Madrid, 31st of October 2003

IBERCLEAR's views on the ECB-CESR consultative report on "*Standards For Securities Clearing And Settlement Systems In The European Union*."

FOREWORD.

I. *First of all, IBERCLEAR welcomes the report as an impressive task in adapting the very general recommendations stemming from the CPSS-IOSCO report. The latter was a report focussing on worldwide systems. As a result, the CPSS-IOSCO report had to be very broad based so as to encompass those systems of developing countries.*

The European Union systems, due to the development already achieved, needed a more exigent and restrictive report. We also welcome the intention to upgraded the regulatory level of the new rules, instead of having recommendations as it is the case with the CPSS-IOSCO recommendations.

II. *Although the title of the Report alludes to clearing and settlement systems, the diversity of matters affected comprises, not only those of clearing and settlement, but other related ones such as securities registration, communication network, messages, custody, legislation, governance, clients, access and securities lending.*

This diversity implies that the entities potentially affected by the referred standards may be very different.

This is shown in the document attached to the Report that refers to the ambit of application of the standards, and that highlights the diversity of matters tackled and the heterogeneity of the entities to which the standards are addressed.

III. *On the other hand, it has to be considered that some of the matters referred in the standards are subject to an evaluation process within the European Union and to various initiatives, some of them of a clearly regulatory nature.*

Taking into account the level of exigence given to the standards in the Report, specially the implementation in the different jurisdictions and the monitoring by the regulators of the addressees' implementation, it seems clearly convenient that such level of coercitivity be carried out by the institutional channels foreseen for the European Union regulation and in close co-ordination with the rest of the initiatives that are being tackled on these matters.

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This is reinforced as some of the standards refer to the existence of a legal framework or rules (standards, 1, 5, and 12) and, in this context, the addressees would be the Member States rather than the central depositories or the other entities referred to in the standards.

Moreover, we notice that, taking into account the remarkable role that the CESR plays in the regulatory activity that is currently taking place in the European Union regarding financial matters, it would be advisable to expressly introduce a reference on its possible role in relation to the standards. This role should be performed through the corresponding recommendations to be drawn up as part of the legislative procedure that formally be entrusted to CESR.

Closely bound to the former comment, we would like to remark the existence of significant legislative initiatives in course within the European Union such as the Investment Service Directive Project, that would affect matters pointed out in the Report and will introduce new concepts and categories.

Accordingly, it is convenient to coordinate the wording of the standards with the treatment that in the mentioned rule-making process would be given to certain matters.

***IV.** We also agree with the idea of following a functional approach for risk mitigation purposes instead of the traditional institutional approach followed in the past. In relation to this, we agree with the answers given by the ECSDA to the specific questions concerning the scope of the standards. However, we disagree with this view when addressing competitive issues.*

We would like to supplement the comments already made by the ECSDA, with whom, generally speaking, Iberclear agrees. From our point of view, the ECB-CESR report deals with risk issues as well as competition issues, although their own report states that only risks are tackled. We do not share this opinion. IBERCLEAR believes that the ECB-CESR report also tackles competition issues for which the final model of the "CSD business" is the main issue at stake. As a matter of fact, the ECB-CESR report mentions as an objective: "Point 4 - To promote the competitiveness of European markets by fostering efficient structures and market-led responses to developments".

I. SCOPE OF APPLICATION.

Given that the Report is based on a previous one published by the CPSS-IOSCO, that defined a series of recommendations, it keeps the structure of defining principles, introducing as a new element the addressees of each standard.

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It seems that the application of the standards to different entities with diverse functions or characterization responds to the convenience of drawing up general principles whose application will depend on the subjective position of the affected entity.

Sometimes the standards affect the different entities in a very dissimilar way. This is the case of standards 14 (access) and 15 (efficiency) that will have a very different scope when they are addressed to central depositories and to custodians.

In addition, it has to be stressed that in other cases, the application of the same principle to different entities could be due to the similarity of functions performed by such entities.

In that case, the type of function should be considered in a more detailed manner. This does not imply major inconveniences as the standards generally refer to many different areas such as legal regime, registry, custody, governance, central counterparty, securities lending, risk management, transparency. Specifically, we notice that some standards might not be defined as such but as a description of an activity –standard 4 (central counterparty), or 5 (central depository).

Accordingly, it could be useful to make a classification by matters or scope of activities and formulate standards concerning them.

II. ASPECTS LINKED TO THE DIFFERENT STRUCTURES IN SSS.

In our view, competitiveness between the efficient structures requires a level playing field among them that, at present, does not exist. In order to achieve the desirable level playing field, we only see two possibilities: (i) either to harmonise all players, which will mean they all acquire "banking" status and compete against each other along the entire value chain of post-trading activities; or (ii) to define the different functions along the value chain and establish a specific level playing field for each specific function. We will return to this point later on.

