Pershing Division of Donaldson, Lufkin & Jenrette Securities Corporation (a Credit Suisse First Boston Company) & Pershing Securities Limited

Joint Work of the European System of Central Banks and the Committee of European Securities Regulators in the Field of Clearing and Settlement

A Call For Contributions From Interested Parties

A Response By Pershing Division of Donaldson, Lufkin & Jenrette Securities Corporation (a Credit Suisse First Boston Company) & Pershing Securities Limited

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1. INTRODUCTION

1.1 Pershing Division of Donaldson, Lufkin & Jenrette Securities Corporation (A Credit Suisse First Boston Company) and its affiliate English company Pershing Securities Limited (regulated by the United Kingdom Financial Services Authority ("FSA") (together "Pershing")), are leading providers of comprehensive brokerage execution, clearance, data processing, and investment products and services to financial organisations worldwide. In the United States and the United Kingdom, Pershing is the leading "clearing broker" namely a firm to which the back-office securities functions of financial intermediaries are outsourced. At present Pershing counts approximately 600 financial institutions amongst its clients, through which more than three million investors are serviced. Pershing provides services to leading banks, broker dealers, credit unions and other financial services providers. Pershing processes approximately 10% of the daily trading activity on the New York Stock Exchange ("NYSE") and 10% of the daily trading volume on the London Stock Exchange plc, has offices in key commercial centres in the United States and has maintained a presence in London since 1987.

1.2 Pershing welcomes the collaboration project between the Committee of European Security Regulators ("CESR") and the European System of Central Banks ("ESCB") (collectively the "Group") in the field of securities clearing and settlement.

1.3 Pershing believes strongly that any smoothly operating clearing and settlement system must recognise and promote the roles of introducing broker (also referred to in the industry as a correspondent) and clearing broker. The introducing brokers have the customer contacts and can therefore advise those customers effectively. The clearing firms on the other hand have the capital and manpower to execute, settle, clear and custody the trades enter by the introducing firms.

1.4 The securities regulatory system in the United States allows each of these types of firms to focus on their particular strengths without being saddled with unnecessary compliance issues. For example, the U.S. system allows introducing firms to carry less capital than clearing firms as long as the introducing firms do not hold custody of customer assets. Similarly, clearing firms do not need to conduct suitability and other "know-your-customer"

procedures as long as these procedures are conducted by the introducing firms that have introduced the customers to the clearing firms.

1.5 The size and depth of the U.S. securities markets can be largely attributed to the interplay of the rules of these two interrelated types of firms. The securities brokerage regulatory system in the United States is built around this interplay. In particular, NYSE Rule 382 and other similar U.S. rules (including the National Association of Securities Dealers Rule 3230. For the sake of convenience where Rule 382 is referred to in this Contribution all such rules are also to be taken as referred to.) specifically allow clearing firms and introducing firms to allocate responsibilities between them. It is important to note that this system is very flexible, there is no rule as to whom responsibility must be allocated, and allocations of such responsibility can be tailored for different circumstances. For example the activities of introducing brokers may differ in each case, and therefore, it is extremely important to have flexibility within the regulations to permit the definition of the model, and the scope of responsibilities of each party to the clearing contract in each instance. Responsibilities should be reflected in the activities performed by each party, rather than a strict set of responsibilities allocated to both introducing firms and clearing firms. Such a prescriptive approach would lead to double regulation of responsibilities, which is unnecessary, particularly when both parties are regulated.

1.6 The net capital and other rules are similarly constructed to follow the allocation of responsibilities under NYSE Rule 382. Essentially NYSE Rule 382 allows a financial intermediary to outsource its back-office function to another party.

1.7 Accordingly, Pershing strongly supports the introduction on a pan European Economic Area ("EEA") basis of a rule equivalent to the NYSE Rule 382 and the related net capital, record keeping and investor protection rules.

