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Euroclear response to CESR's call for evidence on the identification of regulatory arrangements for post-trading infrastructures

Euroclear is a strong supporter of the Code and the Access and Interoperability Guidelines, and is committed to ensuring that the Code can deliver a more competitive and lower cost post-trade industry which offers a real choice of post trade service providers to all users of European securities markets. We are therefore, pleased to be given the opportunity to contribute to the CESR mapping exercise on regulatory arrangements for post-trade infrastructures, and to be able to provide advice on possible solutions.

We list below the main regulatory challenges that we have identified as a result of our Access Requests under the Code of Conduct. In the second part of the response we take the opportunity of describing how, based on our experiences under the Code, CESR might be able to proceed in reviewing the regulatory arrangements for post-trade service providers.

1 Euroclear's requests under the Access and Interoperability Guideline

In the frame of the Code of Conduct's Access and Interoperability Guideline, Euroclear Bank to date has made four requests for transaction feed access:

- Eurex CCP for (German and non German) equities traded on DBAG
- X-clear for securities traded on SW-X
- CC&G for equities traded on Borsa Italiana
- EuroCCP for equities traded on Turquoise

This paper explores in particular the experiences of Euroclear Bank (EB) in its request to receive a transaction feed from Eurex CCP for German equities.

To date, we have not yet encountered regulatory barriers with regard to the other requests because discussions have not yet progressed to a stage where such barriers could be identified.



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Following the access requests to Eurex CCP, the Frankfurter Wertpapierbörse (FWB) issued criteria for clearing houses and CSDs requesting access to the FWB Trade Feed which were presented by FWB to the MoG of July 9, 2008 .

FWB Criteria: Euroclear concerns

There are two FWB criteria which would require EB, as the requesting party, either to make material changes to its business model, or to incur high investment and compliance costs making it difficult for EB to have a positive business case for the requested link. These criteria are:

1. the FWB requirement that settlement should take place in central bank money
2. the FWB requirement that EB would need to provide services also for FWB transactions that are not cleared through Eurex CCP (even when EB has requested a feed solely from Eurex, not from FWB).

It is the first requirement that we wish to highlight to CESR. Whilst we believe that the second requirement is not in line with the Access and Interoperability Guideline, it is clearly not a regulatory barrier per se.

FWB Criteria – Legal background

It is our understanding that, in order to settle Frankfurt Stock Exchange transactions, a CSD must be approved by the Frankfurt Stock Exchange Council (Börsenrat) according to the German Stock Exchange Act. The Exchange Rules of the Frankfurt Stock Exchange (Frankfurter Wertpapierbörse - FWB) provide for admission criteria concerning settlement of stock exchange trades and, in particular, state that companies are admitted to participate in stock exchange trading if the orderly settlement of trades on the Frankfurt Stock Exchange is ensured.

We also understand that the German federal regulatory authority, BaFin, does not have an official role with respect to amendments of the Exchange Rules. The Exchange Rules are supervised by the State of Hessen's Ministry for Economic, Traffic and State Development. Pursuant to the German Stock Exchange Act, an amendment of the Exchange Rules have to be approved by the Ministry, which is legally independent from BaFin (the Ministry is a state - "Länder" - authority; the BaFin is a federal authority).

Consequently, it appears that the FWB has the legal authority to apply specific criteria for the settlement of trades, but that these criteria may run counter to the precise wording of the Code of Conduct. The consequence of these rules would appear to result in any requesting party attempting to access the German settlement



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or Clearing infrastructure having to become, in effect, a clone of the current national incumbent.

FWB Criteria and the German Stock Exchange Act and Exchange Rules

The Exchange Act defines that Exchange Rules may provide for the connection of external clearing and settlement systems to the trading system of the exchange, provided:

- the operator of the clearing and settlement system has the necessary technical facilities and has met the legal and technical requirements for the connection to the trading system and the applicable legal framework;
- the orderly and economically efficient clearing and settlement of exchange transactions is ensured.

According to FWB, the above two high level principles of market integrity and efficiency lead to a set of “derived” requirements that need to be secured by any requesting party:

- Integrity (fair, neutral, transparent, for all members, capable to comply with regulation, secure and safe),
- Efficiency (reliable, risk efficient, STP, cost efficient, for all securities).

The FWB appear to argue that it is only via settlement in central bank money that the efficiency and security of the German Financial markets can be ensured. However, this appears contradictory to the construction of the CPSS/IOSCO and draft ESCB/CESR standards. And it is unclear whether the requirement to settle in central bank money is actually an appropriate requirement for an exchange, or whether it is a requirement that should be solely under the control of the German Regulators only.

