CESR – BCE
STANDARD FOR SECURITIES
CLEARING & SETTLEMENT …

COMMENTS TO THE CONSULTATION

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Those comments are personal opinions in the role of independent expert. They are complementary to the AFTI-FBF one and in line with EBF and GEBC.

1. NATURE OF THE STANDARDS

1 Legal status of the standards

- BINDING : TO WHAT EXTENT ?

It is important to understand clearly the real power of those standards, how they will be en forced and adapted in local regulation. When it is said that those standards are "binding" it is important to evaluate how far they are binding.

If those standard are binding (as much as possible) which is a necessity if the real objective is to achieve an harmonised-domestic european area, those standards should be expressed without ambiguity. Obviously we are facing heterogeneous businesses and environments, and we have to find the proper balance to deal with reality. But it is also a necessity to understand how far those standards impact structurally the actor's organisations and how they will be interpreted by their compliance's department. Too often the wording of those standards leads to ambiguity or misunderstanding and strict orientations are balanced by "open doors" to exceptions or latitude for alternative solutions. As written those standards will be very difficult to transpose domestically & will create divergence risks; also the actors themselves will face difficulties to determine how to streamline consistently their organisations according to those standards.

If the scope of actors concerned by each standard is more focused it will be probably easier to address the standard in a more precise for in.
Also it is difficult to understand the articulation between the 3 levels (standard / key elements / explanatory memorandum). In legal documents we are used to high light the primary text by the surrounding text.

Her it seems that the EM has a wider scope or vision and then creates some confusion to understand strictly the meaning of the standard. An example is in standard 6 about the understanding of the perimeter of responsibility of a CSD that "should easure that the issues are conducted in an adequate manner " Do CDSs have such responsibilities over their members ? KE3 "mentions robust standard and end-to-end audit trail. This comment may be used to justify an extensive responsibility which apparently is not the regulator's view. The overall wording of those standards and the articulation of those 3 levels of explanations should respect this preoccupation and eventually be less ambitious to be more effective & precise.

- RELATIONSHIP WITH OTHER AUTHORITIES

1 - The model issue :

Those standards refer to 2 models, ICSD and classic CSD. Which is a reality. The wording leads to understand that the structure of this new set of regulation is based on a choice. An oral answer indicates that no choice has been made. That implies few remarks :
. A gap exists between our understanding of those standards (some are addressed in the same way to different actors assumed to exercise similar functions which are analysed as different functions in the rest of the world) and the regulator's perception.
. Facing 2 models **necessitates in fact in fact to make a choice**. Making a choice is part of the risk reduction process. Accepting to manage two worlds in the same time may drive to confusion in roles, systems, competition and this confusion is a major for risk factor.

The choice between those models is structural for the industry and should be subject to a political decision through a directive as suggested by the Andria's report.

2 - Other prudential regulations.

The functional approach implies regulation by functions. Why not ? But it seems a necessity to go further and then to follow a kind of **matricial analysis, matching functions & institutions as no function can exist if not exercised through an institution which also is regulated**.
Functions cannot be isolated. It is necessary to analyse rules for their appropriation by institution and evaluate 2 sets of conflicts :
. Conflicts among a portfolio of functions, some functions may be inappropriate to exercise among other functions. Some orientations should be explored around "**conglomeral"** approaches through which a **segregation of conflicting functions in separated institutions** each governed & regulated according to spec. of homogeneous functions could be hosted through a holding co.
. Conflicts between functions & institutions. That is where to analyse those layers of controls between Basle II, banking prudential rules (Commission Bancaire) and CESR-BCE Rules.
For each standard it should be recommended, as it has been the case in the comparative analyses with IOSCO-CPSS, to explicitly mention cross reference with parallel set of regulation.

3 - Towards a "domestic playing field"

We recognise the fact that the report does not refer to "cross-border" and that the assumption is really that European must function a full domestic area. We agree on the fact that the report refers to "systems" and not "national systems". But to clarify the understanding of macro-functions it should be suggested to refer more explicitly to "market-infrastructures" as in § 10 ,instead of systems.

§. 9 Standards are tools… to a **commonly accepted** model. This is the key. This model should clearly define the nature of actors, differences, and their relationship with customers and members. A clear definition of **customers** and **members** is needed. Those standards should fit with a clear post-trade framework.

§. 9-2 The principle of common standards and the acceptation of additional stricter obligations by countries is real problem… the role of CESR to monitor those gaps and to maintain consistency, must be reinforced.

