



**BNP Paribas Securities Services contribution
to ESCB-CESR Consultative Report**

**Standards for Securities
Clearing and Settlement Systems
in the European Union**

October 2003

Table of contents

Executive Summary	p 3
Contribution	p 7
1. Introduction	p 7
2. Adopting a risk-based functional approach	p 7
3. Differentiating infrastructures and custodian banks	p 8
4. Need for a balanced regulatory approach	p 9
5. Impacts of the Standards and proposals	p 10
6. Risks undertaken by CSD infrastructures	p 13
7. Risks undertaken by custodian banks	p 17
8. What can we learn from the US experience ?	p 24
Comments on the individual standards	p 26
Standard 1	p 26
Standard 2	p 26
Standard 3	p 27
Standard 4	p 27
Standard 5	p 27
Standard 6	p 28
Standard 7	p 29
Standard 8	p 29
Standard 9	p 30
Standard 10	p 30
Standard 11	p 31
Standard 12	p 31
Standard 13	p 32
Standard 14	p 32
Standard 15	p 32
Standard 16	p 33
Standard 17	p 33
Standard 18	p 33
Standard 19	p 33

Executive Summary

BNP Paribas is a major international banking group and a market leader in Europe. BNP Paribas Securities Services, a wholly owned subsidiary of BNP Paribas, is a transaction bank, dedicated to providing securities services to financial institutions, mainly banks, brokers and to institutional investors.

Our strategy focuses on Europe, where we have established a presence in 12 countries: Belgium, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Switzerland, as well as the United Kingdom. We cover the whole range of financial instruments: securities (listed and unlisted, bonds, UCITS), derivatives and cash. This activity positions us as a major user of CSD infrastructures in the European Union. For instance in 2002, Euroclear France -the French CSD- settled 26.5 million transactions including 4.1 million for BNP Paribas Securities Services.

We serve international broker-dealers, global custodians, asset managers and issuers. The services covered include clearing, settlement (domestic and cross-border), custody, back-office outsourcing, fund administration and asset servicing. We offer our clients efficient access to major markets across Europe: we combine our pan-European network with a personalised client approach, unmatched local market expertise, a consistently high quality product and service offerings, as well as fully integrated operations and systems technology. As a result, BNP Paribas Securities Services is consistently recognised in all major industry surveys as the premier pan-European bank providing securities services to financial institutions.

Introduction

BNP Paribas Securities Services welcomes the invitation by the CESR/ESCB Group to comment on the Consultative Report on Standards for Securities Clearing and Settlement Systems in the European Union. We share CESR-ESCB objectives of avoiding systemic risk, improving the safety and soundness of securities clearing and settlement as well as harmonising EU regulation.

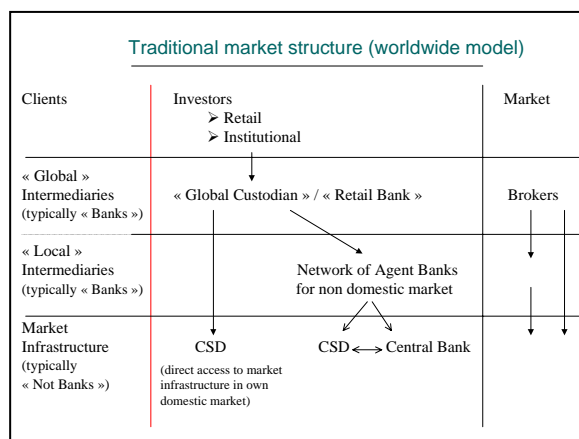
We welcome the proposed Standards as a step towards a better regulatory framework for the infrastructures on which EU clearing and settlement depends. As stated by the Group of Thirty¹, « The global financial system is only as good as the infrastructure that supports it ».

We believe the CESR-ESCB standards should not be drafted in isolation from the generally accepted criteria identified by the G30, the Giovannini Group and the European Parliament (cost-efficiency, avoidance of systemic risk and allowance for a level playing field). Making the right regulatory decision is critical to ensure :

- that the future integrated European market retains the safety and efficiency which currently exists in the European domestic markets,
- ensures a safe issuance and distribution of European stocks,
- guarantees the protection of “Investors” investing in the European markets and
- ensures the smooth functioning of the cash payment systems.

¹ Global Clearing and Settlement – A Plan of action – Group of Thirty – Washington, DC 2003

Infrastructures' and custodian banks' roles and risks are different



The current structure of each European financial market is based on a worldwide proven model, which reflects a functional differentiation between CSD infrastructures and intermediaries (typically custodian banks and brokers) who are the users of these infrastructures :

- CSDs are essential facilities which serve the entire market with the objective of avoiding systemic risk and delivering economies of scale. CSDs perform two interrelated functions which are key to the stability of financial markets: as notary, they guarantee the existence of securities and as operator of securities settlement system, they provide the finality to the settlement of trades;
- Custodian banks facilitate the access to the securities markets, they offer services in a highly competitive environment and manage risks within their capacity as banks. In order to compete, they heavily depend on their capacity to access the CSDs. It is a misconception to believe that a significant part of the EU settlement volumes are "internalised" on the books of custodian banks.

It seems that this fundamental differentiation between the role and responsibilities of CSDs and banks is being questioned, since a new vision for the settlement infrastructure - known as the ICSD mixed-function model – seems to be advocated by CESR/ESCB group for the European Union, whereby infrastructure and intermediary functions are not anymore distinguish one from another. BNP Paribas Securities Services is very concerned that the proposed Standards validate such mixed-function model, which does not best serve the objectives outlined by the CESR-ESCB Group:

- by allowing CSDs to mix infrastructure and intermediary banking services, on the basis of their infrastructure platform (Standards 5, 6, 9, 10), the Standards would increase the risks for the market, rather than reduce them;
- by including in the scope of application custodian banks which are deemed "systemically important" or having a "dominant position" in the relevant market, and regulating them in the same way as infrastructures, the Standards would distort the competitive environment. They may lead to reduced competition in the banking sector and increased concentration of risk, which is in contradiction with the Giovannini Group recommendation: "Concentration of risk is reduced if value-added banking functions are provided by multiple banks in a competitive environment." ²

The attempt to regulate custodian banks in the same way as infrastructures is inappropriate, because the functions performed and the nature of risks undertaken are different. BNP Paribas Securities Services urges CESR-ESCB to further analyse the functions and risks incurred by the various players, in order to implement a balanced regulatory approach.

² The Giovannini Group (Second Report on EU Clearing & Settlement Arrangements, April 2003)

Custodian banks are already regulated

Custodian banks should be removed from the Standards, since they are already regulated in respect of all risks connected with their settlement business, including credit and operational risk. The current banking regulation is designed to avoid market disruption due to the failure of a banking participant and we see no justification to impose additional constraints for a subset of the business, under the supervision of a different set of regulators. Intra-day risks are covered through the monitoring of credit exposures and through the protection of securities settlement systems to which custodians participate.

The proposed scope of application contradicts existing banking regulation and would generate unnecessary costs.

- It extends most standards to custodian banks and would compel them to collateralise their credit lines and adopt CSD standards in terms of governance, client access, risk and cash management.
- The concept of systemically important banks is relevant only in the context of business continuity planning (re Group of Thirty, US Interagency paper, monitoring of the switchover to the euro) and we would not accept this concept to be applied beyond this purpose. Only where systemic issues related to custodians are demonstrably not adequately addressed by their existing regulatory system should additional regulations be considered, and these should be placed within their existing regulatory system. For instance, we would advise that custodian banks targeted as “systemically important” apply the Basel II advanced methodology for the monitoring of their operational risk.
- We do not believe that the concept of “dominant custodians” is relevant, unless the CESR/ESCB Group searches to prevent anti-competitive behaviour from the part of CSD infrastructures and ICSD infrastructures, who de facto benefit from a dominant position and may abuse this position when entering the space of competitive banking services. We would welcome the formal involvement of the EU Competition Directorate on this issue.

Finally, the CESR/ESCB Group may wish to foster the harmonisation of the rules of conduct imposed on custodians, through the monitoring of custodian banks operations, along the lines set by the CMF (Conseil des Marchés Financiers) in France and the Bank of England in the United Kingdom.

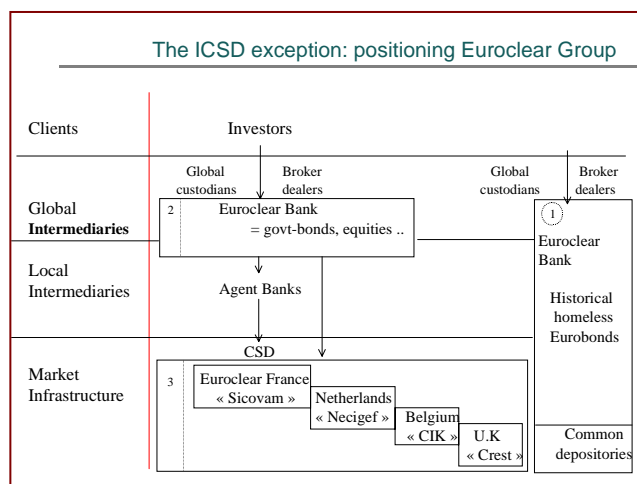
Infrastructures lack a uniform regulation

By contrast, CSDs are not subject to any uniform EU-wide regulatory standards. This should be the priority for regulation and oversight by the CESR-ESCB Group, with a view to reduce risks and enhance the European harmonisation through dedicated Standards. This is consistent with the CPSS IOSCO Recommendations, on which the Standards are based – and which effectively do not extend the scope of application to custodian banks.

We welcome a consistent EU-wide approach which recognises the essential facility role of CSDs and enhances governance, access, efficiency and transparency rules (Standards 13, 14, 15 and 17 respectively) whilst preventing abuse of dominant position. We also believe the Standards should focus on monitoring the specific risks raised by the CSDs: enhancing the monitoring of operational risk, avoiding systemic risk and preventing intra-day risk in connection with the cross-system links which CSDs establish with other CSDs, ICSDs and Central Banks.

Addressing mixed-functions systems

ICSDs are financial conglomerates integrating different legal entities. As shown by the example here below –which specifically refers to the Euroclear group-, the ICSDs mix the functions of infrastructure and intermediary. This situation is an exception which must not lead to the conclusion that all functions are equivalent and that such model must be generalised. We believe that extending this model to all CSDs, as suggested by the Standards, would actually increase the level of risk for the market, distort competition and would not achieve the CESR-ESCB Group objectives.