The requirement for a CSD requesting access to a transaction feed from Eurex to achieve the local status of a Wertpapiersammelbank has now been dropped, but the FWB still require a requesting CSD under the Code to be an ECB eligible SSS, regulated by a member of CESR and a notified system under the Settlement Finality Directive. These are criteria that are met fully by Euroclear Bank.



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FWB Criteria and EU framework for financial stability of securities settlement (CPSS/IOSCO and ESCB/CESR)

The previous text of the draft ESCB/CESR standards would have allowed settlement in commercial bank money (albeit under understandably strict conditions). We assume that the forthcoming ESCB/CESR recommendations would contain the current version of Recommendation 10 (Cash settlement assets): *"Assets used to settle payment obligations from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect the participants in the systems from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose"*.

ECOFIN recently concluded that the ICSDs would be included in the scope of the Recommendations. In theory therefore, from a pure regulatory perspective, EB should be allowed to offer stock exchange settlement for German securities in commercial bank money to those clients that demand such a service. Users would thereby have the option to settlement in central bank money through Clearstream Banking Frankfurt (CBF) or in commercial bank money in EB.

But, ESCB/CESR will only be a possible solution if the following conditions are met:

- *IF* the FWB Criteria fall solely under the responsibility of the German regulatory authorities; and
- *IF* the German regulatory authorities would accept, via a form of mutual recognition, a Belgian regulatory assessment on the compliance of EB with the Recommendations.

FWB Criteria and MiFID

Under MiFID (Article 46(2)) the competent authority of a regulated market cannot oppose the use of a settlement system in another Member State unless this is "demonstrably necessary in order to maintain the orderly functioning of that regulated market". This provision also refers to Article 34(2) of MiFID, under which Member States must require that regulated markets offer their participants the right to designate the settlement system, subject to:

- links/arrangements which are necessary for the efficient and economic settlement of the transaction in question; and



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- agreement of the responsible authority for the supervision of the regulated market that the technical conditions for settlement are such as to allow “the smooth and orderly functioning of financial markets”.

In addition, the competent authority’s assessment must take into account the oversight/supervision of the settlement system already exercised by the authorities with competence for this system (a form of mutual recognition). Therefore, we would normally expect, in the case of Euroclear Bank requesting a feed from Eurex, for the national regulators and overseers of Eurex to rely on the regulation already exercised over Euroclear Bank in Belgium, not to set their own local requirements.

2 High-level view on solution of regulatory barriers

In the context of the circumstances described above, we believe that the following recommendations could help to remove the regulatory barriers that we have experienced to date:

1. Securities regulators (CESR) should set and use common standards for the efficient and sound operation of post-trade infrastructures across the EU, applicable to both domestic and cross-border activity. In this respect, we believe that CESR could proceed in three steps:
 - First, finalise the ESCB/CESR Recommendations, (‘the Recommendations’), after market consultation, based on the draft of September 2004 and according to the ECOFIN conclusions of June 2008, by year-end 2008
 - Secondly, once CESR has finalised the current mapping exercise of national regulatory requirements, it should perform a gap analysis to see which of those requirements are not covered by the agreed ESCB/CESR Recommendations, after which the Recommendations could either be adapted or completed (after due market consultation).
 - Thirdly, CESR should consider how effective mutual recognition of CCPs and (I)CSDs could be delivered across the EU, using the ESCB/CESR Recommendations as the baseline for national regulatory standards.

The result of such an exercise should be that EU securities regulators have, in effect, a single set of ‘Standards’ for post-trade service providers.

2. We believe that ESCB/CESR Recommendation 18 on Regulation, Supervision and Oversight should be reviewed to ensure the following principles are included:



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- Member States should ensure that the national securities regulator is given the authority to set and check compliance against criteria on post-trade infrastructures with regard to safety and soundness of post-trade activities, and financial stability in general. Member States should ensure that such authority is not delegated to private sector infrastructures such as stock exchanges or CCPs. First, because these entities may not be best equipped to set and check compliance with criteria that are designed to minimise systemic risk. Secondly, because such private sector infrastructures would potentially be able to use such authority to establish barriers in favour of the incumbent providers of post-trade services, thereby hindering the successful implementation of the Code.
 - With regard to the Access and Interoperability requests, relevant securities regulators and national central banks (in their oversight capacity) should enter into bi-lateral or multi-lateral MoUs which state how they will apply the ESCB/CESR recommendations to the link.
3. If the above is achieved, we believe that ESCB/CESR could effectively become 'binding' standards for post-trade infrastructures. This would not only ensure quick and effective removal of regulatory barriers but also install the long-awaited common supervisory framework for post-trade activities.

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