§ 11 Custodians

This description of the custodian's ecosystem should be more precisely analysed. References to "settlement infrastructure" should be described as a generic custodian function organised in 2 layers. All custodians receive instructions from their customers to settle transactions. We should identify functional differences between this "customer-settlement-function" and the next layer which could be qualify as "final-settlement- function" (differences are DVP, finality, contractual settlement services, technical solutions, commercial negotiation, nature of credit facilities, nature of money…) This description should differentiate what is happening at the local level (custodian to CSD) & at the cross-border level (custodian to sub-custodian) which in fact covers 2 different sets of functions ,procedures and legal responsibilities.

This description should describe in more detail what is called "internal settlement" and why this exceptional practice for very specific configuration of operations differs profoundly with the systematic "internal settlement" at the CSD level to fulfil the notary function. That will help to better understand the functional comparative analysis between layers of actors in the infrastructure world and in the custodian world.

Obviously some custodians process transactions for "comparable volumes and values "as CSD. But those criteria's are not functionally oriented, just quantitative. It means that those two categories of distinct functions may represent some systemic risk and that those risk must be covered (operational and financial) specifically in a manner adapted to the full nature of those functions.

In the custody area it is also necessary to differentiate 2 major business lines :
. Service to brokers
. Service to institutions
The natures of the functions, and risk involved are significantly different. One is transaction oriented, the other is stock oriented. The risk management process is significantly more sophisticated in the first case than in the second.

§12 Registrar

Obviously they are part of our scope, but it should be recommended to describe in more details their generic functions as similarities at the generic level are materialised by very heterogeneous practices and risks. That will help towards convergence and also to understand the operational consequences of those standards on those actors or functions.

§ 13 Addresses

We agree to enlarge those standards to a wider range of actors in the end to end securities chain. In this chain we should add reference data providers (as FININFO, TELEKURS, ANNA for example). But we should express more precisely the nature of this enlargement and its real meaning.

Also actors around the mutual funds processing, settlement & custody should be part of our perimeter as major risks & inefficiencies exist is this area. This chain of activities, in Europe is not converging & the basic common principles & practices that are used in the securities world are not clearly adopted in the funds' one (as DVP for example). One suggestion should be to assimilate those instruments to securities & recommend to use existing securities circuits to settle (in CSD). The transfer-agent should then be added to the perimeter of those standards.

One other suggestion should be also to express principles for the overall chain:

1) "if functions in the securities chain is concentrated at such a level that it creates a major operational risk then a specific assessment will be needed"
2) a reinforcement of multi-activity common crisis-management procedure is needed between payments and securities world". This crisis-management process should reflect certain guiding principles determine by regulators. (As it is the case in France between CRI – French access to TARGET and Euroclear France).

§ 14 As already suggested when standards address issues that fall under competence of legislative authorities……. That should be explicitly highlighted.

§ 21 Implementation

We agree that those standards must help to European harmonisation. Every initiative must be taken to avoid the fact that for any reason major distortions happen in the implementation process. CESR should be reinforced to assure this consistency mission.

§ **25 systemically important systems**

Systemic operational and financial risks exist. They must be specifically identify for the infrastructures in one side and for the custodians in the other. It should be suggested that each standard should be presented in 2 "chapters", one for infrastructures & one for custodians.

STANDARDS

1 Legal framework

This standard is key to create a level playing field in a real integrated European area.
To answer without ambiguity to the 6 identified key element a kind of set of European legal principles and framework is needed as suggested by the ANDRIA report. That must be the next priority.
KE1 : This is not specific to COSI but to all custodians as all custodians are linked to CSS.

This standard must be more precise on its perimeter. The priority is to identify a legal comparative analysis and communication to members insides Europe. The issue about those matters outside Europe is of a different nature and should eventually merit a specific chapter just devoted to global custodians in relation with sub-custodians and responsibilities for investors.

Coming back inside Europe as in § 29 the list of subject 1 to 15 is the right work program for the commission to define a common legal European framework.

§ 34 Issue about cross-border system. Is this § related to Europe or outside Europe ? This issue should be reviewed in a more detailed manner with global custodians. As this EN is linked to this standard, it may create some misunderstanding on a very difficult issue that should be subjected to a complete study.

In Europe priority must be given to assure that the account audit-trail in the books of the CSD, the registrar and the custodian is legally robust in term of right of ownership and practices in date of change and impacts on proxy voting, dividend and corporate actions. The regulator should trace the gaps and evaluate level of double counting risk.

2 Settlement cycles

Key elements 4-5 are very important. Failures monitoring and action taking should be at a certain stage harmonised between CSDs. The role of market participants and regulators must be clarified as the penalties process and accounting.
When settlement instructions are matched, if at the last minute one leg wants to get out, some standard procedures should be set to define how it is possible (unilaterally or bilaterally). Those rules must clarify business practices & responsibilities separately for trade & settlement matching.