1.8 By way of background rule 382 was introduced into the US following what is now referred to as the "Paper Crunch" of the late 1960's and early 1970's where, as a result of the inadequate and inappropriate regulation and increased trading volumes, a number of securities brokers and dealers failed, unable to cope with back-office demands. At that time there were approximately 16 million shares traded per day. Today, with the benefit of technology, outsourcing, and the beneficial regulatory treatment in large part reflected in the application of Rule 382 US broker/dealers and clearing firms such as Pershing currently handle the trading of over 3 billion shares per day with a substantially shorter settlement cycle. Today, approximately 85% of broker/dealers in the United States use clearing firms such as Pershing to undertake such back office functions and their usage is heavily instrumental in the efficiency and volume of equity trading in the United States.

1.9 Broadly speaking under Rule 382 the allocation of responsibility ensures that the ultimate customer of the introducing broker is afforded the protections to which it is entitled, on the basis that the responsibility has been accepted by a person within the chain of persons involved in the execution of the securities transaction and related activities, but that the responsibility is not duplicated,

thereby enabling the various parties involved to focus on their core area of business.

1.10 In particular it is worth noting that as an additional layer of protection for investors in the United States introducing firms (and also clearing firms) are members of the Securities Investor Protection Corporation ("SIPC") (http://www.sipc.org/) which acts as a form of insurance such that in the event of a failure of such a firm and the loss of securities, investors get their securities back. Pershing strongly supports a similar arrangement for investors on an EEA wide basis.

1.11 It is also worth noting that under the Securities and Exchange Commission rules 15c3-1 and 15c3-3 for regulatory capital purposes and SIPC protection, customers of an introducing broker are deemed to be customers of the clearing firm. This has the effect of allowing the introducing broker to maintain a lower capital requirement (as the custody and monies are held by the clearing broker and not by the introducing broker). Again this promotes the creation of more introducing firms and in turn this promotes the possibility of trading securities to a wider audience given the low barriers to entry for introducing firms.

1.12 At present, broadly speaking EEA member states, treat a fully disclosed/model B arrangement on the basis that Pershing has responsibility similar to those of the introducing broker in respect of its client and do not take into account that Pershing is in this context only a facilitator of trades rather than, broadly speaking, an arranger and back-office service provider which is the role of the introducing firm. This approach creates a double layer of regulation as the responsibility for the consumer protections for matters such as advice etc. apply to the introducing broker (who has day to day contact with its relevant customer) *and* to Pershing (which does not). This double regulation creates regulatory and cost inefficiencies. This is best illustrated by way of example. Under the old SFA Securities and Futures Authority rules, Appendix 41 of the rule book set out explicit responsibilities of both introducing firms and clearing firms. Broadly speaking this Appendix gave clearing firms responsibilities for activities that they themselves were not necessarily carrying out. In turn this could be deemed to have the effect of reducing the responsibilities of the introducing brokers who actually carried out the activity. It did not necessarily take account of the fact that the introducing brokers were regulated and able to take responsibility for their actions. For example, in relation to best execution, the clearing firm was given responsibility for achieving best execution, even if the introducing broker carried out the execution of the transaction. The clearing firm did not necessarily have any control over the price obtained, but took regulatory responsibility for compliance with the requirement. FSA has changed the approach somewhat by including guidance regarding the relationship between clearing firms and introducing brokers in Chapter 5 of the Conduct of Business Sourcebook. However the emphasis is again on making the clearing firm responsible for all aspects of dealing, clearing and settlements, with the introducing broker simply responsible for advice and portfolio management. Whilst this section only has the status of guidance, rather than being specific

rules, it does not allow for the flexibility of the US system, which acknowledges better the differing nature of relationships between clearing firms and introducing brokers.

1.13 The above situation contrasts with the other typical form of clearing arrangement, namely the omnibus/"model A" arrangement in which the clearing and settlement functions etc. are undertaken for an introducing firm by the clearing firm/Pershing but Pershing is unaware of the identity of the introducing firm's customer and the introducing firm's customer is unaware of the identity of the clearing firm. In this situation, broadly speaking a lighter regulatory touch is taken on the basis that the clearing firm, namely Pershing, deals only with institutions.