We suggest that ICSDs ring-fence their CSD activity (box n°3) from their custodian bank business (box 1&2), and be regulated as CSDs in their CSD capacity and as banks in their custodian bank capacity. We see no reason to apply to all market participants the specific requirements imposed on the ICSDs by the regulators because of the peculiarities of the Eurobond market. For instance, the specific rationale requiring ICSDs to collateralise all credit exposure derives from the decision by the ESCB to make some Eurobonds eligible as collateral for the Eurosystem monetary policy operations, in order to mitigate, to the largest possible extend, the currencies banking risk so created. We believe that the recommended “generalisation” of this specific requirement to all financial intermediaries is inappropriate and is missing the point.

Conclusion

We support business principles and models which have a proven track record on a worldwide scale and suggest the draft be amended to reflect them:

- Separation of roles between CSD infrastructures and other market players;
- Balanced regulatory approach which ring-fences infrastructures against credit risk and distributes credit risk across a range of intermediaries;
- Thorough examination of competition issues, since the CSDs are essential infrastructures (and de facto monopolies) and must be prevented from abusing their dominant position.

Contribution

1. Introduction

BNP Paribas Securities Services welcomes the invitation by the CESR/ESCB Group to comment on the Consultative Report on Standards for Securities Clearing and Settlement Systems in the European Union. We share CESR-ESCB objectives of avoiding systemic risk, improving the safety and soundness of securities clearing and settlement as well as harmonising EU regulation.

We welcome the proposed Standards as a step towards a better regulatory framework for the infrastructures on which EU clearing and settlement depends. As stated by the Group of Thirty³, “The global financial system is only as good as the infrastructure that supports it... Because CCPs and CSDs play such a central role, minimizing the risk of their failure is an important objective.”

We believe the CESR-ESCB standards should not be drafted in isolation from the generally accepted criteria identified by the Group of Thirty, the Giovannini Group and the European Parliament: cost-effectiveness, effective competition and minimised risk. They also involve a degree of political action, which is expected under the form of DG Markt second communication on Clearing and Settlement. As stated by the Giovannini Group⁴: “The Financial Industry is the quintessential regulated industry, and therefore it is difficult to conceive reforms that affect the very architecture of financial services which do not involve public authorities. Thus, it would be naïve to assume that the integration of the EU clearing and settlement environment could be left to private market participants alone. On the contrary, the public sector can be expected to play a major role – both in co-ordinating private sector actions and re-regulating clearing and settlement on a pan-EU basis.”

Making the right regulatory decision is critical to ensure that an integrated European market retains the safety and efficiency of current European domestic markets, ensures a safe issuance and distribution of European stocks, guarantees the protection of investors hitting the European markets and the smooth functioning of cash payment systems.

2. Adopting a risk-based functional approach

We understand that the CESR/ESCB Group has used a risk based functional approach in order to establish the Standards, with a view to embrace all relevant functions related to the securities clearing and settlement business. To a certain extent we support the principle of a functional approach, however we believe that considering the book-entry settlement function as a homogenous function across CSDs, banks and ICSDs, from a risk point-of-view is both simplistic and wrong, which has led the Group to drafting inappropriate standards.

Even if the CESR/ESCB Group do not want to differentiate amongst entities on the basis of this different status, it remains to integrate the constraints attached to their status and consider the existing regulatory regimes and risk management controls which already apply to each type of institution.

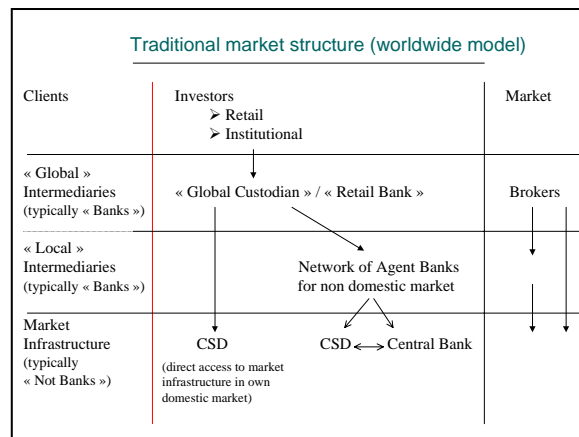
A detailed functional analysis of the different players in the clearing and settlement environment is required to identify the common aspects but also the key differentiators. In particular, there are fundamental differences both in terms of function and risk between the market infrastructures (CSD, CCPs) and the intermediaries (custodians banks) and therefore they should not be subject to the same Standards.

³ Global Clearing and Settlement – A Plan of action – Group of Thirty – Washington, DC 2003

⁴ The Giovannini Group (Second Report on EU Clearing & Settlement Arrangements, April 2003)

3. Differentiating infrastructures and custodian banks

The European financial markets are based on a worldwide proven model, which reflects a functional differentiation between CSD infrastructures and intermediaries (custodian banks):



- CSDs are essential facilities which serve the entire market with the objective of avoiding systemic risk and delivering scale economies. CSDs perform two interrelated functions which are essential for the market: as notary, they guarantee the existence of securities and as operator of securities settlement system, they provide the finality to the settlement of trades. They serve their members on the basis of non negotiable terms ;
- Custodian banks facilitate the access to the securities markets, they serve clients -and not members- on a contractual basis in a highly competitive environment, and manage risks within their capacity as banks. In order to compete, they depend on their capacity to access the CSDs. It is a misconception to believe that a significant part of the EU settlement market is "internalised" on the books of custodian banks. For instance, BNP Paribas Securities Services is a major user of CSD infrastructures in the European Union. In 2002, Euroclear France settled 26.5 million transactions including 4.1 million for BNP Paribas Securities Services alone, across the 7 accounts which we hold at the CSD.

DG Competition recently confirmed these definitions⁵:

- "A CSD is an entity which holds and administers securities and enables securities transactions – such as the transfer between two parties – to be processed ;
- The clearing and settlement services provided by the issuer Central Securities Depository for the securities that it safekeeps must be distinguished from the processing of securities trades by financial intermediaries, such as banks. Intermediaries rely on being able to settle their trades with the Depository where the securities have been issued."

Apart from these key differences, it is worth noting that the settlement performed by an infrastructure has a different legal status from that performed by an intermediary acting as agent: whilst CSDs provide finality of settlement, custodian banks act as intermediaries instructing on behalf of their clients. The legal status of the entity performing the settlement hence determines the legal status of the settlement.

⁵ DG Competition – Press release on the statement of objection to Clearstream Frankfurt, dated 31/03/2003

4. Need for a balanced regulatory approach

It seems that the differentiation between CSD infrastructures and custodian banks is being questioned, since a new vision for the settlement infrastructure - known as the ICSD mixed-function model - is put forward for the European Union, whereby infrastructure and intermediary functions are blurred. BNP Paribas Securities Services is very concerned that the proposed Standards validate such mixed-function model, which opens the door :

- for CSDs to acquire a banking status ;
- for ICSDs to fully merge with CSDs ;
- for banks to become, acquire or merge with CSDs.

This model, in our opinion, does not best serve the objectives outlined by the CESR-ESCB Group:

- By allowing CSDs to mix infrastructure and intermediary banking services, on the basis of their infrastructure platform (Standards 5, 6, 9, 10), the Standards would definitely increase the risks for the market, rather than reduce them ;
- By including in the scope of application custodian banks which are deemed "systemically important" or having a "dominant position" in the relevant market, and regulating them in the same way as infrastructures, the Standards would definitely distort the competitive environment.

BNP Paribas Securities Services considers that the attempt to regulate custodian banks in the same way as infrastructures is inappropriate, because the functions performed and the nature of risks undertaken are different. We urge the CESR-ESCB Group to further analyse the functions and risks incurred by the various players, in order to implement a balanced regulatory approach.

Adopting a balanced approach to the settlement function

We suggest to take a closer look at the levels of risk incurred

Risks/ Institution	CSD	Custodian bank	ICSD
Operational risk	XXX	XXX	XXX
Business continuity risk	XXX	XX	XXX
Credit and liquidity risk		XXX	XXX
Intraday risk / domino effect	XXX	XX	XXX
Market risk		XX	XX

5. Impact of the Standards and proposals

We have summarized our views for each category of institutions involved in the settlement functions.

We consider that the Standards should exclusively focus on CSDs, which concentrate systemic risk.

Regulating the CSDs should be the priority for regulation and oversight by the CESR-ESCB Group, with a view to reduce risks and enhance the European harmonisation through dedicated Standards. This is consistent with the CPSS IOSCO Recommendations, on which the Standards are based – and which effectively do not extend the scope of application to custodian banks. We are of the opinion that custodian banks are already properly regulated through a banking regulation which ensures adequate risk management and sufficient level of capital, whereas CSDs are not subject to any uniform EU-wide regulatory standards. In that respect, we welcome the initiative of the CESR/ESCB Group.

We welcome a consistent EU-wide approach which recognises the essential facility role of CSDs and enhances governance, access, efficiency and transparency rules (Standards 13, 14, 15 and 17 respectively) whilst preventing abuse of dominant position. We also believe the Standards should focus on monitoring the specific risks raised by the CSDs: enhancing the monitoring of operational risk, avoiding systemic risk and preventing intra-day risk in connection with the cross-system links which CSDs establish with other CSDs, ICSDs and Central Banks.

Allowing CSDs to extend credit and as a consequence to take credit risk would increase the risks for the market ; going down this path would also imply that the European Union would embrace a very different operating model from any other major financial markets, including the USA. It would also substantially distort the competitive environment for banks, as banks cannot effectively become CSDs or compete with essential facilities.

Custodian banks should be removed from the Standards, as they are already regulated in respect of all risks connected with their settlement business, including credit and operational risk.

The current banking regulation is designed to avoid market disruption due to the failure of a banking participant and we see no justification to impose additional constraints for a subset of business, under the supervision of a different set of regulators. Intra-day risks are covered through the monitoring of credit exposures and through the protection of securities settlement systems to which custodians participate.

We consider that, as a core principle, a custodian bank must retain the right to select its portfolio of clients (hence credit risks) and monitor them as appropriate (extension of secured and /or unsecured credit for instance). We believe the CESR-ESCB Group should demonstrate the added value of the proposed Standards and measure their impact, especially when proposing that “systemically important banks” collateralise all credit exposures, fully disclose prices and contracts and provide access to all market participants.

