

To the chairmen Mr Jean Michel Godeffroy
and Mr Eddy Wijmeersch and the members
of the Working group 'Standards for
Securities Clearing and Settlement Systems
in the European Union'

Amsterdam, 7 June 2004

Dear chairmen and members of the Working group,

With reference to ensuring a level playing field and the objectives of the standards and the scope of the SCSS (Securities Clearing and Settlement Systems) I intend to contribute to a well-balanced differentiation in definitions and scope of risk management.

In addition, my contribution is also related to the pending discussions in the Netherlands about level playing field.

I hope my remarks/contributions are of interest to you.

1. With reference to the historically based roots of CSDs and ICSDs as well as with reference to the on-exchange component of the capital market and off-exchange component of the capital market I recommend to make a segregation in the definitions and standards between a CSD and an ICSD.
Even the strategy policy of Euroclear Bank demonstrates that segregation in definitions serves clarity.

With reference to the Giovannini-reports, the national markets and the common drawn conclusions I would like to share the following with you:

- A public act is the basis for rules and regulations to ownership and transfer of ownership of securities; these functions are at infrastructural level entrusted to a CSD and the central bank. A CSD facilitates the holding and administration of securities and processing of settlements between the account holders, the admitted institutions, on behalf of the clients of the admitted institutions.
An admitted institution acts as custodian for the investor and maintains a bank licence to serve DVP (with central bank money) at CSD/CB-level.
- If a transaction is concluded on-exchange, the routing of clearing and settlement will take place via the infrastructural CSD/CB to the custodian/client relationship.
- If a transaction is concluded off-exchange, the routing of the settlement will take place via the custodian (if necessary) to the infrastructure to the custodian/client relationship.
- Taking into consideration that the market likes to make progress on cross-border settlement, an integrating capital market which is already served by an European system of Central Banks needs a European system of Central Securities Depositories.

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- The ICSDs (Euroclear Bank/Clearstream Bank Luxembourg) have their roots in the off-exchange Eurobond market. The ICSDs established by the market to serve the depository function for eurobonds and the settlement of the over-the-counter trades in Eurobonds. Nowadays, off-exchange trading in bonds dominate the ICSDs business.
No national public act supports this function explicitly. Moreover, the ICSDs keep accounts at custodians in national markets (or are directly admitted to a national CSD) to serve the settlement of non-internalised (non-inhouse) settlements.
So I propose that your definitions of an ICSD (International Central Securities Depository) will be changed into:
"ICSD = a depository that settles trades in securities as a settlement platform for off-exchange transactions concluded between internationally recognised market participants."
This definition describes the reality and the focus of these commercial organisations.
- If a CSD has not restricted its business to the infrastructural functions of depository and settlement (public act-driven functions) I suggest that you recommend a segregation of functions as separated business units to serve safety, the protection of the end-investors and to prevent systemic risk from commercially-driven activities.
- In your definition of a CSD you provide an option for a clearing function. I suggest that you again recommend to segregate the clearing function from the pure CSD-function.

2. With reference to the definitions of CCP (central counterparty), clearing and clearing house I recommend that you reformulate the clearing house definitions in for instance:

A clearing house is an institution that facilitates clearing (your definition) to facilitate and enter settlement instructions at central depository level.

And for central counterparty (CCP).

A CCP = a clearing house that interposes itself between the counterparties to trades acting as the buyer to every seller and the seller to every buyer.

If a CCP provides the guarantee function in the interposition then we have to add to the recommendations that the CCP has a bank licence and that the admitted members of the CCP have a bank licence.

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In your definition of clearing house you talk about the counterparty risk, which is related to the guarantee function of a CCP. I believe that your definition relates more the function of an ICSD.

3. With reference to your definition of a custodian, you will understand that my proposal is to delete 'often' after entity.
A custodian must be a bank. With respect to your definition of custody risk I would suggest that you put as a demand for a custodian that the custody is segregated from the other bank/operations to protect the customer and to clarify that the custodian is the in-between for holding and administration between the CSD and the client.