2. ISSUES FOR FURTHER CONSIDERATION

Using the same numbering and referencing as the Group's Call for Contributions from Interested Parties, Pershing makes the following comments and/or observations:

2.1 Nature of Recommendations

The legal nature of the recommendations and/or standards to be issued to by the Group should be of equal application throughout the relevant European Economic Area ("EEA") member states.

Attaining a level playing field of rules, regulations and operational procedures throughout EEA member states is of paramount importance. This objective should drive the legal nature of the recommendations and/or standards to be issued by the Group. In Pershing's view this is most likely to take the form of umbrella legislation at an EEA level underpinned by detailed regulation in each member state of a standardised nature. Following on from this, of fundamental importance is the basic proposition that compliance with the rules of one member state (for example the home state regulator – in Pershing's case the Financial Services Authority in the United Kingdom) will automatically mean that the regulatory compliance rules of each relevant EEA member state have also been complied with, excepting the local conduct of business and investor protection rules are concerned. This is the only real way of ensuring simplification of offering services within the EEA on a cross-border basis. If a regulated firm has no presence in the country, it should not have to comply with local regulations, on the basis that the concept of the Investment Services Directive is to establish a level playing field across the EEA, and therefore the "home state" rules should be of equivalent standard to ensure the protection of investors.

For the avoidance of doubt the apportionment of the regulatory responsibilities is in no way intended to remove the ability of local law enforcement agencies to prosecute criminal offences committed in the local jurisdiction.

2.2 Addressee

As referred to at 2.1 above, the appropriate addressee of the possible standards or recommendations to be drawn up by the Group should be driven by the

objective of obtaining a consistent regulatory and legal approach throughout the EEA member states and for the purpose of ensuring the creation of the introducing broker/clearing broker relationship and in turn permitting the more efficient division of labour referred to in this document. In this regard, it seems logical that standards or recommendations drawn up by the Group should be addressed to regulators and legislators. In other words it is proposed that legislators be given power to empower regulators to create appropriate regulations. Pershing is of the view that given the level of detail required in such regulations, and importantly for the need to speedily adopt/amend regulations in light of new market practices, the flexibility of a regulatory body having the power to impose regulations, as opposed to such rules being imposed by legislators, is the preferred alternative.

2.3 **Scope**

Pershing agrees that the scope of the Group's work includes any entity providing clearing and settlement services or associated aspects and is not limited to any particular type of service provider.

More specifically, Pershing agrees that Central Securities Depository's ("CSD's"), International Central Securities Depository's ("ICSD's"), Central Couterparty's ("CCP's") custodians and registrars be included.

Some standards should apply on a differentiated basis to the parties referred to above given that the scope of their business is not directly comparable, in other words, the standards applicable to a custodian should be applied to all persons undertaking custodial services. However, such standards should not, and need not, apply to a person, for example providing clearing and settlement services but not custodial services.

Particular considerations applicable where custody and safeguarding services are provided by credit institutions or investment services firms, relate principally to the ring fencing of relevant securities from general creditors of those firms such that, for example, the insolvency of the relevant firm does not have an adverse effect on the legal owner of such securities, by ensuring that securities held for third parties by a custodian do not form part of the assets available to general creditors. As mentioned above, a scheme similar to the SIPC arrangement would also be of use in this context by, broadly speaking, guaranteeing in the event of the failure of a broker dealer introducing firm an investor would get his his securities.

Sovereign and private debt, equity and other securities, as well as depository certificates, receipts, derivatives, etc., should be included without differentiation.

Recommendations regarding cross border transactions should address the need for standardisation of the laws of ownership, pledging and transfer of securities and the imposition of standardised minimum net capital requirements for clearing firms throughout EEA member states. In turn, minimum net capital requirements for introducing firms could be relaxed to the extent that such firms use clearing firms with higher net capital

requirements. Such an approach fosters increased competition within the industry and promotes more efficient securities trading by way of expansion of the number of introducing firms. This phenomenon has been witnessed in the United States where, since the favourable regulatory treatment accorded to clearing arrangements by the US Securities and Exchange Commission the number of introducing brokers has increased nearly 1000%.