We believe the Standards would in effect increase the cost for the market, seriously reduce the market liquidity and eventually foreclose those banks deemed as “systemically important”. This may in turn lead to reduced competition in the banking sector and increased concentration of risk in the hand of a limited group of services providers, which contradicts the Giovannini Group recommendation: “Concentration of risk is reduced if value-added banking functions are provided by multiple banks in a competitive environment.”

We believe the concept of systemically important banks –introduced by the CESR/ESCB Group– is only relevant in the context of business continuity planning (re Group of Thirty, US Interagency paper, monitoring of the switchover to the euro) and we have great difficulty extending the

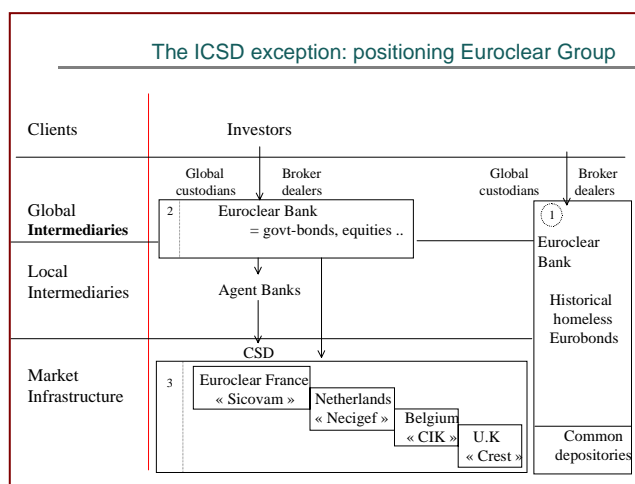
concept outside this context.. Only in such situation where systemic issues related to custodians are demonstrably not adequately addressed by their existing regulatory system should additional regulations be considered ; and these should be placed within their existing regulatory framework. For instance, we would advise that custodian banks -targeted as “systemically important”- apply the Basel II advanced methodology for the monitoring of their operational risk.

We do not believe that the concept of “dominant custodians” is relevant, unless the objective of the CESR/ESCB Group is to prevent anti-competitive behaviour from the part of CSD infrastructures, who de facto benefit from a dominant position (monopoly) and may abuse this position when entering the space of competitive banking services. We would welcome the formal involvement of the EU Competition Directorate in this domain.

Finally, the CESR/ESCB Group may wish to foster the harmonisation of business practices imposes on custodians, through the monitoring of custodian banks operations, along the lines set by the CMF (Conseil des Marchés Financiers) in France and the Bank of England in the United Kingdom.

We consider it is inappropriate to consider that functions of CSDs and ICSDs are “one and the same”.

As described in the chart below , ICSDs (ie Euroclear group, Clearstream group...) are mixed-functions entities which cover both the CSD and the intermediary. In fact these Groups are composed of different legal operating entities which all can be categorised as belonging either to the world of “market infrastructure” or to the world of “intermediaries”. This is very clear when for instance looking at the Euroclear groups : It is operating as a CSD (box N°3) or as agent bank (box n°2). Only in the case of its historical role as settlement agent and custodian for the “homeless” Eurobonds market (box n°1) both roles are slightly blurred, although even in this set up, it does rely on a network of agent banks to act as “depositories” of the bonds. This exception nevertheless must not lead to the conclusion that all functions are equivalent and such model must be generalised.



On the contrary, we believe that extending this model to all CSDs, as suggested by the Standards, would increase the level of risk for the market, distort competition and would not achieve the CESR-ESCB Group objectives. The combining of these two fundamentally different functions within the same entity is in itself a significant source of systemic risk, it would generate the concentration of credit risk since the ICSDs have the monopoly of credit provision for a broad range of securities, it would create “spillover risk” between the various business components and it would generate conflicts of interest in terms of strategic priorities and allocation of development resources. It would also entails “moral hazard”, since a custodian bank combining the role of a “core infrastructure” would de facto become « too big to fail ».

Whilst we understand and fully support the intent of the CESR/ESCB Group to address the specific ICSD case, we believe that the best way to reduce systemic risk and to ensure the soundness of the securities post-trade environment would consist in ring-fencing the CSD activity from the intermediary business, so that each business component can be regulated in a balanced fashion: this would allow ICSDs to be regulated as CSDs in their CSD capacity, and as banks in their custodian bank capacity.

In addition, we see no reason to expand to all market participants the specific requirements placed on the ICSDs by the regulators because of the peculiar organisation and specificities of the Eurobond market. For instance, the need for ICSDs to collateralise credit exposure derives from the eligibility of Eurobonds as collateral for the Eurosystem monetary policy operations and should in no instance be generalised to other market players.

6. Risks undertaken by CSD infrastructures

Given the objective of the CESR/ESCB group to reduce systemic risk and create an efficient financial market, the Standards should focus on the risks undertaken by CSD infrastructures, which are essential facilities and as such the cornerstone to any efficient and secure financial market.

The CSDs operates as the Central Banks for securities

CSD activities appeared at the end of the 19th century and, although we currently miss a regulatory definition of CSDs at EU level, all CSDs conduct similar activities, which are essential to the stability of their respective financial markets.

- CSDs have been established with the same objective – to facilitate the circulation of securities without the handling of physical documents. This objective has been reached in all countries by the representation of securities in book-entry form, either through immobilisation or full dematerialisation.
- CSDs provide 2 essential functions which are closely interrelated: **as notary, they guarantee that the securities which circulate do exist, they maintain the accounting balance for the issues and ensure the central custody of the securities ; as settlement operator – ie as operator of a Securities Settlement System-, they ensure the finality of trades in their respective jurisdictions.**

These functions can easily be compared with the role performed by a Central Bank, who monitors the issue of cash and its safe circulation through the payment systems.

CSDs may –at the margin- differ between themselves, depending mainly on the legal and historical context in which they were created. The United Kingdom and Luxembourg have especially addressed the “settlement” aspect, whereas most countries, like France, Germany, Holland, Spain, Italy, the Nordic countries, and also the USA, have built their CSD entities around the two functions of notary and settlement agent.

The French definition provided by the Conseil des Marchés Financiers⁶ reads as follows :

“The functions of a central depository (of financial instruments) are:

- 1- record in a specific account the entirety of the financial instruments making up each issue accepted for deposit by the depository,*
- 2- open current accounts for custody account-keepers, other central depositories and French and foreign institutions that the depository has accepted as members under the conditions set by its operating rules; in the case of institutions from a country outside the European Economic Area, their membership must not have been opposed by the CMF within one month following the date at which the CMF was notified by the central depository;*
- 3- ensure the circulation of financial instruments by book-entry transfer from one account to another;*
- 4- verify that the total amount of each issue accepted by the depository is equal to the sum of financial instruments recorded on member accounts,*
- 5- take all steps necessary to enable the exercise of rights attached to the financial instruments,*
- 6- transmit registration information regarding holders of financial instruments between members and issuers,*
- 7- issue certificates representing French-law financial instruments for use abroad.*

A central depository may accept for deposit financial instruments for which it does not hold the account of the issue. In such a case, it must at all times make sure that the quantity of financial instruments deposited with it is equal to the sum of financial instruments recorded on the accounts of its members.”

⁶ General Rules, Title VI, Custody and Account-Keeping of Financial Instruments, 18 January 1999

As the activities of financial markets increased, the importance and sensitivity of CSD activities increased in parallel, leading to the constitution of specific entities fully dedicated on this sole activity. CSDs are typically non-banks and are granted a specific status by law.

The fact that some CSDs do benefit from a banking licence should not confuse us on the core activity which they perform. In Germany, Clearstream Frankfurt was granted a banking status for supervisory reasons, with the specific ability to act as CSD. In the USA, DTC is chartered as a limited purpose trust company by the New-York State Banking Department, in order to be granted access to the Federal Reserve System, but is not authorised to engage in general banking business.

Historically, CSDs were not for profit utilities, owned and governed by participants. This remains the case in the USA, but has become less relevant in the European Union as a result of the recent consolidation process.

CSDs concentrate flows to deliver efficiency

CSDs service the entire (national) market with the aim to maintain the highest possible safety and guarantee the lowest cost.

The search for efficiency implies a single place of deposit for the issues and the concentration of flows, making CSDs natural monopolies, who enjoy a statutory or de facto monopoly on the segment of securities which they cover.

- As recently stated by DG Competition⁷: “Typically, there is one CSD per Member State.” In most countries, the National Central Banks used to be involved to cover the government bonds segment. This is still the case in the US and in Belgium, when most Central Banks have transferred this role to the national CSD which now maintains all national securities.
- The Group of Thirty confirms⁸: “Many infrastructure providers operate as effective monopolies within the market they serve, because they have been granted such status through legislation or market convention, or because it would not economically be viable for an alternative organisation to attempt to compete with the existing market structure”.

CSDs serve the market as essential facilities

CSDs meet the criteria laid down by the European Court of Justice⁹ in order to be considered as essential facilities:

- They offer all users services they cannot provide themselves and for which the value increases with the increase in the number of users. Those services require the implementation and management of network systems, that could not be easily duplicated given the costs and implementation delays.
- They are essential to all participants operating in the competitive financial services sector, who could not conduct their business without access to these infrastructures at a competitive and economic price.
- These infrastructures were put in place to limit the risks incurred in the financial markets by mitigating the risk of default or error, and to promote to promote economies of scale.

⁷ DG Competition – Press release on the statement of objection to Clearstream Frankfurt, dated 31/03/2003

⁸ Global Clearing and Settlement – A Plan of action – Group of Thirty – Washington, DC 2003

⁹ Judgement of November 1998, in Oscar Browner GmbH & Co. KG v. Mediaprint, case C/7/97 (1998) ECR I-7791, where the Court ruled that an infrastructure can only be considered as essential if it appears to be economically unfeasible or unreasonably difficult to duplicate it in a reasonable time period.

Risk profile of CSDs

As a result of their essential facility position, CSDs are systemic by nature and have been strictly controlled – at the national level in each European country, by federal law in the United States – to prevent conflict of interest with their users and to protect the market against systemic risk.

As a general rule, CSDs have been placed under the close supervision of their respective securities market regulators and their National Central Bank and have been strictly regulated by preventing them from assuming any form of credit and liquidity risk.

- **CSDs typically do not take credit risk**

Any security transaction involves 2 legs, a “securities leg” and a “cash leg”.

