ECSDA
European Central Securities Depositories Association

22 January 2009

ECSDA RESPONSE TO ESCB/CESR CONSULTATION ON SSS RECOMMENDATIONS

ECSDA welcomes the opportunity of commenting on the revised ESCB/CESR Draft Recommendations for Securities Settlement Systems and Central Counterparties ("The Recommendations"). In particular, we welcome

- the compromise that has been reached by the authorities that has enabled the Recommendations to be revived and, in due course, implemented,
- the fact the Recommendations are now directed at the public authorities rather than the CSDs themselves,
- the work undertaken by CEBS, as a result of the ECOFIN conclusions, to analyse whether the Recommendations could lead to any inconsistencies (especially for those CSDs that are banks) with the CRD's in the treatment of custodians.
- the return to the CPSS/IOSCO wording for Recommendation 9 on credit risk.

ECSDA has always believed that the Recommendations are a vital component of the post trade policy framework and that, in their current construction, and subject to the comments that follow below, the Recommendations should be a major contributor to delivering a more balanced regulatory framework for CSDs across Europe.

Our major outstanding questions and comments are listed below, starting with general comments on the process and assessment methodology and concluding with our specific comments on each of the Recommendations themselves.

Comments on this document can be addressed to ECSDA via the Chair of the ECSDA Public Policy Working Group (paul.symons@euroclear.com)

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General Comments

ECSDA has long been a supporter of functional regulation (as explained in ECSDA's previous responses to previous consultations by ESCB/CESR[1]) and continues to believe that the delivery of a regulatory framework which assesses activities and their associated risks irrespective of the entity providing those services, is the most appropriate mechanism for delivering a level regulatory playing field across all providers of post trade services in Europe (whether such services are provided by CSDs, agent banks or other entities).

But, ECSDA has also always recognised the complexities of delivering such a regime and understands why ECOFIN therefore, restricted the application of the standards to CSDs and ICSDs only. It is in this context that we greatly welcome the active involvement of CEBS in examining any discrepancies between the CRD and the ESCB/CESR Recommendations for banks. It is vital that any gaps that are identified as part of the review are acted upon and closed by the appropriate regulatory action.

There are two main questions that we have on the application of the recommendations:

(i) How will the CEBS conclusions be applied to those CSDs that have a banking licence? Will (for instance) recommendation 11 and 17 be redrafted to include explicit reference to the CRDs framework for operational risk management?

(ii) A number of recommendations are not actually within the control of the (I)CSDs (this was true of the old ESCB/CESR draft Standards as well). In particular, any changes to national law that may be required as a result of implementing Recommendation 1 (Legal framework) will rest with national public authorities not with CSDs. Recommendation 3 (settlement cycles) and Recommendation 4 (CCPs) also do not apply to (I)CSDs. In addition Recommendation 2 (trade confirmation) also contains elements that cannot be delivered by the (I)CSDs themselves. The public authorities to whom the Recommendations are addressed should reflect this within the Assessment Methodology.

In addition, we would suggest that reference should be made to the ECB's Glossary of Terms that was released for consultation in September 2008 and to which ECSDA responded in January 2009, rather than constructing a specific glossary for these Recommendations.

[1] Particularly in October 2003.

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The Assessment Methodolgy

Whilst ECSDA welcomes the move to switch from Standards addressed to (I)CSDs to Recommendations addressed to Regulators, we believe that the non-binding nature of this document could raise some level-playing field concerns about the way in which these Recommendations will be assessed within each jurisdiction. It is possible that some Member States could decide to apply different or stricter principles to assess their respective markets.

ECSDA accepts the need for an effective assessment methodology and believes that regulators should ensure as level a playing field as possible, while taking into account the differing risk profiles, services and scales of CSDs within the EU.

In addition, the introduction of a new methodology should not lead to (I)CSDs having to complete an additional annual compliance questionnaire; ECSDA Members are already burdened by the requirements of the Association of Global Custodians and CPSS/IOSCO, as a minimum, and (as you are aware) have been examining way of streamlining the requirements of such bodies into a single annual disclosure framework which can be used by all stakeholders. ECSDA would like to draw the attention of ESCB/CESR to this work, and to hold further discussions on how such work could be used in the context of the Recommendations.
ECSDA notes that The Assessment Methodology itself is not always consistent with the text of the Recommendations themselves. For instance;

(i) In assessing compliance with the DVP Recommendation, the suggestion is that all CSDs should be judged against an obligation to settle at least 95% of transactions on ISD. A more tailored approach is needed depending on the specific market.

(ii) In the context of CSD links with low volumes the assessment methodology, helpfully, does not require the application of DvP. This comment should be recalled in the explanatory memorandum of Recommendation 19.

The Recommendations for (I)CSDs

ECSDA has the following comments on the Recommendations themselves

Recommendation 1

Some of our Members had a concern (in Section C4 on page 18) that the ECSB/CESR recommendations were encouraging CSDs to support information provided to participants with, “where appropriate, an internal or external analysis or opinion”. The provision of an external

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legal opinion on the issues identified in Section C4 is a significant administrative and cost burden to all CSDs but particularly to the smaller CSDs in Europe. We would urge Regulators to take a proportionate response to this Recommendation. In addition, a CSD's participants could place an undue reliance on the opinion (whether it is internal or external) of the CSD and might not undertake its own due diligence.