2.4 **Objectives**

Pershing agrees with the stated objectives and considers them sufficient.

Duplication of Supervisory Responsibilities in EEA Member States

As referred to above of specific importance to Pershing in this sphere is allocation of specific responsibilities such as the "know your customer" responsibilities with respect to accounts introduced to Pershing and other clearing firms by introducing brokers/financial institutions. As mentioned above the ability to allocate such responsibilities would enable Pershing and other clearing firms to focus on their specialty, namely the provision of certain "back-office" functions such as execution, clearing, settlement, custody etc. (and taking compliance responsibility in connection therewith) and to rely upon the introducing brokers expertise in the area where it has specialism, for example assessing it's client's investment objectives and advising accordingly.

At present, on a fully disclosed/model B basis technically Pershing and other clearing firms can have an indirect relationship with private customers, by virtue of the manner in which Pershing and other clearing firms contract and the context in which they contract. However, in the context of "Rule 382", Pershing and other clearing firms allocate such responsibilities to the introducing broker which in turn affords its customers the various customer protections. Pershing and other clearing firms simply facilitate the trades of the introducing firm's customer under these arrangements and afford the introducing broker and its customer the appropriate protections, in the context of the work they undertake by way of maintenance of the minimum capital requirement. By way of explanation, the role of a clearing firm and the benefit derived from Rule 382, are set out more fully below.

Background

As a clearing firm, broadly speaking, in the United States Pershing's role and objective is to execute, clear, settle and custody securities trades at the lowest possible cost to investors to promote as liquid and efficient a securities market as possible. In the United Kingdom, Pershing undertakes a similar role, however, there is less emphasis on execution.

The essence of the relationship between the introducing firm and the clearing firm is that the introducing firm specialisation rests with its personal contact with the investor and its provision investment advice to its customer. In contrast the clearing firm, in the United States Pershing, focuses on the execution, clearing and settlement of trades together with certain other back office functions, for example on a fully disclosed/model B basis it can prepare

and send the relevant statements of account for individual customers. By virtue of the fact that the clearing firm focuses purely on the provision of these services and does so for many introducing firms it has the size, capacity and economy of scale to minimise the cost of execution, clearing and, in some cases, consequent custody of the resultant security from the trade. This has the benefit of enabling the introducing firm to significantly reduce its overhead and provide services to its customer at a greatly reduced price, facilitating market liquidity and trading in equities generally.

As mentioned above there are two types of clearing arrangements that predominate the securities industry in the United States:(i) the fully disclosed/model B agreement; and (ii) the omnibus/model A agreement.

The fully disclosed/model B agreement where the identity of the introducing firms customer is disclosed to the clearing firm is the more common of the two arrangements. The reason for the popularity of the fully disclosed/model B arrangement is because in these circumstances in the United States the clearing firm may prepare and deliver direct to the introducing firm's customer certain administrative documents including trade confirmations and monthly statements of account. In doing so the introducing firm is able to dramatically reduce its overheads by effectively "outsourcing" a significant proportion of its back office function.

By way of contrast, under an omnibus/model A arrangement, in the United States neither the clearing firm nor the introducing firm's customers are advised of each other's identities. Therefore in contrast under these arrangements the clearing firm by definition cannot liaise direct with the introducing firm's customer and provide to it the monthly statements of account etc. This means that the introducing firm cannot maximise the cost saving potential of using a clearing firm in these circumstances.

In essence the economic effect of fully disclosed/model B arrangement is to enable the cost of undertaking securities transactions to be driven down by enabling introducing firms to subcontract back office arrangements of settlement, clearance and custody to clearing firms, utilising the clearing firms' economies of scale but without imposing upon the clearing firm the regulatory burden of compliance with "know your customer" requirements and other supervisory responsibilities which, in light of the introducing firms existing supervisory responsibilities, would be duplicative if also imposed on the clearing firm. This is accomplished in the United States by virtue of NYSE Rule 382 and National Association of Securities Dealers (NASD) Rule 3230, which set forth the collective responsibilities to be covered in clearing agreements but permit firms to divide the responsibilities between them.