The ultimate requirement to settle securities transactions is a perfectly safe and secure environment has always implies that:

- CSDs do not act as principal in the transactions, particularly in securities lending transactions, and they do not extend credit to their members ;
- The settlement function is combined with the use of Central Bank Money¹⁰, the “cash leg” of the transactions is settled on the books of the relevant national central bank, on the accounts of the CSD members. CSDs merely act as a technical operators, by transmitting the cash settlements to the Central Bank.
- Credit risk is contained at the level of the financial intermediaries, who are members of the CSD and maintain account(s) with their respective Central Bank. In particular, the fact that some market participants do not have direct access to Central Bank Money does not involve that the CSD takes risks, but rather that those participants elect another intermediary, acting as settlement bank, to represent them at the Central Bank.

This fact has been reinforced by the creation of the European Central Bank (ECB) and the implementation of monetary policy operations in Europe; Securities Settlement Systems play an essential role in ensuring the smooth operation of cash payment systems operated by the Central Banks: “Central Banks are primarily concerned with the smooth functioning of these systems [i.e. SSSs]”¹¹.

- **CSDs do not take liquidity risk**

Similarly, CSDs are prevented from taking individual exposure in terms of liquidity risk. They rather ensure that their systems are protected against liquidity constraints which may arise at the level of their individual members.

CSDs may hold a cash transfer account with the Central Bank, which is used for instance to balance the debit and credit movements resulting from the payment of dividends. In this instance, the liquidity risk is borne by the custodian bank acting as paying agent towards the issuer, who transfers cash to the CSD account in order for the dividend to be distributed to all market participants.

¹⁰ Commercial money may be used but it is rarely the case. Settlement in central bank money protects the CSD against credit and liquidity risks and is enforced to protect core facilities against systemic risk.

¹¹ ECB monthly Bulletin, February 2000, p.56. This concern has been reiterated within the study of the role of the Eurosystem in payment and clearing systems (ECB Bulletin, April 2002, p.47).

- **CSDs face operational risk**

As defined by the Basel Group, the operational risk covers "the risk of loss resulting from inadequate or failed processes, people and systems or from external events".

This is the major source of risk to which CSDs are exposed: since they operate complex processes and systems, their exposure is very significant. Moreover, given their monopolistic situation the potential damage of any default impacts not only the CSD but also all their members and the financial market as a whole. This deserves a very close monitoring, including the monitoring of their business continuity planning, and we welcome the initiative of the CESR/ESCB group in that respect.

- **CSDs generate intra-day risks through cross-systems links**

Finally, CSDs expose other systems to which they are connected via cross-system links - these may be other CSDs, ICSDs or Central Banks – to operational risk, as well as to the risk of unwinding transactions, which results from the delivery of non revocable securities.

The need for EU regulation of CSDs

CSDs have historically been created at a national level and they are typically regulated at national level. There is no EU wide uniform legislation that covers CSDs, notwithstanding their systemic importance (the Settlement Finality Directive only tackles a specific aspect of the CSD operations).

We believe this gap should be bridged by a Clearing and Settlement Directive which would define the role and function of the CSDs as well as the constraints attached to it (regulatory category, requirements as to capital adequacy, risk management, standards of governance and control procedures...). This would be supplemented by standards, such as the standards proposed by the CESR/ESCB Group, which would then benefit from EU law status and be enforced in a harmonised manner, which is not currently the case for the European Monetary Institute standards¹².

Conclusion

The role of the CSD is fundamental to the post trade environment and its core infrastructure role is a major source of systemic risk. Until now, such concern has been addressed through the establishment of specific entities exclusively dedicated to CSD activities, in order to mitigate as much as possible any type of risk, especially financial risk associated with these activities.

We notice that the current draft of the Standards would endanger this principle, since CSDs would be allowed to take credit risk- the requirement to collateralise this risk only mitigate the risk but not eliminated it- and would contradict the prime objective of the CESR/ESCB Group which consists in reducing systemic risk.

Our detailed comments on the Standards supports the objective to ring-fence the activities of the CSD from any type of credit risk, in order to prevent systemic risk. Moreover, we suggest that the Standards should focus on regulating the infrastructures, as it was intended by the CPSS/IOSCO recommendations.

¹² EMI – November 1997 – Standards for the use of EU securities settlement systems in ESCB credit operations

7. Risks undertaken by custodian banks

The role of the custodian bank

Custodian banks are important players in the post trade market, however their role is fundamentally different from the role of CSDs.

Custodian banks facilitate the access to securities markets

- They are members of the post-trade infrastructures and provide their clients with an indirect access to the CSD infrastructure ; clients may decide to use a custodian bank, either because they are not eligible themselves for membership in the CSD, or –assuming they can be a member themselves– because it is more convenient for them to “outsource” this function to a custodian bank.
- Custodian banks serve clients - not members- on a bilateral contractual basis, in a highly competitive environment. Their clients are typically investors, corporates and financial intermediaries, both domestic and international.

Custodian banks provide services which support market developments

- They deliver a processing capacity and ensure the compliance with systems and regulations,
- They hold cash and securities accounts on behalf of their clients, to whom they provide clearing, settlement, custody and banking services,
- They cover a broad range of instruments, including equities, bonds and derivatives,
- They manage credit and liquidity risk: they grant credit lines and act as principal in a range of transactions,
- They also provide a major source of liquidity for broker dealers, via cash and securities financing operations, as well as collateral management,
- Other aspects of value added services include fund related services, depository bank, issuer-related services (corporate trust, paying agent, registered share services) as well as outsourcing services which may cover middle and back-office functions.

Unlike for CSDs, “book entry settlement” is not core to custodian banks

Part of the confusion introduced by the Standard comes from the concept that custodian banks performing “book entry settlement” or “internalising” settlement transactions should be treated as infrastructures, on the basis that the function is of the same nature. We disagree with this view: book entry settlement is the core activity of a CSD for all dematerialised or immobilised securities, it is by nature incidental for an intermediary. Custodian banks are not able to provide settlement finality without accessing the CSD and any movement which involves a change in the position in its account (s) at the CSD.

If we compare the securities world with the cash world, it appears that a retail bank transferring cash across 2 client accounts does not fall under the same regulation as a Central Bank or as a Cash Payment system. Similarly, a custodian bank may happen to have customers who need to transfer securities between each other and this movement will not necessarily materialise at the level of the CSD: it may for instance correspond to a transfer of securities between two accounts belonging to the same group , or between fund compartments. We do not see why this would bring specific risks to the market or lead to additional regulation.

Custodian banks are liable to their customers for the assets safe-kept on their behalf, which do not enter the custodian bank balance sheet. According to general French law, BNP Paribas Securities Services is normally under an absolute obligation to segregate its clients’ assets from its own assets within its books and with its correspondents and to return the assets to the owner.

In addition, custodian banks have to abide by the rules of the CSD, which often impose segregation rules at the level of the CSD and force the settlement of transactions on their books. For instance, in Italy, Greece, Spain, the United Kingdom and in the Nordic countries, all transactions are materialised at the level of the CSD. In France, the segregation between client accounts and proprietary accounts is

compulsory: BNP Paribas Securities Services maintains multiple accounts with the CSD. In 2002, Euroclear France settled 26.5 million transactions including 4.1 million for BNP Paribas Securities Services.

It is totally incorrect to assume that “90% of equity transactions settle on the books of agent banks”, meaning that they do not materialise on the books of the CSD. In addition, this should be compared with the ICSD practice related to :

- government bond markets (e.g. German, Dutch, Danish government bonds), where a substantial part of the settlement activity has been transferred from the CSDs to the books of ICSDs with the ICSDs operating an omnibus accounts with the CSD,
- the equity markets (Greece, UK for instance) where specific access rights have been granted to the ICSDs, allowing them to operate on the basis of an omnibus account at the level of the CSD, which is not the case for other custodian banks.

Custodian banks manage traditional banking risks

Custodian banks manage a broad range of risks related to their activity : operational risk, credit and liquidity risk, market risk. These risks are traditional banking risks which are already well managed and controlled via an very extensive set of prudential and banking regulation.

- **Operational risk**

Operational risk is the primary source of risk for a custodian bank. The existing banking regulation largely addresses the control of operational risk.

As stated by the **Basel Committee**¹³, operational risk is defined as: *“The risk of loss resulting from inadequate or failed processes, people and systems or from external events”*. The banking industry has undergone developments which have increased the range and importance of operational risk (large-scale mergers, sophisticated financing techniques, larger volumes...). This is particularly true for custodian banks who need to cope with fast growth of business volumes and large scale of technology developments.

Given the broad definition of operational risk, the sources of risk are potentially numerous, nevertheless they mainly stem from incidents in delivering the various processes (e.g. error in the transmission of instructions, wrong information on a dividend payment), internal or external system failure and disruption of the activity. The Committee advises that: *“The emergence of banks acting as very large-volume service providers creates the need for continual maintenance of high-grade internal controls and back-up systems....Banks should have in place contingency and business continuity plans to ensure their ability to operate as going concerns and minimise losses in the event of severe business disruption.”*

The **Commission Bancaire** rule 97-02 was updated to reflect the Basel Committee recommendations. It requests that a bank implements adequate internal control environment, including the definition and control of operational procedures and the allocation of permanent staff dedicated to the monitoring of operational risks.

The upcoming **Basel II regulation** introduces an “operational risk” capital charge requirement, which corresponds to 9% to 20% of the operational risk exposure depending on the method used.

The Advanced Measurement Approach (AMA) is based on an internal risk measurement system, which requires that banks meet qualifying criteria which are both qualitative and quantitative. We would advise that custodian banks identified as “systemically important” apply this method.

¹³ Basel Committee on Banking Supervision – Sound Practices for the Management and Supervision of Operational Risk – July 2002

We outline below the most significant qualifying criteria:

- the board of directors and senior management must be actively involved in the operational risk management process;
- the bank must have an independent operational risk management function that is responsible for the design and implementation of the bank's operational risk management system;
- the bank has, in the supervisory authority's view, sufficient staff resources in the use of AMA in the major business lines as well as the control and audit areas;
- the risk measurement system must reflect the Basel II's definition of operational risk;
- any internal operational risk measurement system used for regulatory capital purposes must be supported by loss database systems that are consistent with the Basel II's definition of operational risk.

Furthermore, the upcoming translation of Basel II into the **Capital Adequacy Directive**¹⁴ clearly identifies custody activities (appendix H-3) and maps them with the Investment Services Directive: "Custody under ISD: safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management".