Firstly, the European Union has started down a completely new road with regards to the central registering, clearing and settlement business. Traditionally, this sensitive sector has been regulated by following a restricted institutional approach, an approach which has been implemented, not only in the USA but all over the world.

On the other hand, at this point, we have to recognise that the situation in Europe is not at all comparable to the American one. In Europe, there are two ICSDs that do not exist in any other part of the world. ICSDs have a two-fold role: a traditional CSD role for international securities (and since 1999, as a result of purchasing various national CSDs extended their roles and influence domestically). But at the same time, ICSDs have an intermediary role for those markets all around the world for which they do not control the traditional CSDs. This intermediary role is very close to that of the agent bank role and, indeed, ICSDs compete with agent banks for the cross-border transactions.

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Additionally, there are many different CSDs in the European Union owing to history and differences still in place due to legal, tax and market practices issues.

Secondly, we can count the different players in the European settlement field:

1. CSDs: most of them not allowed to bear credit risks even though some of them were banks (but very limited in their banking services).

2. ICSDs: two-fold role as we explained earlier.

3. Agent banks.

The ECB-CESR report follows a functional approach for risk issues as well as for competition. We can understand the functional approach from the perspective of risk and consequently we fully support the ECB-CESR approach in extending most of the standards, not only to securities settlement systems, but also to systemically important institutions (i.e. the scope of the standards).

We acknowledge the US regulators initiative. The American regulators define "core clearing and settlement organisations" as firms that play a "significant role in financial markets". However, American regulators only apply these terms to risk issues, following a strict institutional approach as far as infrastructural issues are concerned (i.e. the DTCC as the unique clearing and settlement institution, while agent and custodian banks compete for the non-core activities of this business).

Thirdly, the functional approach which is applied to infrastructural issues (e.g. governance, competition, supervision…) could have two very different interpretations as we have explained earlier:

1. The interpretation that all players included in the settlement field should compete on a level playing field. This would imply that the three groups of different players would therefore need to be regulated, controlled and supervised in the same way. Standard number 9 appears to follow this interpretation.

2. The alternative version is that the functional approach must separate core services from non-core services (i.e. value added services) and regulate, control and supervise them both differently. Standard number 6 seems to follow this alternative interpretation.

Fourthly, in our opinion, the ECB-CESR report tries to reach a state of equilibrium between the two former interpretations. This could result in further confusion concerning the final model of the EU's ultimate settlement and central registering businesses which would need to be implemented in Europe.

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From our standpoint, the first interpretation would need us to regulate CSDs, ICSDs and agent banks exactly in the same way, with the same limits and supervisors, and would result in the following consequences:

a) Forcing all players (CSDs, ICSDs and agent banks) to be banks and to compete amongst each other for all services along the settlement activities value chain.

b) Opening the current monopolistic business to free competition between CSDs, ICSDs and agent banks not only for value added activities but also for core activities.

c) If all players were banks (see point "a" above), this would imply that all players would be under the control of the banking supervisor in those countries (such Spain) in which supervisors are currently split.

d) Granting EU membership to all players, including CSDs, which are currently not entitled to it.

III. DEFINITION AND DIFFERENTATION OF CORE SETTLEMENT ACTIVITIES.

The functional approach, understood as regulating core and value added functions separately, is consistent with the regulation followed in other financial markets such as banking activities and insurance companies. As we understand the situation, banking activities are regulated following a functional approach (the function of taking deposits) and why the institutions allowed to enter into this sector must be credit institutions specifically regulated as such. This permits not only commercial banks, but also saving banks, cooperative banks and other cooperative credit institutions to compete openly and fully between each other.

This alternative interpretation applied to core settlement activities would not lead us necessarily to a monopoly provided that it is not limited to offer these services exclusively to the current national CSDs in terms of their national securities. There could be other CSDs competing for the same securities with other CSDs or even other companies entering into this sector to compete against the traditional CSDs (being ICSDs buying CSDs or even agent banks creating CSDs companies or buying existing CSDs). The only prerequisite for allowing competition is the removal of barriers to entry which would lead to systems being interoperable.

The value added function must therefore be one of open competition amongst players with "banking" status (be it ICSDs or agent banks). The level playing field in this instance must be fully respected by, for example, establishing an independent, reliable and safe core infrastructure.

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To sum up, our interpretation of the functional approach is that core services must be regulated separately from value added services. We support the view that core services must be offered by institutions on the basis of equality. We therefore advocate a "CSD" status that could theoretically be obtained by any player (i.e. current CSDs, ICSDs or agent banks). However, once an institution is given the "CSD" status, strict regulation and control must be applied to all of them in order to maintain the necessary state of equilibrium – that of the level playing field.

From our interpretation, Standard number 6 could be considered logical. "As CSDs are the only place where ultimate settlement occurs for immobilised/dematerialised securities, they should avoid taking risks to the greatest practicable extent". This should be applicable for any institution having a "CSD" status.

