement on non-discriminatory terms or not at all. (For example, several local jurisdictions impose requirements that investors access local CSDs directly or at use only local banks for the settlement and servicing of their securities portfolio. Another example would be laws that require the involvement of a local credit institution to ensure the application of withholding tax on outbound dividend and interest payment and/or to offer withholding tax relief at source or through refund procedures.) Such rules (i)

constitute an obstacle and/or an extra cost in case of foreign market makers which need to set up separate and costly local arrangements with each of the markets in which they are active and (ii) prevent foreign intermediaries from offering a service to such remote market makers and to develop services that meet the needs of an industry which is moving away from its national environment towards a cross-border global one.

- Harmonise in areas where differing standards create substantial costs for cross-border investment, such as withholding tax relief procedures.

The governance arrangements of infrastructure and service providers should support the objectives of users, owners and the public interest. This includes (i) an efficient service, (ii) in a risk-controlled environment, (iii) responsiveness for service enhancements depending on market needs, (iv) at minimum cost while still maintaining sufficient investment capacity for the development of new services and systems as demanded by clients.

Even if the above objectives would normally apply to all service providers at the trading, clearing and settlement levels, we recognise that the barrier to entry for providing services at the clearing and settlement levels may be higher than for trading services, as evidenced by the rise and fall of electronic exchanges in Europe and the US.

Hence it is key to focus initially on the governance arrangements of providers of clearing and settlement services, in a way that does not depend on their status or their stated profit- or not-profit orientation (should apply equally to CCPs, CSDs, ICSDs, and also to large domestic or regional providers of settlement services).

Even though there is no single adequate governance structure for all providers, our view is that every structure should maximise user-representation, in generally comparable proportions to their use of the provider services, and at the same time avoid any dominance of specific users or user segment. This brings the following key advantages:

- The governance structure prevents abuses of monopolistic or dominant market positions;

- It ensures that the infrastructure provider is responsive to the market needs for new services;

- It also makes the "profit vs. non-profit" debate largely irrelevant because it inherently minimises potential conflicts between users' and owners' objectives: in their capacity as shareholders, the users ensure that adequate revenues are generated to sustain new service developments in a risk-controlled environment, that they are adequately compensated for the capital they provide, and that excess income is returned to the market through price reductions.

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