Date: November 2003
Ref.: CESR/03-393

PUBLIC STATEMENT

THE FOURTH MEETING OF THE MARKET PARTICIPANTS CONSULTATIVE PANEL

The Market Participants Consultative Panel held its fourth meeting on 11th November 2003 in Paris.

The discussion during the meeting was facilitated by the Chairman of CESR. In his remarks, he thanked the panel for their contribution to the overall process of consultation conducted by CESR and he stressed the recent encouraging result of approval by the European Securities Committee, without any vote against, of the first implementing measures under the Market Abuse Directive.

Eddy Wymeersch, Co-Chairman of the Joint CESR-ESBC Expert Group on Clearing and Settlement, Callum McCarthy, Chairman of the CESR ISD Expert Group on Intermediaries and Jacob Kaptein, Chairman of the CESR ISD Expert Group on Markets attended the meeting.

The discussion was mainly focussed on two different subjects: clearing and settlement; best-execution and execution-only business.

1. Clearing and settlement

Following a presentation by Dominique Hoenn, complemented by remarks from Ignace Combes, the members of the Panel discussed on the regulatory approach to clearing and settlement in Europe. The presentations are enclosed. This discussion serves the work that CESR, jointly with the ESCB, is likely to finish in 2004 by adopting standards for the European securities clearing and settlement systems. Eddy Wymeersch explained the nature of the joint exercise and noted that whilst the ESBC mainly concentrates on financial stability issues, CESR mainly takes care of investor protection and functioning of financial markets. He also noted that the main regulatory concerns addressed by the Group and emerged during the consultation process, refer to risks and particularly the settlement and credit risks. Members of the Panel noted that the latter, in principle, is addressed by banking prudential regulation and that double coverage of same risk should be regarded as inappropriate. Regulators should further demonstrate that for systemically important institutions there could be need for further intervention to mitigate that risk. Members of the Panel expressed support to the exercise and to the functional approach which has been adopted by the Group. The discussion concentrated on Standard no. 9 on collateralisation, and particularly on the scope of application of this standard to big institutions. It was noted that the definition of systemically important banks should be refined to reach a more balanced approach. It was also noted that further analysis as regards impacts of the Standards should be conducted by the Group.

2. Best-execution and execution-only

Following presentations by Sonja Lohse and Donald Brydon, the members of the Panel discussed two of the most debated issues under the revision of the investment services directive (ISD2). The presentations are enclosed. These are areas in which CESR will soon have to respond to mandates from the EU Commission.

As regards best execution, members of the Panel suggested that common principles would be established to ensure uniform application across Europe; however, a certain degree of flexibility should be left to address domestic specificities and different market structures and models. Level 3 work might complement in the future regulation in this area. It was also noted that proper distinction should be made between professional and retail clients as regards the elements and factors to be taken into consideration to achieve best execution: for retail clients full information on execution policy, as well as their express consent on it and on off-exchange execution, were advocated. Some members recalled the importance of making reference to the concept of "relevant market". Members of the Panel invited CESR to address the appropriate level of detail in providing technical advice for the implementing measures under the revised ISD; need for ensuring legal certainty, from one side, and need to avoid unnecessary cost, on the other, were suggested to CESR as driving criteria for conducting its future work.

As regards execution-only business, it was recalled the significance of this low-cost service for a number of clients. Members of the Panel considered that due attention should be paid to the awareness and consent of clients to the limited extent of this service and the differentiation in terms of risk of products offered in the course of such service. In this regard, no suitability test should be conducted for each transaction, but some sort of assessment of adequacy at the beginning of the relationship seems to be necessary.

3. Other issues.

3.1. Financial markets conditions

CESR has been asked to provide its contribution to the analysis conducted by the Economic and Financial Committee on the conditions of the European financial markets. Members of the Panel contributed to such debate in the light of any future intervention from CESR, particularly in the area of credit risk transfer. Members of the Panel considered that financial markets reacted smoothly to recent difficulties; this might imply that, overall, markets proved to behave properly. Nonetheless continuous monitoring should be ensured by authorities to avoid too much reliance on this fact. More transparency in certain market activities, particularly Over-the-Counter transactions, should be asked by regulators; market participants will accept these requirements for their own interest, benefiting from more information available in the market. Aspects affecting the role of insurance companies and particularly re-insurance companies should be addressed by insurance regulators. CESR members should adequately monitor the possibility for retail investors to invest in complex products, including hedge funds. The role of investor education and improvements in standards for corporate governance were stressed as tools, among others, to restore confidence of investors in financial markets. Evolution of interest rates and prices of real estates should be monitored for their potential impacts on mortgages.