Also, we believe that core activities must be able to cover widest framework possible to the point where the boundary, which distinguishes banking activities, meets that of the value added activities. We can cite some core activities mentioned in the ECB-CESR report such as the central recording of the amount of each security issued by the issuer, facilitating the exercise of securities holders' rights and corporate actions by connecting issuers and investors (through intermediaries), ultimate settlement agent… We would also like to add a very important activity such as settlement in central bank money for domestic transactions as well as highlight the registering or notary function of the CSDs.

IV. CUSTODIANS.

As regards concrete aspects linked to the treatment of the custodians, the extension of the standards operating systemically important systems:

a) Definition and differentiation of such custodians.

The Report highlights criteria to identify custodians that operate systemically important systems so that certain standards would apply to them (paragraph 4 and subsequent paragraphs of the Report on the ambit of standards).

This initiative must be cautiously approached, as it introduces an element of differentiation among the depository entities. Bearing in mind the objectives pursued through the formulation of standards (paragraph 4), it seems that these should be applicable to all entities in regard to their function rather than in terms of volume which could entail a systemic risk and compromise the right functioning of such systems.

To support this suggestion, it must be stressed the importance of defining and grading what we understand as "systemically important systems", as it is a concept open to different interpretations.

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b) Standards applicable to custodians.

Nevertheless, the type of standards to be addressed by entities and the detailed aspects of their definition must be examined on a case-by-case basis.

As pointed out before, an eventual differentiation by areas of activity would contribute to such examination.

It is particularly remarkable that standard 9, risk control, mentions mitigation measures such as full collateralisation that must be requested to custodians that operate systemically important systems.

It seems that, when referring to the activities of such entities as participants in a settlement system managed by a CSD, the risks mitigation must be part of a different set of standards, such as those established on Basel I and II or others regarding the management of own resources.

V. ASPECTS REGARDING CCPs.

Also, we fully endorse the view that "the risks involved in offering CCP services are particularly difficult to manage and therefore require exceptionally high levels of risk management that may even necessitate separating the CCP services into a distinct legal entity". Here, the report follows our understanding of a functional approach. Our only thought is that maybe this approach could also be deemed necessary as far as value added activities are concerned.

Eventually, the three different functions (i.e. core settlement activities, value added services and CCP services) could coexist inside a holding company. The DTCC could be the model for separating CCP and CSD functions, although there is a clear risk of contagion among firms within the same group (i.e. "the so-called piercing of the veil" principle).

This interpretation could also lead to the tackling of post-trading risks stemming from three different functions: 1.) from central counterparty clearing function (i.e. addressed to institution with the CCP status), 2.) from value added services in the settlement field (i.e. addressed to ICSDs and agent banks) and 3.) from ultimate settlement and central registering services (i.e. addressed to institutions with CSD status).

VI. SETTLEMENT MATCHING AND RISKS IN CROSS-SYSTEM LINKS.

It has been mentioned before the wide and heterogeneous contents of the standards. Standard 2 is a good example, as it relates to trade confirmation and settlement matching.

In paragraph 41, there is a point stating that if there is an increase in the number of organisations providing matching utilities, it is important that their systems are interoperable in order to avoid

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inefficiency and the fragmentation of the market. Similarly, on paragraph 42 reference is made to the fostering of initiatives aimed at introducing and expanding the use of matching utilities.

Whilst we share the concern regarding the increase of market efficiency, it does not seem that the Report is the adequate channel to tackle this issue nor to solve the relevant issues linked to such efficiency. More specifically, as the Report is focused on clearing and settlement of trades and other related aspects, it should not refer to market efficiency from the point of view of trading.

On the other hand, but still with regards to clearing and settlement, the comments about market fragmentation seem not enough as it is not clear how the interoperability of the systems can avoid the fragmentation of the market. In case that with such comment were suggesting alternatives –such as the possibility of choosing the settlement system– we must refer to what was mentioned regarding to the co-ordination of other regulatory initiatives and, more specifically, the provisions that the new ISD project devotes to this matter.

Something similar happens with standard 19, risks in cross-system links, particularly in paragraph 204, which refers to the interaction of three jurisdictions. Any initiative that contributes to minimise risks associated with the securities settlement is desirable. Nevertheless, there must not be situations prejudiced or conclusions reached whose substantive viability is pending, in many cases, on a formulation and exact definition within the European regulation.

VII. THE SAFEGUARD OF CLIENTS' SECURITIES.

It is important to highlight the contents of standards 6 and 12 that pursue, through several measures, the protection of the investors' securities and their safeguard (paragraphs 77, 85, 136 and subsequent). Any initiative which contributes to clarify and protect the securities of the client should be welcome. The Spanish system follows the same philosophy and has proven to be a reliable system that offers an adequate response to the concerns raised in the Report.

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