In addition in sections C7 and C8 we suggest the wording should be changed from "law chosen" to "law applicable". Issues relating to the applicable law are related typically to the location of the SSS, nor chosen by the counterparties.

Recommendation 3

As we mention above, Settlement Cycles are not usually under the control of a CSD; they are usually a function of the trading platforms rules, since the settlement period is an integral part of the trade price. Recommendation 3 therefore, cannot be addressed to (I)CSDs.

In addition, section B3 references ECSDA standards on SSS opening hours although the wording is different to that used in the ECSDA Standard which says "All European SSSs should start DVP settlement by the opening time of the relevant European currency's banking system and continue to offer DVP settlement until, at a minimum, two hours before the banking system closes."

Section C1 indicates that "The longer the period from trade execution to settlement,… the larger the number of unsettled trades". The length of the period of transaction processing (from trade execution to settlement) may actually have a positive effect on settlement on due date. We suggest the wording is changed from "the larger the number of unsettled trades" to "the larger the number of open trades prior to settlement".

Recommendation 5

On page 33 Section C5, the Recommendations suggest that "the choice between centralised securitised lending facilities and bilateral arrangements should be left to the sole discretion of participants …so that participants are not de facto forced to use the facility. We would point out that in some jurisdictions (such as Spain) the use of a centralised securities lending facility operated by the CSD is mandated by law as one mechanism, amongst others, to guarantee the settlement of certain trades.

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Recommendation 6

Point 3 under section B on page 35 contains a number of statements that we believe are either incorrect, or represent an extremely interventionist approach to the structures of existing CSDs within Europe. There are three broad issues that we wish to raise:

(a) The Recommendation refers to the provision of "final" settlement at the CSD with the recording of changes in "legal title"; this is not necessarily true for all CSDs[2] and indeed the settlement can also be final from the perspective of a customer when internalised across the books of an agent bank (for instance). We would suggest that the first sentence of this paragraph is deleted.

(b) The Recommendation also refers to the necessity of "separating the CCP services into a distinct legal entity". The reasoning behind this conclusion is not explained. ECSDA believes that this is an extremely interventionist conclusion to reach without any accompanying risk analysis; separation into a separate entities is merely one (extreme) risk mitigating measure that a CSD might take to manage the risks of operating a CSD and a CCP. We would suggest that the sentence is revised as follows "Besides, the risks involved in offering CCP services are of a different nature to those raised by performing CSD activities *and therefore, where groups offer an integrated CCP and CSD service particular attention should be paid to the risk mitigation measures implemented*." Any changes to this recommendation should be made consistent with Recommendation 4 (CCPs).

(c) The Explanatory Memorandum C1 mentions the "core" activities a CSD performs. ECSDA believes that the notion of "core" activities of CSDs re-opens a debate which was never concluded successfully and which is not necessary to reopen in the context of these Recommendations.

Recommendation 11

ECSDA supports the overall ambition of the Recommendations to strive for lower recovery times for critical institutions. However we have a number of specific comments in this area.

The Recommendation requires that risk control systems and related functions should be "subject to frequent and independent audits". ECSDA accepts that some CSDs already provide their customers with a SAS 70 Report (or equivalent) and recognises the importance of such measures. However, the requirement for all CSDs to undertake such independent audits of their

[2] As demonstrated by ECSDA's comprehensive review of CSD services in 2005 available on www.ecsda.com

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systems and controls would add a significant administrative and cost burden to their business. Regulators should have discretion as to when to request a CSD to undertake such a review and with what frequency such a review should be undertaken.

In Section C10 it is stated that the business shall be resumed no later than two hours after the occurrence of a disruption for CSDs. ECSDA believes that two hours is a reasonable target for many systems, but a CSD provides many different services, with different scopes, sizes, service levels, etc, and it is far from obvious that 'one size fits all'. The paragraph might be rephrased to to say "A maximum objective of two hours unavailability for critical settlement services is given as guideline. However, the actual requirements for each particular system/service should be determined as required by each CSD taking into account the characteristics and specifics of each CSD's services"

On page 53 (Section C11), the Recommendations require CSDs to establish "a second processing site that actively backs up the primary site … ." Regulators should ensure that such a requirement, which would require significant investment by some CSDs, is proportionate to the risks that would be mitigated If this Recommendation is interpreted as requiring CSDs to hold staff permanently at two separate locations, it would add a significant administrative inefficiency and cost burden to their business, in particular for smaller CSDs.

Recommendation 12

In order to deliver compliance with Key issue B3 on page 56, national legislation may need to be altered in some Member States; this should be recognised in the wording of the Key Issue.

Recommendation 14

ECSDA welcomes that the Recommendations note that denial of access should only be based on risk-related criteria or other criteria as set out in EU Law. However, some members with an international client base have observed that to require all such refusals to be explained in writing might also not be permissible where the refusal is related to suspicions about potential illicit activity (such as suspicions about money laundering).

Recommendation 17

Explicit reference could be made here to compliance with the Basel II/CRD framework (and to risk disclosures under Pillar 3 in particular), for those CSDs which are banks.

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