Custodian banks may also be subject to rules defined by the securities regulator or the Central Bank. In France and in the United Kingdom, such rules exist and provide additional comfort in terms of operational risk control, since they detail operational control procedures and require business contingency plans. The **Conseil des Marchés Financiers**¹⁵ has specified the human resources, systems, procedures and controls that a custodian bank needs to implement in order to be authorised as member of the CSD infrastructure. Article 10 specifies contingency planning and regular testing: *"Both the physical and logical security of all processing routines and information exchange systems shall be ensured. In particular ... a back-up plan and appropriate procedures shall be drawn up to ensure service continuity."* It is worth noting that these rules apply to all custodian banks, regardless the size of their business.

Finally, to meet the quality standards expected by their clients, in particular the large US funds, custodian banks have to comply with the regulation enforced on their own clients. For instance, the **SEC rules 17F5 and 17F7** in the USA which regulate US pension fund assets, require that all custodian banks along the chain present adequate financial strength. These rules also require extensive business contingency planning, with regular live testing, which in practice are delegated to the custodian banks. As a consequence, custodian banks often call for an external audit opinion of their control procedures and their level of efficiency (e.g. **SAS 70, US standard, or FRAG 21 in the UK**).

- **Credit risk**

Custodian banks manage credit risks related to the financing of their clients. This activity generates both intra-day credit risk, due to the time difference between securities settlement and cash settlement, and overnight credit risk (in case of client overdraft). Custodian banks manage credit risk under the cover of existing banking regulation, which defines both organisational and financial obligations.

Credit risk monitoring process: as part of their credit monitoring process, custodian banks must perform an extensive credit review for all clients and implement credit lines in accordance with the services provided. The client activity is then processed within those credit lines which define the maximum credit exposure that the custodian bank is ready to take on that client. If the limit is reached, the activity of the client will either be blocked or postponed until such time the credit exposure has been reduced. **A custodian bank may also refuse clients for credit risk reasons.**

More specifically, in France, the **rule 97-02 of the Commission Bancaire** requests that banks implement a risk management system that provides for analysis of risk, monitoring the evolution of the risk, identifying / calculating potential losses:

¹⁴ Review of Capital Requirement for banks and investment firms – Commission Services - 3rd consultation paper – 1st July 2003

¹⁵ CMF - "Performance requirements for custody account-keepers" (decision n° 2001-01)

*“Article 1 : Reporting institutions shall set up an **adequate internal control system** by adapting the systems provided for in this Regulation to the nature and volume of their activities, their size, their establishments and the various types of risk to which they are exposed. Internal control includes in particular:*

- a) a control system for operations and internal procedures;*
- b) the organisation of accounting and information processing systems;*
- c) risk and result measurement systems;*
- d) risk monitoring and control systems;*
- e) a documentation and information system;*
- f) **a system for monitoring flows of cash and securities.***

*Article 18 : **Reporting institutions must have a credit risk selection procedure and a system for measuring this risk** that allow them to:*

- a) centralise their balance sheet and off-balance sheet exposure vis-à-vis a counterparty or counterparties deemed to constitute a single beneficiary within the meaning of Article 3 of Regulation 93-05 aforesaid;*
- b) assess different categories of risk using qualitative and quantitative data;*
- c) carry out overall allocations, if they are significant, of their commitments by groups of counterparties whose risk level as assessed by the institution is rated identically, by economic sector and by geographical area.*

*Article 30-1: Service providers must have an intermediation risk¹⁶ selection and measurement procedure. **Service providers must have a system for monitoring intermediation transactions** that makes it possible to:*

- a) record transactions already completed without delay. Transactions transmitted by principals that are not immediately posted to their accounts or formally accepted by them must be regarded as own-account positions with regard to the monitoring and control of risks;*
- b) take the necessary measures to be able to calculate at the end of each day the market value of long or short positions of principals who require close monitoring following the assessment referred to in paragraph 2 above. The value of these positions shall be reconciled daily with their transaction value;*
- c) assess at the end of each day the market value of financial instruments provided as collateral by principals;*
- d) record at the end of each day and retrace individually all errors in the acceptance and execution of orders. These positions must be considered, from the standpoint of risk monitoring and control, as own-account market risks. Service providers that are not authorised to provide the own-account trading service shall unwind such positions without delay. When the error exceeds a threshold set by the executive body, each incident must be recorded in a descriptive document brought to the attention of the official referred to at Article 8 above.*

Service providers shall ensure that they are able to reconstruct the chronology of transactions and assess positions taken during the day after the event.”

Prudential ratios: Commission Bancaire rules 91-05 and 93-05 request that banks, including custodians banks, comply with prudential ratios, namely the solvency ratio, Cook ratio and large exposure ratio. Those ratios define capital requirements which are proportionate to the bank's credit risk exposure. This obliges the custodian bank to manage a level of capital suited to the level of credit risk incurred, encompassing securities lending transactions. As outlined by the Basel Committee¹⁷: *“Banks may engage in risk mitigation techniques (e.g. collateral, credit derivatives, netting arrangements and asset securitisations) to optimise their exposure to market risk and credit risk”*. Nevertheless, **as a ground rule-within their limits set by the regulators-, banks should remain free in the manner they define their credit portfolio risk and in their manner they manage such exposure.**

¹⁶ Intermediation risk is defined as the risk that a principal or counterparty will default in a transaction involving financial instruments for which a reporting institution has guaranteed final settlement.

¹⁷ Basel Committee on Banking Supervision – Sound Practices for the Management and Supervision of Operational Risk – July 2002

Intra-day risk: the existing banking regulation is less explicit, since prudential ratios are based on overnight exposures. Intra-day credit risk is nevertheless well addressed through the credit risk monitoring requirements.

- Custodians banks monitor intra-day credit lines by client and the transactions are processed within those lines. In particular, a transaction may be put on hold until the credit exposure has reduced.
- In practice, since an intra-day risk can become an overnight risk, the monitoring of the intra-day risk is based on the rules governing overnight risk. For instance, the definition of the intra-day credit maximum exposure is calculated by taking into account the potential capital adequacy requirement in case of an overnight exposure.
- Intra-day credit risk is also addressed through additional rules placed by the securities regulators and the Central Banks. For instance, CMF¹⁸ specifies in Article 39: *“The investment services supervisor shall ensure that counterparty risks, both credit risks and settlement risks are monitored on a permanent basis”*.
- In addition, insolvency provisions contribute to reducing this exposure and protecting securities settlement systems against systemic risk. Article 431-2 of the French monetary and financial code specifically covers intra-day risk exposure and provides that a client owns the financial instruments it has bought, only when it has paid the price for them; in the meantime, the intermediary remains the owner. Article 431-3 specifically addresses the issue of credit risk exposure in connection with DVP securities transactions: in case of client default, the custodian bank becomes the owner of either the cash or security leg of the DVP transaction.
- Finally, securities settlement systems are protected against the failure of one of their members, either through the development of Real Time Gross Settlement Systems or through the protection of Net Settlement Systems. This directly places collateral obligations on custodian banks, as members of the infrastructure, and we do not see any reason to expand the collateral obligation any further, in particular by encompassing the clients of the custodian bank, as suggested by the draft Standard (Standard 5 and 9).

- **Liquidity risk**

Again, this risk is a traditional risk that any bank manages. For a custodian bank, the liquidity risk is related to the securities and cash clearing and settlement processes, given the volume of transactions. It is mainly an intra-day risk due to the different settlement cycles between cash and securities. The general liquidity risk is addressed with the existing banking regulation and prudential ratio (liquidity ratio, own funds and permanent capital ratio ..).

Commission Bancaire rule 97-02 requests custodian banks to monitor their liquidity risk, including intra-day risk.

« Article 31-1. . This Article applies only to providers of investment services who guarantee settlement in transactions involving financial instruments and to the legal persons referred to at Article L. 442-2, point 3 of the Monetary and Financial Code aforesaid, referred to hereafter as service providers.

*1. Service providers must have a system for measuring the liquidity risk arising from the performance of investment or clearing services that allows them to **assess all flows of cash and securities at the settlement date**. In particular, service providers shall take into account certain or foreseeable flows of cash or securities related to futures transactions or transactions involving financial futures.*

*2. Service providers shall ensure that they assess the different stages of the delivery and payment process for the different instruments they deal in and for each delivery-versus-payment system used. In the event of delay or non-payment, transactions must be monitored until the date at which the position is finally unwound. **When transactions are processed by a delivery-versus-payment system that provides for intra-day final settlement, the measurement system must also identify forecast intra-day flows of cash or securities** so as to take account of deadlines for unilateral cancellation of payment or delivery orders. Service providers shall monitor on a daily basis transactions that have given rise to fails and shall ensure that they are cleared as soon as possible.*

3. Service providers must have a system for measuring resources in the form of readily available securities or cash that enable them to meet their commitments with regard to

¹⁸ Conseil des Marchés Financiers “Performance requirements for custody account-keepers” (decision n° 2001-01).

*counterparties, in compliance with the rules on the segregation of assets laid down by the regulations in force. **In this respect, they shall take the necessary measures to ensure compliance with their obligations in connection with delivery-versus-payment systems that provide for intra-day final settlement.** »*

As mentioned, a range of obligations are derived from the operating procedures of the securities settlement systems. Indeed, these systems have increasingly build safety barriers including the requirement for collateralisation (Relit + and RGV in France, Express 2 in Italy, NGSM in Germany...). For gross settlement systems, participants need to pre-fund their transactions. For net settlement systems, default funds have been established implemented in most European countries in order to limit systemic risk arising from the default of one participant .

- **Market risk**

Custodian banks typically only take in very limited market risks, since taking market positions is not in their core functions. The market risk is limited to clients operations and custodian banks cover these positions on a regular basis, in order to limit the market risk exposure of the bank. . True market risk remains at the level of their underlying clients.

In addition, even though their exposure is limited, custodian banks are subject to the prudential banking regulation which applies to credit risk, (i.e. strict risk monitoring system and procedures¹⁹ and sufficient capital to cover potential losses²⁰ (Cook ratio, Basle I)).