A more in-depth discussion will be conducted at the next meeting of the Panel to address issues related to global approach to regulation, and in particular regulatory arbitrage between European and other major financial markets.

3.2. "Level 3" of the Lamfalussy procedure

Members of the panel acknowledged the preliminary results of the initial activity of the Review Panel in the field of implementation of CESR Standards for Investor Protection and ATS. The Panel also discussed the role of CESR in the overall "Level 3" of the Lamfalussy procedure and, in particular, a possible role to strengthen the cooperation and coordination between CESR members including a "mediation mechanism" for solving problems in the eventual conflicts in day-to-day decisions. Members of the Panel expressed support for the Lamfalussy procedure and welcomed the recent results of CESR, with particular regard to transparency of its process and the establishment of an effective network of European securities regulators to ensure a real level playing field; however, some concerns were expressed on the excessive level of detail of some regulatory interventions.

3.3. Report on recent events and on future CESR activities.

In the second part of the meeting, the discussion concentrated on the organisation of CESR work and its priorities for 2004. The report on recent CESR activity as well as the work programme for 2004 did not raise any objections from the members of the Panel.

3.4. Partial renewal of the composition of the Panel

Members of the Panel discussed different criteria for the renewal of the Panel. Clear preference was indicated in favour of keeping the existing members in charge for the next year and for enlarging its composition to 15 members. The proposal envisages that starting from 2005 three blocks of members will be selected on a random basis for partial renewal in the following years. Final decision will be taken by CESR at one of its next meetings.

Next meeting

It was agreed to hold the next meetings of the Panel in Paris, on 11th March 2004 and 10th June 2004.

A series of issues have been raised for discussion during the next meeting and in particular, priorities for the post-FSAP phase, corporate governance, relationship between CESR and the US SEC and the overall transatlantic relationship, the consultation practices, financial analysts.

* * *

The members of the CESR Market Participant Consultative Panel are:

- Pr Luis Miguel Beleza, Consultant of the Executive Board, Banco Comercial Português;
- Dott Salvatore Bragantini, CEO, Centrobanca S.p.A.;
- Dr Rolf E Breuer, Chairman of the Supervisory Board, Deutsche Bank AG;
- Mr Donald Brydon, Chair of the Financial Services Practitioner Panel and Chairman of AXA Investment Managers;
- Mr Ignace Combes, Vice-President, Management Committee of the Board of Directors, Euroclear Bank;
- Mr P.P.F. de Vries, Director, Association of Shareholders, Vice-President, Eurosharehoders;
- Mr Lars-Erik Forsgardh, Chairman of World Federation of Investors and CEO, Swedish Shareholders Association;
- Mr Dominique Hoenn, Deputy General Manager of BNP Paribas, Vice-Chair of the Supervisory Board of Euronext;
- Ms Sonja Lohse, Group Compliance Officer, Nordea AB;
- Mr Mariano Rabadan, Chairman of the Spanish Association of Investment and Pension Funds (INVERCO);
- Pr Dr Emmanuel D. Xanthakis, Non-Executive President, Marfin Bank and Marfin Portolio Investment Company.

Standards for securities clearing and settlement in the European Union

CESR Meeting
11th November 2003

Introduction

- We welcome the invitation by CESR-ESCB Group to comment on the draft standards for clearing & settlement.
- We share CESR-ESCB objectives of avoiding systemic risk, improving the safety and soundness of securities clearing and settlement and harmonising EU regulation.
- We agree that some banks can be considered as systemically important (re US Interagency Paper and Switchover to the Euro), leading to the monitoring of their business continuity planning and operational risk management practices. In particular, we would advise that they apply the Basel II advanced methodology.
- We question the proposed scope of application which goes far beyond these objectives and extends most standards to custodian banks, contradicting with existing banking regulation and generating unnecessary costs.