Pershing strongly supports the introduction on a pan EEA basis of a rule equivalent to the NYSE Rule 382 in order to facilitate the use of the fully disclosed/model B arrangement on a pan EEA basis, enabling EEA residents the efficiencies of securities trading available to US residents.

NYSE Rule 382, requires with respect to all fully disclosed/model B arrangements (namely an agreement under which the introduced customers

name and address are disclosed to the clearing firm) the clearing agreement between the clearer (namely Pershing) and the broker or other financial institution specifically identify and allocate certain functions and responsibilities constituting at least the following:

2.4.1 opening, approving, and monitoring of accounts;

2.4.2 extension of credit;

2.4.3 maintenance of books and records;

2.4.4 receipt and delivery of funds and securities;

2.4.5 safeguarding of funds and of securities;

2.4.6 confirmations and statements; and

2.4.7 acceptance of orders and execution of transactions.

The NYSE does not opine as to who should "own" these responsibilities. NYSE Rule 382(c) requires that the customer whose account has been introduced to a clearing house on a fully disclosed/model B basis must receive written notice of "the existence of the agreement and of the relationship between the introducing and carrying organisation" (namely Pershing) which notice "shall include a disclosure of the allocation or functions and responsibilities which are customer related". In practice the clearing firm sends this notice to the relevant customer.

At present, throughout the EEA member states, a fully disclosed/model B arrangement is, broadly speaking, inefficient and not cost effective. Various individual member states regard the relationship between the clearing firm and the ultimate customer (of the introducing firm) as constituting a direct private customer relationship (by virtue of the identity of the relevant introducing firm's customers) and thereby impose upon the clearing firm a higher level of regulatory compliance obligation than would the case if the clearing firm were to solely have a relationship with a broker or other financial institution (for example as it does in the case of an omnibus/model A arrangement). However, this regulatory burden does nothing to assist such a private customer since it has the effect of driving up the cost of undertaking securities transactions. Moreover, this additional regulatory layer offers no additional protection to the private customer who is being advised by the introducing firm, which is already subject to the private customer regulatory regime in the relevant member state. The inability for clearing firms to offer introducing firms fully disclosed/model B clearing arrangements throughout the EEA means that the most efficient form of clearing and settlement of securities transactions within the EEA cannot be offered to EEA residents.

2.5 Access Conditions

The different regulatory approach adopted in each EEA member state inhibits efficient cross border clearing and settlement relative to domestic transactions.

As is stated in the Giovannini Report, "Complications arise because of the need to access many national systems, whereby differences in technical requirements/market practices, tax regimes and legal systems act as effective barriers to the efficient delivery of clearing and settlement services. The extent of the inefficiency that is created by these barriers is reflected in the higher cost to pan EU investors and is inconsistent with the objective of creating a truly integrated EU financial system."

A system designed to encourage fair and open access would likely result in greater efficiencies in clearing and settlement services.

2.6 Risks and Weaknesses

As referred to above, the most relevant factors to risks and weaknesses in terms of clearing and settlement of domestic and cross border transactions are as follows:

2.6.1 Legal Risks

The current lack of standardisation of laws for ownership, pledging, transfer and clearing and settlement of securities throughout the EEA increases risks and costs.

2.6.2 Operational Risks and Weaknesses

From an operational perspective, the fragmented national clearance, settlement and depository systems is inefficient, is not cost effective and, as such, inhibits EEA financial integration.

2.7 Settlement Cycles

Pershing is of the view that in view of the goal of harmonising the regulatory position generally movement be made toward the standardisation of settlement cycles throughout the EEA.

2.8 Structural Issues

Custodians, CCP's, Registrars, CSD's, and ICSD's should be considered as commercial firms driven by regular competition and should not be considered as utilities whether or not they operate within a monopoly environment. In turn, these firms should then be regulated.