Conclusion

We recommend that custodians are excluded from the scope of the Standards:

- Custodians do not perform the same role as CSD infrastructures, they are for profit organisations who serve clients and are liable to their shareholders. Hence, the standards designed for essential facilities are not relevant (standard 1, 13, 14, 15, 17).
- Custodian banks already effectively manage their risks, which are addressed by the existing banking regulation and fall under the responsibility of the banking supervisor. Standards which address the risk issues (standard 5, 7, 8, 9, 10, 11, 12, 19) should focus on CSD infrastructures and exclude custodians, in order to avoid potential conflict of rules and confusion about the supervisory authority.
- Custodians do not decide on the rules of the securities settlement systems, therefore they should be excluded from the scope of the standards that define how the infrastructure should work (standard 2, 3, 16). They will nevertheless be impacted by those standards through their membership to the CSDs.

We suggest that regulators could search further comfort along the following lines:

- Monitoring of operational risk
- Advise that banks deemed “systemically important” apply the Basel II Advanced Measurement Approach
- Promote best practice rules for custodian banks, on the basis of the French and UK examples:
 - dedicated management / personnel / expertise;
 - procedures and sound accounting practices ;
 - segregation of client assets ;
 - reconciliation procedures ;
 - internal and external audit ;
 - insurance policy ;
 - legal agreements ;

¹⁹ For instance in France rule 97-02 of the Commission Bancaire

²⁰ For instance in France rule 95-02 of the Commission Bancaire

- business continuity planning through disaster recovery plans and on-line testing of back-up procedures.
- Promote best practice rules for the monitoring of intra-day risk
 - Existence of an independant credit committee, separated from the custody business line;
 - Allocation of credit lines by client ;
 - Intra-day monitoring of risks and exposures (before and after the fact) ;
 - Control procedures and audit trails ;
 - Exception processing procedures.

8. What can we learn from the US experience ?

The CESR-ESCB Group based its Scope of Application proposal on the US experience (Interagency Paper on Sound Practices to Strengthen the Resilience of the US Financial System). We confirm that the United States have a long history of regulating the post-trade environment and this could be taken as a valid example, under the provision that specific references be placed into their right context.

The US enforced regulation of the post-trade environment by way of a Federal Law.

In 1975, the Securities Exchange Act established Securities Depositories and placed them under the regulation of the SEC (Securities and Exchange Commission).

Securities Depositories are included within the definition of **"clearing agencies"** in **section 3 (a) (23) of the Securities Exchange Act**.

This definition covers, inter alia, the custody of securities in connection with a system for the **central handling of securities** whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned or pledged by bookkeeping entry without the physical delivery of securities certificates.

Section 17a of the Securities and Exchange Act requires clearing agencies to register with the SEC. In order to register a *clearing agency*, the SEC reviews the structure, rules and operations of the *clearing agency* and determines, among other things, that:

- the *clearing agency* is open to participation to all banks, broker-dealers, investment companies, and so forth,
- the rules of the *clearing agency* ensure a fair representation of its participants in the administration of its affairs,
- the rules of the *clearing agency* provide for equitable distribution of costs among participants,
- the rules are designed to protect investors and the public interest and are not designed to allow unfair discrimination in the admission of participants or among participants in the use of the *clearing agency*.

Clearing agencies are treated in the Securities Exchange Act as a type of "self regulatory organisation" ("SROs"). SROs are permitted to establish rules governing their activities, membership, disciplining of members and so forth, subject to review by the SEC.

This law established infrastructures as performing a central role for the market and separated the various layers of infrastructures that is the Exchange, the Central Counterparty and the Securities Depository.

This law also fostered the consolidation of Securities Depository infrastructures in the US: although it allows in principle free competition between Central Securities Depositories, it has fostered the consolidation of the activity with DTC, who **de facto is in a monopoly position**. Today, DTC (Depository Trust Company) holds 99% of US non governmental stocks. Besides the DTC, three depositories hold the remaining 1% and the Federal Reserve holds the Treasury Bonds.

In terms of oversight, DTC is supervised by the SEC, the Federal Reserve and the New-York Banking Department.

- DTC was created in 1973 and its prime regulator is the SEC.
- DTC was chartered as a *limited purpose trust company* by the New York Banking Department and as such is supervised by the New York Banking Department. This charter was chosen to grant DTC eligibility to become member of the Federal Reserve System and have direct access to the payment facilities of the Federal Reserve.

- A *limited purpose trust company* is permitted to engage solely in the fiduciary functions specified in its charter and is **not authorised to engage a general banking business**.
- DTC is technically subject to capital regulation as a New York Bank. The organisational structure and operating rules of DTC address the extent to which the obligations of participants are supported by **required capital contributions to DTC, by collateral and by membership qualifications**.
- As member of the Federal Reserve system, **DTC is subject to regulation by the Federal Reserve Bank**. In particular, a member bank may not make fundamental changes in the nature of its business without the permission of the Federal Reserve Bank.
- DTC does not take credit and liquidity risk: **cash settlements are processed in Central Bank Money on the books of the Federal Reserve Bank**. Cash settlements are processed through the Fed Wire system, that is the wire system maintained by the Federal Reserve Bank, in which funds are transferred from the account of one commercial bank at the Federal Reserve Bank to the account of another commercial bank at the Federal Reserve Bank.
- DTC is ran as a utility, which is user-owned and user-governed. The stockholders are the institutions which are participants in DTC, they elect a board of directors, which appoints a management team. DTC charges fees based on costs, with a non profit orientation: DTC does not distribute dividends, but enforces a policy of end-of-year rebates in order to pass any profits back to the users.

Access to DTC for non US applicants is based on the agreement of the home country supervisor to exchange information with the SEC, **as well as the enforcement of US rules on the applicants**. In particular, these rules include:

- a minimum capital requirement (10 times higher than for a US applicant),
- the release of immunity on assets held in the US,
- the recognition of US court and US jurisdiction,
- the abidance by US accounting rules.

Further to the events of 09/11/2001, the US regulators (Federal Reserve, Comptroller of the Currency and the Securities and Exchange Commission (SEC)) published an "Interagency Paper on Sound Practices to Strengthen the Resilience of the US Financial System" which is used as a basis for the CESR-ESCB Group proposal.

It is worth noting that:

- The US regulators focused on enhancing business continuity planning from the part of private sector firms that provide clearing and settlement services, when their market share is considered as "significant".
- The US regulators did not seek to submit these firms to new regulation concerning the management of their credit or liquidity risk, neither did they allow the DTC to expend its activities beyond its current charter.
- Instead, the US regulators invited more competition in the field of private sector firms, in order to ensure a sound distribution of risk.

To conclude, it appears that the Standards have taken a line which is very remote from the US example. We would advise the CESR-ESCB Group to re-assess the Standards in order to avoid introducing diverging regulations on a transatlantic basis.

Comments on the individual standards

Standard 1: Legal Framework

We fully support that a clear legal framework is needed in the post trade activities to ensure financial stability and secure the securities clearing and settlement business. We suggest this is ensured by the way of a European Directive on Clearing and Settlement that would embrace all aspects of the business. As a result, this standard should be addressed to the relevant European legislator.

Key element 1: We believe that the proposed drafting of the standard is inappropriate and irrelevant for custodian banks. Custodians already benefit from a clear European-wide legal framework for their activities under the ISD and general commercial banking directives. As such, the standard would lead to the duplication of rules and would create distortion of competition among custodian banks. In particular, the standard would oblige some custodians (those “operating systemically important systems”) to publish sensitive information, such as contractual arrangement with clients. We suggest that Key element 1 is amended to exclude custodian banks from the scope of application, and restricted to CSDs and CCPs. In addition, mixed-function systems should be included for their infrastructure role. Key element 1 could be amended as follows: “this standard 1 is addressed to CSDs, CCPs and ICSDs in their infrastructure role”.

Key element 2: This standard would lead to an obligation for “custodians operating systematically important systems” to make their contractual arrangements with their clients public and accessible. The role of custodian banks, even deemed systemically important, is fundamentally different from the role of infrastructures. Custodian banks serve their clients on a bilateral contractual basis in a highly competitive environment. They are not operators serving participants (as mentioned in paragraph 29). As a result, disclosure requirements which are appropriate for essential facilities do not make sense for custodian banks.

Key element 3, 4, 5: The obligations should be clarified as the operators are not responsible for the drafting of the legal framework. For instance, although legal certainty is necessary, the operators themselves cannot “address any conflicts of law issues for cross-border systems”. There is indeed a lack of a minimum level of consistency in legal and regulatory framework across Europe, as the Lamfalussy Committee and Giovannini Group reports have pointed out. We recommend that some key areas for harmonisation such as securities finality, transfer of ownership should be addressed as soon as possible by the relevant European legislator.

Standard 2

We fully agree with the principle that trades should be confirmed without delay after the trade execution. However, we consider that settlement matching brings settlement obligations and as such is part of the settlement cycle addressed by Standard 3.

Key element 1: we agree with the addressees, however we suggest that harmonisation of trade confirmation practice should be adapted to the actual needs of the relevant market. That is why, instead of imposing a standard we would suggest amending it into a recommendation, which would allow a market driven approach. This approach would both provide the required level of harmonisation to reduce the risks and preserve the necessary flexibility to take into account specific market practices and practical constraints. It would also be easier to implement as a market convention would not necessary require harmonisation of the national legal framework.

Key element 3: We are not convinced that the request for trade confirmation by indirect market participant to occur no later than T+0 can be implemented for those participants located outside Europe in a different time zone.

Key element 4: We suggest to keep the original CPSS IOSCO definition and allow for market conventions to define the appropriate deadlines, in line with the settlement cycle.

Standard 3 – Settlement cycles

Key element 1: We believe, as for Standard 2, that the definition of settlement cycles should be regulated through market conventions between concerned parties rather than through compulsory standards. The CESR/ESCB Group seems to agree with this principle, since Key Element 3 states that the harmonisation of settlement cycle is “primarily a task for market participants”. In order to reinforce this principle, we suggest that Key element 1 is amended to become a recommendation.

In addition, we do not understand why custodian banks are considered as addressees, since they do not decide on such matters. Settlement cycles are determined at the level of securities settlement systems, which are operated by the CSD infrastructures. As members of the infrastructures, custodian banks have to comply with these rules but are not in a position to monitor the final settlement of the trades.

We suggest that Key element 1 is amended as follows : “This recommendation is addressed to CSDs, ICSDs in their infrastructure role and CCPs”.

Key elements 2 and 3: further clarification is required to exclude the OTC business from the scope of this standard. Indeed whereas an harmonisation of settlement cycle on regulated market is welcomed, it is not the case on OTC business, for which freely negotiable settlement cycles are needed. Regarding rolling settlement, T+3 is the current practice in most European countries, and we do support that any shortening of the settlement cycle should be based on a cost/benefit analysis.