Introduction

- Today's European markets are based on a worldwide proven model, which is being questioned as the debate centres around 2 very different visions for the European settlement infrastructure:
  - pure infrastructure model, ring-fenced against credit risk (referred to as the CSD model)
  - mixed-function model, where infrastructure and intermediary functions are blurred (referred to as the ICSD model)
- We are concerned that the proposed standards validate the mixed-function model; we fear this model:
  - increases risks rather than diminishes them, hence conflicts with the CESR-ESCB objectives
  - distorts the competitive environment and conflicts with the public policy criteria identified by the European Commission - COM (2002) 257
- We urge CESR-ESCB to further analyse the functions and risks incurred by the various players, in order to achieve a balanced proposal.

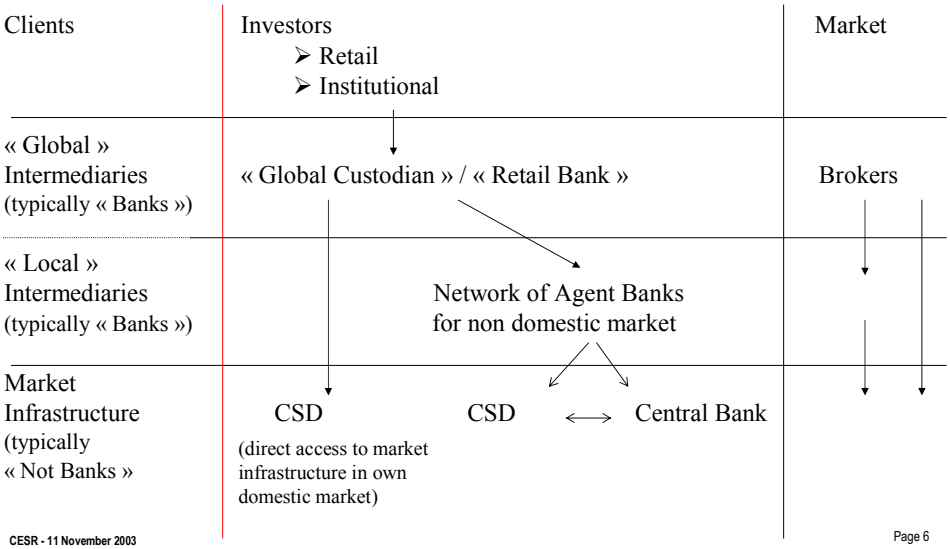
What is clearing & settlement ?

- **Clearing and settlement of securities is a core function on which fundamental confidence in the financial market depends**
  - Clearing is the process following a trade in which the arrangements for transfer of title and funds are agreed
  - Settlement is the process by which the ownership interest in securities is transferred from one investor to another, generally in exchange for a corresponding transfer of funds
- The goal is to provide the buyer with **irrevocable delivery of a security** from the seller at or very near the precise moment when the seller receives final and **irrevocable payment for it** from the buyer**.**
- **It affects all market participants**
  - Issuers: safety of issue
  - Asset managers and investors: protection of investments
  - Intermediaries: finality of trades
  - Central Banks: systemic risk and protection of cash payment systems

Clearing & settlement infrastructures

- **"The global financial system is only as good as the infrastructure that supports it."** G30 - Jan 2003 - Washington
  - **CCPs** (Central Counterparties): clearing and netting functions
  - **CSDs** (Central Securities Depositaries): functions of notary public and operator of settlement system
- **These infrastructures serve the market as essential facilities** (a concept which is well defined in the EU)
  - **They offer all users services that they cannot provide themselves** and for which the value increases with the increase in the number of users;
  - **They are essential to all participants operating in the competitive financial services sector,** who could not conduct their business without access to these infrastructures at a competitive and economic price;
  - **These infrastructures were put in place to limit the risks incurred in the financial markets** by mitigating the risk of default or error in clearing and settlement, and to promote economies of scale.

Traditional market structure (worldwide model)



CSDs = the Central Bank for securities

CSDs worldwide are based on a common model

- **Notary role**: CSDs guaranty that the securities which circulate do exist
- **Settlement operator**: CSDs facilitate the circulation of securities without the handling of physical documents (book-entry settlement); this is achieved either through immobilisation or true dematerialization of the underlying securities

DG Competition confirms this definition (statement of 31/03/2003)

- A CSD is an entity which holds and administers securities and enables securities transactions -such as the transfer between two parties - to be processed.
- **The clearing and settlement services provided by the issuer Central Securities Depository for the securities that it safekeeps must be distinguished from the processing of securitie trades by financial intermediaries, such as banks**. Intermediaries rely on being able to settle their trades with the Depository where the securities have been issued.