3 Settlement cycles

KE1 : This standard applies to all the industry.

5 Securities lending

A. Practices around securities lending may be of very different nature and should be specified as different practices or controls may generate different level of risk.

Obviously securities lending must be encouraged. But the risk for custodians and CSD are radically different. The **custodian is in relation with an individual account** and trades related to that account. Its responsibility is to assure that during all the settlement cycle the provision of that specific account remains positive to cover the chain of trades for this investor in that securities.

The custodian must at its level take any initiative to assure its responsibility and either to stop the settlement process for this transaction if at any point there is no provision or uses securities lending facilities as needed.

In this condition, securities lending function at the CSD level is marginally necessary except in the chaining process.

At the CSD level securities lending is then very different in nature because it matches an **omnibus account** (assets belonging to different investors) **to a chain of transactions** from also different investors, customers of a specific custodian. A failure at this level implies a procedural failure at the custodian level unless the pile of transactions and its order create at an instant **a technical gap** that in this only case could be cover by a technical securitites lending facility. But that in reality should be exceptional for classic custodians. In the case of brokerage-clearing it is different & its belongs to a different sub-business line with a specific

Before setting standards at this level it should be recommended to analyse with the market the real interaction of needs between the custodian & the CSD to clarify in an harmonise way roles, responsibilities & risk-sharing.
The principle except for chaining purposes must be that the custodian has full responsibility to monitor and trigger securities lending needs based on individual positions. In this case it should conceivable to use a centralised process at the hand of the custodian where he indicates for a specific transaction the need to be covered by a collective security lending process.
B –In a centralised S-L process, the regulator should fix some common rules or principles to guarantee equal rights among the pool's participants in the way that their securities will be used.
C – When we face a collective or centralised securities lending service, some common principles should be set to fix the rule on how to manage a kind of audit-trail between the omnibus custodian's S-L account and the individual investor and beneficiary of S-L services.
D - Financial risk KE 6&7 : CSD are not supposed to be principal.

6 CSD

This standard recognises the evolution toward dematerialization & book entry. It recognises the overall coherence end-to end of the system to guarantee investors by robust accounting standard (§3) and end-to-end audit trail (§77) in relation with std.12.

This standard should precise which body is in charge to define those common procedures and accounting principles and to control end to end (CSD plus members) the strict implementation of those principles.

The standard mention that "CSD should ensure…" is it clear that this responsibility is at the CSD level (that was the case with SICOVAM in France, then this responsibility has been transferred to the regulator – CMF) ?

It is clear that the regulator must be active to determine how and to which extent the overall post-market organisation "should ensure that the issue ... are conducted in an adequate and proper manner".

This standard should be modified (as I asked twice in expert meeting but this idea has not been clearly reported in the minutes):

1. It should define the nature of responsibility for CSDs to ensure how those transactions registered in a proper manner;
2. It should recognise that "robust accounting standard" (based on common principles in Europe) must be defined and that a "body" ,probably under CESR's umbrella, should be identified.
3. It should define how this end-to-end audit trail should be controlled and by whom in a coherent manner all over Europe. This is important to assure convergence in the way custody business practices and how the chain between CSDs and custodians will be implemented according the same prudential principles within all type of remote access configurations.

§. 77, 78 is interesting in the way that it recognises the specificities of the notary function which is the CSD's core function.

§. 79 On the risk aspect we suggest to skip :" the greatest practicable extent"; "avoid taking risk" is our real objective for the sake of the industry as we do not understand why taking risk (between european members and for european-domestic transactions) is a necessity or is needed. No need, no function ,except if needs are demonstrated.

§. 76 Corporate actions are mentioned. It is important to clarify what differentiates corporate actions functions at the CSD level versus custodian level. Those functions are radically different. The CSD is an intermediary between the issuer via the centralisator and the custodians community. It helps to trigger the operation which then is driven by each custodian towards individual customers which will be informed to take actions and will send instructions to be processed by the custodian and consolidated or centralised at the centralisator level. At this stage the CSD is more passive and just settles transactions.

Some other functions may be important in the dividend payments' centralisation where CSD may take part in some financial services' functions under the control of the centralisator. But that also some guiding principles could be proposed & discussed within the industry to clearly identify from where distortions could arise & what kind of risks must be addressed.

7 DVP

The definition of DVP at the CSD level and at the custodian level is different. It seems difficult to define a strictly unique set of principles for both, specially in the context of central bank money environment at the CSD level and not at the custodian level. For the custodian the "payment system" is internal and linked with the cash accounting procedures for all other banking operations….