4. I believe that a risk-based functional approach can only be served if we define precisely the different functions and classify under which public act a function is practised.

As long as there is no 'European' legal framework available for securities clearing and settlement systems, we have to formulate the standards in a way which supports the idea of a European system of central securities depositories. Precise definitions and standards with a clear focus on the logistics of clearing and settlement promote integration in the European markets.

In the different national markets a licence is required to operate as an exchange, to operate as custodian (bank), a licence for a clearing house with central counterparty and guarantee capacity promoted will be, a public act supports/protects ownership and transfer of ownership, a public act for central bank capacity.

Standards must serve: investor protection, consistent basis for regulation/oversight, to avoid systemic risk, to guarantee the level playing field for competition.

Supportive is: efficiency, communication formats and European-wide practices.

Taking these objectives/criteria into consideration it is wise to be explicit in the explanatory memorandum for the application of the standards what the scope of the risk functional approach is based on the segregation of the differentiated functions:

- clearing house
- clearing house + CCP (guarantee)
- settlement/custody - infrastructural layer (CSD + CB)
- settlement/custody - commercial layer (custodian - client).

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Implicit choices, which could be more explicitly formulated:

- central bank money and the Target System is leading for the settlement/custody infrastructural layer; (standard 3/10);
- directive final payments; (standard 7);
- collateral maintained at central banks to be used on a flexible basis via central bank/Target in different CSD/CB systems (standard 3, 7, 10);
- segregation of customers' securities in an entity not vulnerable for the commercial/operational risk of the bankactivities of a custodian.

5. Specific remarks related to the standards.

Standard 4.

I recommend:

- to formulate that a CCP/plus guarantee is regulated under a bank licence;
- to formulate that the admitted facilitators: the clearing members maintain a bank licence and are admitted institutions to the CSD;
- risk control/supervision by the central bank.

Standard 5.

I recommend:

- to add that 'securities lending' is a commercial function; if an CCP or CSD would provide a securities lending service it must be segregated from the core function.

Standard 6.

I would recommend to restrict CSD to the infrastructural CSD.

With reference to standard 9: a CSD should restrict itself to an infrastructural function.

The standards 6 and 9 should not cover an ICSD (!).

If a CSD grants credit facilities it must be fully segregated from the infrastructural function holding/administration securities and serving settlement between admitted institutions to serve transfer of ownership on behalf of the investor.

The basis for investor protection is fundamental and must be dominant for the scope of operations of a (infrastructural) CSD.

To facilitate DVP (standard 7) the admitted institution (custodian/bank) has access to facilities at central bank level.

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Custodian banks are subject to the supervision and control of risk management by the central bank or relevant authority. In this context and related to the description of custodian banks which operate systemically important system leading principles are/must be:

- administrative organisation/operations/IT/control of the custody function under supervision/control of the regulator plus the Basle-II recommendation for operational/IT risk;
- disaster recovery/threats analysis and judgement;
- segregation of the holding and administration of the securities in a segregated entity (depository trust company) not vulnerable for traditional commercial bank risks to protect the investor. This recommendation is related to standard 12. (!)

So for standard 6/9/12 (related to 1) the functional differentiation of the infrastructural and commercial layer for settlement/custody is of paramount importance.

Standard 14.

Your access standard applies to the infrastructural CSD and CCP. These standards contributes to the level playing field for the commercial settlement/custody layer.

The CSD-infrastructural definition again clarifies this standard.

A custodian as a bank has a client acceptance policy which must be tested against the criteria of prudent conduct supervised by the securities regulator bodies (investor protection interest).

I have indicated in my comments the relevant criteria for access for a CCP, and CSD/CB.

I would like to thank you for your attention. I hope that we will set standards, which indeed contribute to integrating of the European capital markets.

Kind regards,

Ted van Heese
Managing Board KAS BANK