Key elements 4 and 5: as part of the harmonisation process, key elements 4 and 5 could be amended to suggest that maximum periods are defined for the recycling of failed instructions, at matching level on one hand and settlement level on the other hand. In addition, common rules could define that failed instructions are dropped by the CSDs at the end of the recycling period.

Standard 4 – Central Counterparties (CCPs)

Key element 1: In case this standard is maintained by the CESR-ESCB Group, we suggest it is addressed exclusively to CCPs. We understand the need to regulate CCPs, who are exposed to systemic risk, but fail to understand why market participants should be included in the scope of this standard. A firm legal background at EU level, providing for the definition of CCPs and the allocation of regulatory responsibility would also help in supporting such a standard. We suggest that key element 1 is redrafted as follows: “This standard is addressed to CCPs”.

Key element 2: CCPs are essential facilities, which perform 2 central functions for the market: netting and central counterparty. As a result, they are systemic in a similar manner to CSDs and we support the fact that should be requested to limit their risk exposure. We also believe they should focus on core activities, within the scope of their CCP licence. We understand the approach of a benefit/cost analysis and believe that the benefits of CCPs (reducing risk exposure through netting processes, reducing capital requirements, increasing market liquidity ...) have been tested in most EU markets. We would therefore expect this standard to regulate the activities and the role of the CCPs and to promote their consolidation around a limited number of CCPs in the European Union, in order to avoid unnecessary duplication of costs.

Key element 5: CCPs should use central bank money for cash settlement, in order to limit their credit and liquidity risk. We suggest Paragraph 59 and Paragraph 63 are amended to strengthen this principle.

Standard 5 – Securities lending

Securities lending transactions follow various purposes: fail coverage, search for liquidity, strategic trading position. Where the technical coverage of failed transactions is relevant to reducing systemic risk at the level of clearing and settlement infrastructures, the other lending activities belong to commercial functions performed by financial intermediaries, in competition with other intermediaries.

We agree with the principle to promote securities lending as fail coverage for CSDs and suggest the standard focuses on this activity. However, we believe it is not in the role of CSDs to engage in risk-taking principal or bilateral lending: this activity should be removed from the scope of the standard, and commercial banks should be removed from the scope of application.

In addition, should CSDs develop or desire to develop commercial activities, they should do so under the frame of a custodian bank undertaking which is separate from the CSD, for risk and competition issues.

Key element 1: Custodian banks should be excluded from the scope, irrespective of their size or market share. The existing banking regulation already covers all risks related to securities lending transactions (see our general comments on Custodian Banks' risk profile) and we do not see any need for implementing additional rules. In addition, requesting specific risk mitigation measures such as full collateralisation will create conflict of rules, since the banking regulation addresses the credit risk through capital adequacy requirements and monitoring of credit exposures. We therefore recommend that Key element 1 is amended to state that: "this Standard is addressed to CSDs and ICSDs in their infrastructure capacity".

Key element 3: We welcome Key element 3 as seeking legal and tax harmonisation across the EU.

Key elements 5 & 8: Where centralised securities lending mechanisms are implemented by CSDs, the role of the CSD should be strictly limited to a technical and administrative role, facilitating the process. The role of providing securities to a centralised pool belongs to custodian banks, who are direct participants to the CSD, are equipped to assume the related credit risk, and should be provided with equal access to the CSD. Key elements 5 and 8 should be modified to restrict the role of CSDs to the role of an operator, undertaking no credit risk. Similarly, paragraph 72 ought to specify that, although institutional investors may be incented to lending securities, they are effectively represented in the centralised pools by their respective custodian banks.

It is also worth mentioning that the requirement for such securities lending mechanism at CSDs level is mainly due to the variety of settlement cycles between the various CSDs, as well as lack of intra-day settlement. The harmonisation of those cycles (see standard 3 - key element 6) would significantly reduce the necessity and interest of such programs.

Key element 7: The prime objective of regulation should be to protect CSDs against risk. This objective is consistent with the recommendations of the second Giovanni report, which stated that CSDs should not concentrate risks which are not essential to their core settlement function. As a result, we strongly disagree with the proposal to authorise CSDs to act as principal in securities lending transactions, even under the coverage of new risk mitigation measures.

We understand that Key element 7 reflects the current regulation for mixed-function entities (ICSDs) and we share the objective of the CESR/ESCB Group to avoid that such a mix brings additional risk for the market. The proposed risk management measures could appear as a solution to address the specific risk related to these entities, however we believe it would be more appropriate to clearly separate the two activities –intermediary role versus infrastructure role- and enforce a balanced regulation for each business component, CSD on the one hand and custodian bank on the other.

We suggest that Key element 7 and paragraph 71 are amended to reflect these principles.

Standard 6 - CSDs

Key element 1: We agree with the Standard, which recognises the central role of CSDs, and suggest it is addressed to CSDs. A firm legal background at EU level, providing for the definition of CSDs and the allocation of regulatory responsibility would also help in supporting such a standard. We suggest that key element 1 is redrafted as follows: "This standard is addressed to CSDs".

Key elements 2 and 3: We support the objective to promote dematerialization and central immobilisation of the securities within the CSDs and to request robust accounting standards.

Key element 4: As explained in Chapter 6 (Risk profile of CSD infrastructures), CSDs are the backbone of the financial markets and we welcome the standard in its objective to regulate CSDs activities. Given the fundamental role of the CSD and its high structural exposure to systemic risk, we believe CSD activities should be restricted to core activities and ring-fenced from risk-taking commercial activities. As a result, we suggest that CSDs should mitigate operational risk to the greatest practical extent, whilst avoiding credit and liquidity risk. We recommend to amend the Standard as well as Key element 4 and delete "to the greatest practical extent" in both cases.

Explanatory memorandum: We notice that one of the major changes with the CPSS-IOSCO version is the extension of CSD activities to non-core activities, such as listed in paragraph 79 (credit extension, securities lending, clearing, matching, etc), which involve credit and liquidity risk for the CSD. This reflects the option taken by mixed-function models. We believe the standard should recognise the role of CSDs as essential facilities and suggest that CSDs activities are clearly separated from custodian bank business, for risk and competition issues. The setting up of “corporate governance” rules within mix functions entities does not seem to provide for an adequate level of ring-fencing, since this is best addressed through a dedicated CSD entity with dedicated facilities (technical platform, operations, financial statements and governance).

Standard 7 – Delivery versus payment (DVP)

Key element 1: The misconceived functional approach has led the group to including custodian banks into the scope of application, which is inappropriate. Indeed DVP can be achieved at the CSD level, whereas custodian banks do not monitor the finality of settlements and cannot provide settlement in central bank money. Imposing DVP to custodians in order to reduce systemic risk is therefore irrelevant and we recommend to amend Key element 1 to exclude custodian banks from the scope of application of this standard. Key element 1 should read: “This standard is addressed to CSDs, including ICSDs in their infrastructure role”. Paragraph 91 should be amended accordingly.

Key element 2: We agree that providing DVP at the CSD level for the settlement of securities transactions in the eligible currencies of the CSD will contribute to reducing systemic risk, as it eliminates the “principal risk”. We would suggest that the standard defines more clearly the requirements under the notion of “actual DVP”, since 3 different DVP models exist. The ESCB would be best placed to monitor the harmonisation process at EU level, since it constantly assesses settlement infrastructures, in order to monitor the ESCB credit policy.

Key element 5: We would suggest to complete Key element 5 to request that CSDs separate securities positions, according to whether they have been settled with finality or are still awaiting finality. Such a requirement would in turn ensure that cross-system settlement is performed exclusively on the basis of final positions and avoid the risks that unwinding in the delivering system affects the receiving system.

Standard 8 – Timing of settlement finality

Key element 1: As for standard 7, we believe it is inappropriate to include custodians banks in the scope of application of this standard. Indeed, custodians banks can confirm the settlement of transactions to their clients only when the finality of the settlement has been confirmed at the CSD level. Custodian banks do not monitor the timing of CSD settlement finality, they can only reflect the CSDs organisation and decision on that matter. We recommend therefore to amend Key element 1 as follows: “This standard is addressed to CSDs, including ICSDs in their infrastructure role.”

Key element 3: We welcome that Key element 3 defines both real-time and multiple batch processing as different ways to achieve finality. We believe however that those two types of processing should be both offered as they are complementary and provide different benefits ; players of the systems are different as wholesale institutions will focus on real time systems whereas retail banks will prefer multiple batch systems. We would therefore suggest that the key element 3 should be modified as follow “settlement finality should be provided in real time and by multiple batch processing during the settlement day”.

Key element 7: We agree that interoperability across system should not lead to increased systemic risk. In that respect, CSDs should not take on risk which would derive from the practice of another CSDs. As stated on Standard 7, this will not depend so much on increasing the number of batches, but rather on requesting that finality of both cash and securities is a pre-requisite to any transfer of securities through cross-system links. We suggest that Paragraph 100 and 101 are amended accordingly

- paragraph 100: delete “or the linked settlement systems should prohibit their retransfer prior to their becoming final”
- paragraph 101: delete “in the absence of intra-day procedures, a significant number of batches during the day should provide an acceptable degree of intraday finality in the cross border of securities via links” and replace by “intra-day finality should be obtained prior to any delivery across links”.

Standard 9 – Risk controls

Key element 1: A clear distinction between CSD infrastructures and financial intermediaries such as custodian banks is required for this standard also.

We recognise that this standard has been tailored to address the specific issues of mixed-function systems, and searches to expand the current risk monitoring procedures of ICSDs to all infrastructures. We believe that the financial market would be better protected against systemic risk by ring-fencing the CSD infrastructures from any commercial business and by applying the appropriate regulation to each business component. As a result, we agree that this standard is addressed to CSDs, including ICSDs in their infrastructure role, however we believe it is not appropriate to include custodian banks, whatever the size of their business.

From an economic perspective, intermediaries bring liquidity and help develop the financial market. In the securities business, custodian banks provide credit facilities which allow the processing of client trades, with the necessary cash or securities advance. Requesting that custodians banks do not take any risk actually contradicts their role. In addition, as we have amply demonstrated (see Chapter 7 on Custodian banks risk profile), financial intermediaries are already supervised within the existing banking regulation, and we do not see any reason to extend the scope of controls for a subset of the banking business, outside the responsibility of banking supervisors.