CSDs share common risk characteristics

- **CSDs concentrate flows to deliver efficiency**
  - They service the entire national market with the aim to maintain the highest possible safety and guarantee the lowest cost
  - The search for efficiency involves a single place of deposit and concentration of flows, making them natural monopolies DG Competition: ”Typically, there is one CSD per Member State”
  - As a result, CSDs are controlled - at the national level in Europe, by federal law in the US - to prevent conflicts of interest with their users and to prevent systemic risk
- **As a general rule, CSDs have been prevented from assuming credit risk**
  - dedicated legal entity, typically not a bank
  - precluded from providing any form of credit
  - placed under the close supervision of their respective securities market regulator and their National Central Bank: settlement in Central Bank Money, monitoring of operational risk

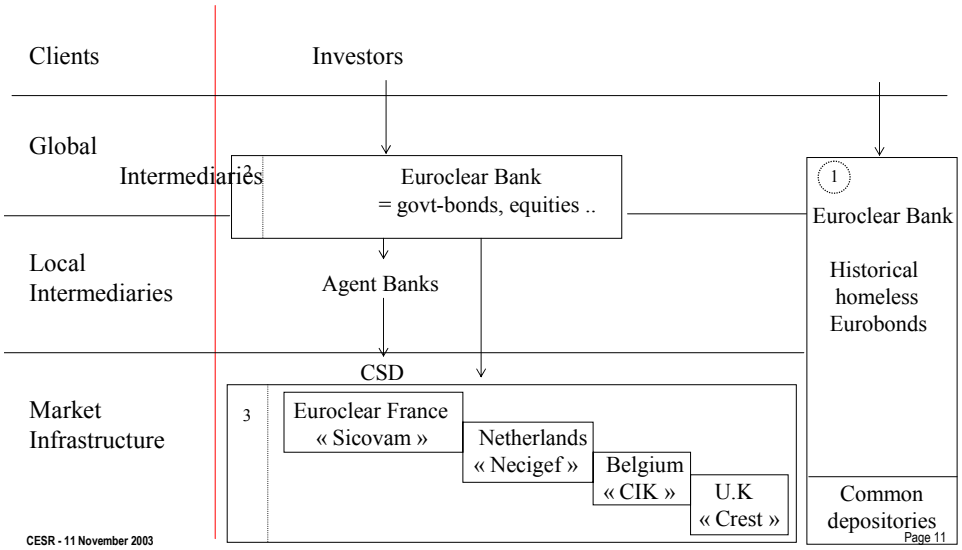
What do custodian banks bring to the securities market ?

- **Custodian banks facilitate the access to securities markets**
  - Custodian banks are members of the post-trade infrastructures
  - Their clients are investors and financial intermediaries, both domestic and international
- **Custodians provide services which support market developments**
  - Processing capacity and compliance with systems and regulations
  - Holding of client cash and securities accounts: clearing, settlement, custody and banking services
  - Coverage of all instruments: equities, bonds, derivatives
  - Manage financial risks: act as principal in transactions, grant credit lines
  - Source of liquidity for broker dealers (cash and securities)
- **The benefits of competition**
  - Distribution of credit and liquidity risk across a wide range of players
  - Pressure on price and services: serving clients, not members

Custodian banks manage traditional banking risks

- **Operational risk (primary source of risk)**
  - operational mistakes
  - impact on securities and payment systems
  - business continuity
- **Credit & liquidity risk**
  - cash payments connected to the clearing & settlement activity
  - intra-day risk
  - overnight funding risk...
- **Market risk**
  - foreign exchange risk
  - interest rate risk
  - counterparty risk

The ICSD exception: positioning Euroclear Group



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What functional approach for the European post-trade environment ?

- As stated at the Open Hearing, the European regulators are presented with 2 different visions of the settlement infrastructure

ICSD Model **CSD = ICSD = Bank** **Same regulation**	**Pure CSD model** **No banking risk** **Separate regulation**

- **It appears the model favoured by CESR-ESCB is the ICSD model, which opens the door:**
  - for CSDs to acquire banking status
  - for ICSDs to fully merge with CSDs
  - for banks to become, acquire or merge with CSDs

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The implications of the draft standards

