

ANNEX I

Extract of the Response of French financial services industry professionals to the Commission's communication on clearing and settlement mechanisms in the European Union

III – Clarification of the various services supplied

The French industry bodies share the Commission's desire to clarify the various services supplied, whilst at the same time emphasising that the roles of infrastructure and of market participants are distinct and need to be viewed as such.

They would therefore propose:

- That functions are identified and then allocated between infrastructure and market participants;
- That the different criteria governing the infrastructure of domestic European markets and the relationship of market participants to this infrastructure be analysed.

In a second phase (see Section IV), they would propose:

- Verifying that the criteria covering infrastructure remain valid in a harmonised European environment and are compatible with the criteria of general interest identified by the Commission: protection of individual investors, minimising systemic risk, and ensuring competition.
- If so, to establish them as a condition of the emergence of pan-European infrastructure;
- The establishment of a shared set of rules for market participants, in order to allow equitable conditions of regulation and competition in custody services throughout the European Union.

A. Functions served by clearing and settlement infrastructure

1) CCP – Central Counterparty

Functions

The CCP fulfils two functions in the common interest which are complementary and closely linked:

- Novation: the CCP interposes itself between the two parties to the trade and manages counterparty risk.
- Netting: calculation of net positions and reduction of balance sheet exposure.

Criteria

Whilst by no means providing an exhaustive list, some essential criteria should be emphasised:

⇒ Centralisation of transaction flows, ensuring economic maximisation of this function.

- The role of a CCP is all the more effective as it allows centralisation of risk, with the purpose of reducing risk levels for the market as a whole. CCPs therefore enjoy a privileged position in their market segments.
 - This position has been sought by market participants and is now established in most European countries, in order to enhance the operation of financial markets and trading platforms.
 - In return, such a position warrants robust protection against risk and suitable regulation from central banks and regulators, coupled with specific rules covering conflicts of interest with members.
- Some CCPs hold banking licences to strengthen the prudential framework and the supervisory rules under which they work.

⇒ Open access

- Equality of access for investment services providers holding a European 'passport'.

⇒ Harmonised regulations and practices

- Regulation on margin calls in the central bank currency in addition to other collateral.
- Redemption and bond lending procedures.

⇒ Mutualisation for the benefit of the market

- Mutualisation of investment and costs.
- Procedures for sharing losses resulting from the failure of an investment services provider.
- Transparency of pricing.

2) CSD – Central Securities Depository

Functions

Central Securities Depositories (CSDs) provide two functions of general interest, which are complementary and closely linked.

⇒ Notary

- Securities coding
- Central depository for an issue of securities where these are dematerialised (registration of the whole issue) or central securities depository: this allows continual checking of the accounting balance between the total of the issue or the stock of outstanding securities and the sum of stocks held in securities current accounts.
- Exchange of nominative information between custodians and issuers, and in some countries, management of a central register of investors.

⇒ 'Primary' SSS (equivalent to central bank securities for the currency covered by CPSS/IOSCO standards).

Central custody of members' rights

- Management of securities accounts for custodians and foreign CSDs, within a double accounting framework for dematerialised and physical securities.
- Consolidation of securities transactions affecting the stock of securities.
- Management of cash positions or cash accounts (by delegation from the central bank or in co-operation with banking regulators).

Settlement

- Trading and settlement matching.
- Circulation of securities through transfers between securities accounts.
- Processing of wholesale and retail transactions on organised, OTC, primary, grey and secondary markets.
- Corporate actions' processing.
- Interconnection with central banks: automatic transfers of cash balances, intra-day liquidity injections into cash and security payment systems, collateralisation of capital flows and optimisation of collateral, implementation of monetary policy operations.

For all these functions, the CSD makes available to its participants the necessary means of communication and issues operational rules.

In general, CSDs do not hold banking licences. Where they do hold such licences, in practice these reflect the extension of their core activity to custody account management services identical to those provided by market participants.

Criteria

Whilst not an exhaustive list, some key criteria need to be highlighted:

⇒ Centralisation is justified by the provision of services in the general interest.

CSDs hold dominant positions which put them in a monopoly position (*de facto* if not by right) in their market segments:

- Centralisation of the issuance account, linked to the notary function, guaranteeing the existence of the security;
- Operational integration with other market infrastructure (markets, CCPs, and national central banks in their role as regulator), and centralisation of capital flows to ensure efficient processing of transactions.
- Direct links with ESBC banks for monetary policy operations.
- Direct links with other European CSDs for international transfer of securities.
- A key and pivotal role between issuers, Treasuries, ESBC, trading and clearing platforms as well as traders and investors' representatives: treasury managers, domestic and international market participants, Treasury Note Specialists, managers of custody accounts (retail accounts, institutional accounts, issuers, market participants, etc.).