- For instance, the existing regulation already fully covers Key element 6.
- Full collateralisation is far less sophisticated than the credit risk management methods developed in the world-wide banking regulation (solvency ratio, large exposure ratio, Basel I and II). Whilst the collateralisation method may reduce credit risk exposures, it actually generates other risks, such as market and legal risk.

We believe that the risks are globally best addressed through the combination of various prudential risk control endorsed in the banking regulation, rather than by imposing one single method such as full collateralisation. Furthermore, we believe that this measure will actually increase the cost of collateral and hence the cost of transactions for custodian banks' clients. It will also reduce dramatically the liquidity of the market, which is a fundamental factor to guarantee the efficiency of the market. Those consequences seem to be in contradiction with the stated objectives of the CESR/ESCB group, which consist in increasing the efficiency of the market.

We recommend therefore to modify the Key element 1 as follow : "This standard is addressed to CSDs and ICSDs in their infrastructure capacity."

Key elements 3, 4 and 5: Besides, we consider that Standard 9 introduces the possibility for CSDs to develop non core-activities and in particular to grant credit, a function which is clearly not in the remit of their core essential facilities role and introduces undue risk for the market. We reiterate our strong opposition to allowing CSDs to provide credit facilities. We suggest that the standard confirms the principle of a CSD taking no credit and liquidity risk. Therefore, the risk mitigation measures proposed in key element 3, 4 and 5, which may be needed today for ICSDs, would not be needed for CSDs.

Standard 10: Cash settlement assets

Key element 1 : we do not understand why custodian banks, even systemic ones should be included in the scope of this standard. Indeed as detailed in chapter 7 on Custodian banks risk profile the existing banking regulation and the rules of the securities settlement system themselves already address the liquidity risk of custodian banks including intra-day liquidity risk.

We recommend therefore to amend key element 1 to address this standard only to CSDs and to ICSDs in their infrastructure capacity.

Key element 2 : Given the fundamental role of the central bank that we recommend, we welcome the key element 2 that require to facilitate access to central bank money to all entities which are eligible. For users that do not have a central bank cash account they should appoint a settlement bank which has access to a central bank account.

Key element 3 and 4 : The Standard 10 distinguish two concept : the cash settlement agent which is the entity where the ultimate cash settlement occurs and the settlement banks which are entities who act for the users of the settlement system.

According to the principle that a CSD should take no risk (credit or liquidity) we believe that the CSD should always use the central bank as the cash settlement agent. The use of central bank money at the CSD level should not be an option but should be mandatory. Indeed authorising commercial money to settle securities transactions at the CSD will increase the level of risk for the CSD and hence for the whole financial market, which is in contradiction with the prime objective of the CESR/ESCB group to reduce systemic risk. Moreover we do not see how a custodian bank could be held accountable towards its clients for the failure of the settlement agent selected by the CSDs, as custodian banks have no right to impose any choice to the CSDs.

The use of the central Bank as settlement agent is the only real guaranty against the failure of the settlement agent.

We recommend therefore to modify the Key element 3 and 4 as follows :

“ Key element 3 : CSDs should use central bank money only.

Key element 4 : Only central banks should be allowed to act as settlement agent”

Standard 11- Operational reliability

As we have explained in chapter 6 and 7 on the risk profile of respectively CSD infrastructures and custodians banks, operational risk is the major risk in the securities clearing & settlement business. We welcome therefore the objective of this standard to ensure strong monitoring and control of these operational risks.

Key element 1 : we believe that this standard should focus on the infrastructure only as the potential damages due to operational issues within a CSDs or a CCPs would be extremely significant and could potentially disrupt the whole financial market. Moreover the operational risk of custodian banks is already addressed with existing banking regulation both at EU level with the forthcoming regulation Basel II (pillar 2 article 4.3) and at domestic level with for example the French rule 97-02 of the Commission Bancaire (see chapter 7 section on operational risk).

We therefore recommend to amend Key element 1 to apply this standard to CSDs and CCPs only.

Nevertheless we agree that operational risks of institutions accessing the infrastructure should be controlled to limit systemic risk for the market. We understand the objective of the CESR/ESCB group with this standard. And we could accept additional rules to provide further comfort that operational risk is well managed within those institutions to the extent that there is no duplication and/or conflict of rules with the existing/ forthcoming banking regulation.

Those additional comfort could for example, be drawn around the lines of requiring contingency planning and disaster recovery plans or requiring that those institutions used the most advanced approach- AMA - (as defined in Basel II) to monitor and control their operational risks. In any event such a proposal would have to apply to all custodians and not only specific ones in order to preserve the level playing field.

Standard 12- Protection of customer securities

We fully support the aim of this standard to ensure the protection of client's securities. Nevertheless we believe that this is already addressed in EU directives such as the DSI or the directive 97/9 on investors indemnification system. We suggest that a detailed analysis is performed to ensure that duplication and potential conflict of rules is avoided.

Standard 13- Governance

Key element 1 : Requirement in terms of governance need to be differentiated for market infrastructure versus financial intermediaries. Whereas the proposed standard is fundamental for a utility, it is not applicable for a commercial enterprise. In particular ensuring effective user representation or defending public policy interest do not fall under custodians banks responsibilities that are for profit organisation serving clients.

On the other hand strict governance requirements are key for market infrastructure. This standard should recognise the essential facility role (network of general economic interest) of CCPs and CSDs, thereby obliging them to abide by the highest set of governance rules, as suggested by the Company Law Action Plan consultation, as well as prevent them from spoiling the competition framework as suggested in the Green Book on Services of General Interest consultation.

We therefore recommend that key element 1 should be amended as follow : “The standard is addressed to CSDs and CCPs.”

Regarding ICSD, we recommend that the two activities are ring-fenced in two separate entities and that the relevant governance requirements are applied. In addition rules to resolve conflict of interest between the two entities within the same group should be defined to ensure that both the public interest and the competition field are preserved.

Standard 14- Access

Key element 1 : As for standard 13, the misconceived functional analysis has led the group to inappropriate standard. Indeed we consider that the proposed standard is in contradiction with the commercial purpose of custodian bank whatever market share it has. A custodian bank should be free to define its commercial strategy and hence should not be required to de facto accept all clients except for risk justifications. Moreover if a custodian bank rejects a clients , as the banking environment is fully competitive , a client can always find another provider, which is not the case for an infrastructure.

This standard is indeed essential for the market infrastructure. Custodian need to have access to the infrastructure at an economic price to be able to provide their owns services. Therefore a fair access to all intermediaries should be ensured to guarantee that the competition between financial intermediaries is not distorted. Minimum requirements can/ should be defined to protect the market infrastructure from systemic risk, however those criteria should be risk oriented only and non discriminatory.

We therefore recommend that key element 1 should be amended to reflect that this standard is only applicable to CSDs and CCPs

Standard 15- Efficiency

Key element 1 : We support the general principle to promote efficiency. However we believe it should be more a general objective than a regulated standard.

Regarding the addresses, it is inappropriate to include custodian banks even with important market share. indeed custodian banks operate in a highly competitive environment and the competitive pressure will ensure efficiency automatically. We recommend therefore to amend the key element 1 to restrict the scope of application of the standard to the CSDs and CCPs only.

Key element 3 and 6 : we agree that efficiency should be part of the infrastructure objective, but this request of efficiency should not be detrimental to the risk management (operational risk). In addition infrastructures should be required to disclose the composition of costs and revenues and have policies in place which prevents the subsidisation of one group of users by another. Potential cross-subsidisation among services and users group should only be possible with the agreement of all users.

Key element 3 and 5 : we find that inter-operability should not be elevated as a standard. Inter-operability is only one way to increase efficiency, but other solutions exist such as integration. Key element 3 and 5 should be amended to precise that the various solutions to increase efficiency should be assess in terms of cost/benefits analysis before imposing a specific way.

Standard 16- Communication procedures

We agree with this standard that promote harmonisation of market practices across Europe for communication procedures, messaging standards and straight-through processing. It actually supports the Giovanni recommendation.

We would like to reinforce that the harmonisation process should be done in close co-operation with market participants.

Standard 17- Transparency

Key element 1 and 4 : We support the general principle of transparency. The requirement for transparency in terms of costs and risks, as proposed in this standard is essential in an utility context, however it is inappropriate for custodian banks which are in a competitive environment. Indeed the requirement to made public price/costs and risks related information would damage the commercial position of the custodian and is contradictory to the basic business of a bank that is competing to get customers and tailored its commercial and contractual arrangement with its clients on a bilateral basis. In addition custodian banks under the existing and forthcoming banking regulation are already requested to disclose risks related information to their relevant supervisory body.

Therefore we consider that the key element 1 and 4 should be amended and refers only to the market infrastructure CSDs, CCPs.

Regarding the ICSDs we believe that the two different activities should be ring-fence in a way that the activities can be clearly regulated differently. This standard would apply only to their infrastructure role

Standard 18- Regulation, supervision and oversight

We support the objective of this standard to promote co-operation both nationally and cross border between the various supervision bodies that leads to consistency in supervision but also in efficiency. We fully support the principle of one authority as leader of the supervision, including for entities active in various EU member states. And based on the European model of mutual recognition, this authority should be the competent authority in the origin country.

Standard 19- Risk in cross-system links

Key element 1 : As explained before, custodians are members of the infrastructure, they are users of the securities settlement system (SSS) and do not operate it . Only CSDs operate SSS, define membership criteria and determine market practices. We do not understand why custodians, even those operating systemic important systems, are included in this standard, as only CSDs decide to set up cross-system links and operates them. The custodian's securities settlement system, plays a different role as the SSS : the SSS ensure the settlement finality of a securities transaction whereas the custodian's system can not. It can only provide the settlement finality after the SSS has confirmed that finality.

We recommend therefore to exclude the custodians and to amend key element 1 accordingly.

Key element 2, 4 and 5 : We support the general principle to promote links between CSDs, as we believe this could be a an intermediary solution to actually build a single European financial market.

However those links should not lead to an increase of the CSDs risk. In particular CSDs should not be financially exposed to each other. We believe as explained in our chapter 6 and in our comments on standard 5 and 9, that CSD should not take any credit risk. The second Giovanni report states that, it is not essential for a CSD to extend credit to perform settlement and infrastructures should not incur risks that they can avoid. We therefore recommend that any cross border transfer of securities should be done only on a irrevocability based.

We would like also mention that the links between CSDs will only increase the efficiency and safety of the market if cross border settlement procedure are done on an harmonised basis.