- **The CSDs would be entitled to take credit risks**
  - Increases systemic risk and diverges from the US model
  - Distorts the competitive environment for the banks and leads to the concentration of risks: banks cannot possibly create new CSDs or compete with essential facilities
- **The ICSD model becomes the norm in the European Union**
  - No change in their current regulation, based on an exception
  - Systemic risk: risk of contagion to other CSDs and payment systems, risk of international delivery of revocable securities
  - Credit risk and liquidity risks: risk of excessive concentration, risk of spillover between the bank and the infrastructure, moral hazard effect (too big to fail)
- **Banks would be regulated as if they were infrastructures**
  - Banks are already regulated: the standards (systematic requirement for collateralisation of credit, full disclosure of prices and contracts) are in contradiction with this regulation
  - The impacts for the market must be weighed: cost increase, reduction of market liquidity, foreclosure of competition

What can we learn from the US experience ?

- **Regulation enforced by law at Federal level**
  - Securities Act adopted in 1975, despite strong opposition by infrastructures
  - Drawing the line between post-trade infrastructures and banking intermediaries
  - Objective: allow infrastructure consolidation, allow competition amongst banks, protect investors interests
- **Balanced regulatory approach**
  - DTC (CSD) undertakes no credit risk, settles cash on the books of the Federal Reserve, does not act as principal
  - Banking regulation for banks, with enhanced controls on Business Continuity Planning, post 09/11/2001
- **Centralised oversight: SEC, Federal Reserve, New-York Banking Department**
- **Challenge for CESR-ESCB and EU Commission**
  - The right choice for a European model is critical (safety, soundness, efficiency and competition)
  - Adopt a balanced regulatory approach which recognises the differences in the roles and responsibilities of the different players

Adopting a balanced approach to the settlement function

We suggest to take a closer look at the levels of risk incurred

Risks/ Institution	CSD	Custodian bank	ICSD
Operational risk	XXX	XXX	XXX
Business continuity risk	XXX	XX	XXX
Credit and liquidity risk		XXX	XXX
Intraday risk / domino effect	XXX	XX	XXX
Market risk		XX	XX

Regulating CSDs in a balanced fashion

Principles

- recognition of the CSD's role as essential facility
- monitoring of operational risk
- avoidance of credit risk
- avoidance of domino-effect in relationships with other CSDs and payment systems
- prevention of anti-competitive behaviour, rather than after the fact control

Current regulation: EU finality directive and ECB standards for monetary policy operations

Proposal

- **CSDs should be the priority for regulation and oversight by the CESR-ESCB Group, with a view to reduce risks and enhance European harmonisation**

- This process must fit within the EU Commission public policy and be granted a clear mandate

Regulating CSDs in a balanced fashion

Summary comments on CESR-ESCB draft standards

- **Standard 5: Securities Lending**
  - Central securities function to cover failed transactions only
  - No securities lending as principal
  - No direct access to institutional investors
- **Standard 6: CSDs**
  - Control of CSDs in a uniform manner across the Union
  - Control of CSD core activities via a dedicated entity (platform, operations, financial statements, governance)
  - Value added functions performed under a separate banking licence
- **Standard 9: Risk controls in systemically important systems**
  - No allowance for credit risk
  - No need for credit mitigation techniques, no incentive to develop moral hazard

Regulating CSDs in a balanced fashion

- **Standard 10: Cash settlement assets**
  - Compulsory settlement in Central Bank Money
  - Gross settlement or protection of net systems
  - Use of competing agent banks when recourse made to commercial bank money (eg settlement in US dollars)
- **Standard 11: Operational reliability**
  - Important standard to enforce, both to avoid fraud and ensure business continuity planning
- **Standard 12: Protection of customers' securities**
  - Segregation of customers' securities from the custodian own securities is an important aspect to protect the customers holdings
  - CSDs should provide absolute safety to the assets deposited in their books and avoid recourse to loss sharing arrangements

Regulating CSDs in a balanced fashion

- **Standard 13: Governance**
  - Avoid any conflict of interest, particularly those due to management
  - Adopt best standards available (as proposed by the Company Law Action Plan for listed companies)
- **Standard 14: Access**
  - Harmonize the access to CSDs for EU applicants, in order to support the principle of the home country supervision
  - Enforce the same level of control for applicants coming from non EU countries, on a compulsory basis
- **Standard 19 (and 8): Risks in cross system links**
  - Allow cross-system delivery, only on the basis of securities which have been irrevocably settled in the delivering system

Regulating custodian banks in a balanced fashion

Principles

- **Credit and operational risks are already properly addressed.**
- The proposed scope of application, which extends most standards to custodian banks, would duplicate existing banking regulation and generate unnecessary costs. As a result, **custodian banks should be removed from the draft CESR-ESCB standards.**
- **The concept of systemically important banks is relevant in the context of business continuity planning** - re US Interagency Paper, Group of Thirty, Switchover to the Euro. We would not accept this concept to be applied beyond this purpose.
- In all cases, a bank must retain the right to select its portfolio of credit risks and monitor them as appropriate (secured, unsecured).