Again, the substance of our discussions on this subject is not relate by the minutes of the 1st of October meeting. Most of the doctrines on DVP refer to risk consolidated at a market infrastructure level mainly due chainings and netting procedures as explained in & 87. This situation is by nature different inside banks. Now if the regulator wants to minimise risk at the custodian level it should conduct a specific analysis to transpose the concept inside banking accounting architecture . This standard should be presented to address separately those 2 risks issues, DVP for CSD & for custodians. (§91 points out that even the concept of finality at the custodian level and the CSD level is different and should be more explored).

Obviously with §92 the standard goes to new territories which is the definition of DVP in the relation between Global custodian and sub-custodian. This is a real issue to be explored by the regulator in connection with custodians.

In this relation the standard makes some confusion between this previous issue and the links between CSD and other CSD (which usually are Franco) and should be developed following the ECSDA proposed architecture.

8 Finality

Again the nature of finality in the banking world and between bankers and infrastructures is of a different nature and should be addressed differently (the multiple batch processing refers usually to CSD's practices and architecture to address chaining's issues and also chainings between CSDs called "the bridge" when it refers to Euroclear and Clearstream. As this bridge is concerned the regulator should edict some principles to manage the bridge risk and rules to assure that the two ends of the bridge are strictly on the same level playing field).

KE3 – Usually in bank the final accounting process is not intra-day and consolidates all transactions issued from all business lines ...

KE6 – "unilateral revocation". This standard should recommend a positive principle to face this situation. If for a reason ,after settlement matching one leg is not able to deliver, what should be the recommended attitude ? Either the transaction is processed as it is and if a provision exists on the omnibus account the system will use securities that do not belong to the right investor or the regulator defines the principle of an obligation for the custodian to cover this predicable fail in certain conditions....

9 Risk controls

The explanatory memorandum (§ 104 to 112) shows the complexity of the problem and ambiguity of solutions by expressing principles and immediately exceptions, as "no credit whenever practicable or a marginal amount …"
It seems that the clarity of this key standard would benefit of a more detailed functional analysis on risk controls :

1-First it is important to segregate :
. risk related to securities lending and credit
. risk related to end of period net settlement due to the failure of a major participant.
2-Second, in reality major risk management processes and inter-relations is quite different between market infrastructures managing for participants a set of relatively reduced number of functions and other institutions managing many more interrelated functions, backed-up on a group risk control mechanism imposed by regulators and best practices.

- KE2 :Net-settlement risk at the CSD level:
The Lamfalussy principle implies that net systems cover the failure of a major participant. We know that the way to cover this risk, the evaluation of this risk….is costly and based on different mechanisms that may create competitive gaps. It seems important that at this level of standard in Europe, more precise guidelines and principles should be edicted by regulators to assure a certain level of harmonization and competitive level playing field.

Securities lending at custodian level. The best practice rules proposed to monitor credit analysis, quality of borrowers, limits & collateral management, reporting are in line with what should be done and may be reinforced through those standards in correlation with what is done through Basle 2 standards and processes.

It is clear that systemic risk do exist but this standard should recognise that by nature they are different at the banking level and at the market infrastructure level (the same problem in the

payment world with ACH or RTGS and participants). Those two sets of risk must be addressed in relation with the contractual arrangements between banks and customers, and M.I. and participants.

The minutes of. 1st October meeting refer to “spontaneous ... toward more collateralization”. I do not recall for this conclusion. If this is true for CSD it is more complex at the bank level where exists as it is more or less mentioned in EM, many alternative solutions to manage and cover risks.
This standard should then be more explicit in coherence with other prudential guidelines to suggest new best practices or principles.
Also to be clearer this standard should concentrate on financial risk controls and let STA11 concentrating on operational risk.

10 Cash settlement

This standard should be more direct in setting central bank money as an objective, as mentioned in key 2.

§ 116 multicurency system for CSD is a field on which more elaboration is needed. As our task concentrate on European needs it is necessary to define bridges between Euro and non Euro countries. The issue of non European currencies is more a pure banking issue and may create constraints of different nature.

13 - Governance

This is very a important standard for M.I.

The problem is about “dominant actors” until this type of actor is in the competition arena I do not see how it is possible to combine the status of customers and the one of participants (that normally are represented at the board level). The transparency level between an explicit M.I. and an institution create in fact a difference in nature. To avoid ambiguity and confusion which is a major source of weakness , it should be recommended that, when a certain limit of consolidation is reached, the institution concerned changes its nature from “dominant” to M.I.

Now if a dominant position is observed by regulators or the European commission ,if this position cannot be fragmented then it must be transformed on market infrastructures.
This way there is no ambiguity.

PS Please find in my mail an article publish in French in AGEFI 10th of October that summarise positions & issues.