This position has been sought by the markets as CSDs play an essential role in ensuring the stability of financial markets, protecting investors, ensuring efficient transactions and providing information to issuers. In return, this position warrants robust protection against risk and particularly close supervision by central banks and securities regulators.

⇒ Open access

- Equality of access for market participants holding a European ‘passport’ (no credit risk criterion).
- Open access on the basis of validation of technical and operational suitability of a new participant.
- Participants should be able to choose freely between direct access or access sub-contracted to another participant.

⇒ Enhanced supervision

- Respect for the legal context (issuers, investors).
- Supervision by the ESBC and by securities regulators.

⇒ Absence of risk

- The interconnection of CSDs with other European infrastructure for the movement of securities and cash requires absolute protection against risk.
- Protection against systemic risk by the exclusive use of cash accounts with the national central bank for the settlement of all transactions in domestic currencies (euro in the euro zone, GBP in the UK, Norwegian Krone in Norway, etc.).
- No exposure to banking risk through granting of credit lines to participants.
- No own-account securities positions.
- Suitable management of operational risk (emergency planning).

⇒ Mutualisation for the benefit of the market

- Mutualisation of investment and costs.
- Transparency of pricing.
- Strong involvement of users in governance.
- Development of activities within a framework which avoids conflicts of interest.

B. Market participants

Functions

Market participants handle a variety of transactions on their own account and/or on behalf of their clients (retail and/or institutional investors).

They are users of, and in some cases shareholders in, market infrastructures. In general their participation is linked to their status or possession of a ‘passport’.

- Markets and trading platforms: trader (pure or clearing).
- Clearing houses: clearing (individual or multiple).
- CSDs: custody account managers.
- National central banks: settlement agent (direct or on behalf of another participant).

The function of traders has been studied in detail as part of the work on the ISD. However, it would be useful to clarify the rules covering functions associated with clearing and the management of custody accounts.

In the case of clearing, the French experience of the status of clearing members of regulated markets shows that they have played a key role in establishing the security and competitiveness of the French market. In France, this function has been clearly identified, whether it is carried out:

- On an establishment's own account, as a single clearing member.
- On behalf of third parties, as a general clearing member, which imposes greater capital coverage and the signature of a delegation mandate by the market member.

Similarly, managers of custody accounts fulfil a wide range of functions:

- Banking (cash accounts, financing with commercial money, risk management)
- Secondary SSS: custody and settlement management in commercial money on behalf of clients.
- Fund administration.
- Transfer agent services.
- Issuer services – registrar.

Criteria

⇒ Evaluation of client risk

In some of these functions, the commercial relationship requires an analysis of the client's credit risk.

Just as banks are evaluated through external ratings, their management of client relationships includes risk analysis and the granting of credit lines.

⇒ Competition

Whilst this activity is seeing a phase of consolidation, local and regional European companies still play a significant role. It is therefore necessary that this competition should not be skewed by access to infrastructure.

Managers of custody accounts must be able to continue to provide these services in a highly competitive environment for prices and services, based on a comparative analysis of the quality of these services.

⇒ Banking supervision

- Subjugation to solvency ratios
The acceptance of banking risk is directly linked to the processing of custody, settlement and clearing operations on behalf of clients.
Clearing and the management of custody accounts are industrial functions which require high levels of investment in IT facilities and human resources.
- Harmonisation of custody services across Europe does not imply regulation of participants under the same conditions as that of infrastructure on the pretext that they also process settlement of securities transactions. (A comparison with the payment

environment shows that participants are not regulated in the same way as payment systems, even though they manage capital flows on behalf of their clients). However, the French industry bodies are in favour of the establishment of a genuine rule book, which would allow the “same business, same rules” principle to be established and would make a strong contribution to the professionalism of this area. Such a rule book has already been introduced in France (Chapter VI of the CMF’s Règlement Général), in which technical, accounting and prudential constraints are backed by a system of supervision and control.

⇒ Shareholder governance

European banking establishments active in this field are either specialised divisions of major institutions, or business entities dedicated to providing custody services. Their governance and management is therefore dependent on their shareholders, with success built on their competitive positioning and their long-term undertakings to clients.