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RESPONSE OF SIS GROUP
TO
THE CONSULTATIVE REPORT OF ECB/CESR ON
STANDARDS FOR SECURITIES CLEARING AND
SETTLEMENT SYSTEMS IN THE EUROPEAN UNION
OCTOBER 2003

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The SIS Group

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1 Introduction

We welcome the ECB/CESR initiative to set up standards for securities clearing and settlement systems in the European Union. We fully agree, in the opening section of the Consultation Announcement (CA), with the objectives of the standards and with the idea that the standards follow a functional and not an institutional approach.

We, however, regret that later in the CA the functional approach is not always followed. The most obvious example is Standard 6 that addresses institutions (CSDs).

We strongly believe that the standards must be measured against basic primary objectives that we have to support. Defining objectives on a secondary level is, in our opinion, dangerous and would lead to the wrong results. The basic primary objectives we can identify are investor protection (protecting the assets of the end investor, Objective 6 on page 3 of the CA) and market protection (Objectives 2 and 3 of the CA). Keeping the markets where issuers and investors meet, the primary markets, and where buying and selling investors meet, the secondary markets, up and running also in times of distress or potential disorder. Both objectives can only be achieved by applying a strictly functional approach.

We fear that some of the objectives stated on page 3 of the CA might be completely missed due to the institutional elements in the standards. We think in particular of Objectives 2 (safety, soundness and efficiency of securities clearing and settlement), 6 (protection of investors) and 7 (integration of the European markets). We also fear that ignoring competition issues may have an adverse impact on the safety of the markets. We would like to explain this in some more detail in the following sections.

2 Protection of Investors

The holdings of retail investors are often represented by a chain of book entries in the computer systems of a series of service providers (the bank of the end investor, the custodian of the bank, the CSD of the custodian). The failure of any of the systems or the insolvency of any of the service providers will put the holdings of the end investor at risk. It is therefore important that all systems and all service providers in the chain be subject to the same safety measures. This can only be achieved if the standards are addressed to functions, because all service providers carry out the same functions (basically settlement and safe-keeping).

It is much more difficult to achieve a high and consistent level of safety along the entire chain from end investor to CSD if the standards are addressed to different types of service providers, and the objectives will be totally missed if some service providers are not addressed at all or not with the same strictness as others.

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To impose different standards on different types of service providers also has a detrimental side effect that is not taken sufficiently into consideration in the CA: it distorts competition (cf. below).

3 Safety, soundness and efficiency of securities clearing and settlement

The markets consist of more than just CSDs. Even if all the systems of the CSDs function without fault and interruptions, the functioning of the entire markets is not ensured. Keeping markets up and running in times of distress or potential disorder requires that all market players of a certain size remain fully operational. Only with the participation of all significant service providers will markets remain open and assets accessible. To regulate markets as a whole calls for a functional approach; the institutional approach will lead to inconsistencies and to loopholes in the safety concepts.

4 Competition issues

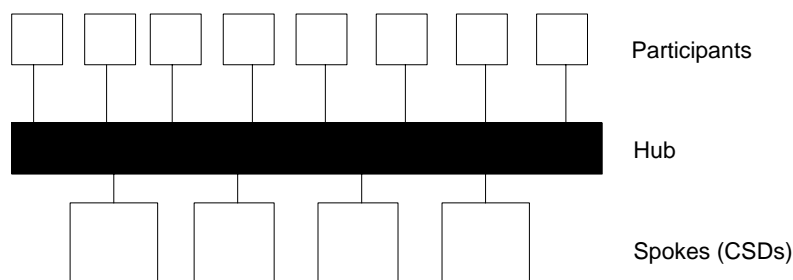
We do understand to a certain extent that "issues related to competition do not fall within the mandate of the Group". However, to ignore competition issues can have implications that go completely against the objectives that should be achieved with the standards. Objectives that must be achieved with measures of competition law must be achieved by applying such measures and not by applying secondary measures in another field. If this is not done the objectives will not be achieved without distortions.

Business will, for example, move from institutions with stricter regulation to institutions with less strict regulation. The commercial impact of such a move may not worry those concerned only about the safety of settlement. But there is also an impact on safety: business not just moves from one type of institution to another, it also moves from the safe to the unsafe! We would like to illustrate this with an example that has great relevance to objective 7 (integration of the European markets).

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5 Integration of the European markets

In a few months from now the European markets will comprise 25 countries with 25 CSDs. It is still unclear how this fragmented market should integrate. But there is wide agreement that market forces should play an important role in determining the most efficient solution. One possible solution is the so called hub and spokes model. In this model the system of a single service provider (the hub) links to all CSDs (the spokes) and all intermediaries link to the system of the hub. The service provider that runs the hub is likely to be a global custodian or group of global custodians, since these institutions already avail of the necessary infrastructure.



The hub and spokes model

It is very obvious that in this model the risk is concentrated in the hub. The CSDs act merely as vaults or as intermediaries between the hub and the registrars. The model raises strong doubts about the correctness of arguments like "CSDs are the only place where ultimate settlement occurs" that are used to justify the institutional approach of Standard 6. The model also makes clear that the proper functioning of the systems of the CSDs is not sufficient at all for the proper functioning of the markets.

However, the most important lesson from the hub and spokes model is this. To impose stricter rules on CSDs than on operators of a hub may have the highly undesired effect that systemically important functionality moves from strictly regulated institutions (CSDs) to less strictly regulated ones (custodians). This not only misses the objective of safe settlement, it also misses the objective of promoting integration, because it

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hampers competition between different models of integration (to the disadvantage of models where CSDs play a significant role).

6 Conclusions, recommendations

The objectives of the standards can only be achieved if the functional approach is used throughout. All elements of institutional regulation go against the objectives of the standards.

We therefore recommend eliminating all elements of institutional regulation in the standards. We fully support the response of ECSDA, which goes in exactly this direction.

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We would like to thank ECB/CESR for the excellent and highly professional work done so far and also for the open-mindedness with which the current consultation round is conducted. We hope that our comments will find their way into the next version of the Standards.

Yours sincerely

Fritz Klein

Member of the Executive Board

Martin Trüb

Strategic Projects