Regulating custodian banks in a balanced fashion

Current banking regulation

- **The current banking regulation is designed to avoid market disruption due to the failure of a banking participant.**
- It sets:
  - organisation and internal control procedures within the bank,
  - financial obligations to monitor financial risks. e.g. Cooke ratio
  - oversight and sanction role, under the responsibility of the Banking Supervisor.
- **Although intra-day risks are not addressed as such, they are in effect covered**
  - through the intra-day protection of securities settlement systems which applies to custodian banks, as participants to these systems - ref CSD regulation,
  - through the intra-day monitoring by custodian banks of their credit exposures and of the clients' use of credit lines.

Regulating custodian banks in a balanced fashion

Intra-day credit risk monitoring is best addressed by the following mitigation procedures

- Existence of an independent credit committee, separated from the business line;
- Allocation of credit lines by client;
- Intra-day monitoring of risks and exposures (before and after the fact);
- Control procedures and audit trails;
- Exception processing procedures.

Regulating custodian banks in a balanced fashion

Upcoming banking regulation

- Basel II will further define and enhance the monitoring of operational risks and explicitly targets custodian banks (Pillar 2, article 4.3).
- Basel II encompasses the operational risks incurred by the custodian as well as the risks generated by the custodian towards multilateral systems, such as payments and securities settlement systems.

Additional rules already applied to custodian banks

In addition to banking regulation, custodian banks abide by the rules:

- set by national regulators (securities regulators and Central Banks) to control applicant members to post-trade infrastructures,
- set by the market infrastructures themselves,
- imposed by clients to control the safety of their deposits with custodians (US 17 F5, UK FRAG 21) or to validate their operational procedures (SAS 70).

Regulating custodian banks in a balanced fashion

Proposal

The CESR-ESCB Group may wish to pursue further harmonisation through the application of common standards for the monitoring of custodian banks operations, along the lines set by the CMF in France and the Bank of England in the UK:

- dedicated management / personnel / expertise
- procedures and sound accounting practices
- segregation of client assets
- reconciliation procedures
- internal and external audit
- insurance policy
- legal agreements
- business continuity planning through disaster recovery plans and on-line testing of back-up procedures
- ...

Regulating ICSDs in a balanced fashion

Principles

- In their CSD capacity, they should be regulated as CSDs
- In their custodian bank capacity, they should be regulated as banks.

We recognise that the admission of some Eurobonds as collateral for the Eurosystem monetary policy operations created a specific challenge to the European Monetary Institute in 1997, which led to the requirement put on the ICSDs to collateralise their credit exposures.

This requirement was the answer to a specific concern of the EMI, which should not become the norm. We suggest that:

- this rule is limited to this specific aspect of the market,
- the CESR-ESCB draft is reviewed for CSDs and for custodian banks.

Conclusion

- We support the CESR-ESCB objectives to manage systemic risk inherent to the post-trade environment
- We support principles which are well proven on a worldwide scale
  - Separation of roles between CSD infrastructures and other market players
  - Balanced regulatory approach which ring-fences infrastructures against credit risk and distributes credit risk across a wide range of intermediaries
  - Thorough examination of competition issues since the CSD essential infrastructure must be prevented from abusing its dominant position
- The current draft goes against these principles and cannot be accepted in its current format
- We suggest the CESR-ESCB adopts a balanced approach, as presented in this document, and we are prepared to provide any advice which the CESR-ESCB group may seek on the issue

Appendices

- G30 recommendations
- Giovannini Group recommendations
- European Parliament recommendations
- The US DTC example

G30 recommendations

Global Clearing and Settlement - A PLAN OF ACTION - Group of Thirty© - Washington, DC – 2003

*« **Because CCPs and CSDs play such a central role, minimizing the risk of their failure is an important objective**.(page 40) »*

« The potential for systemic risk in cross-border activities is more widely recognized. The added complexity of cross-border business requires greater awareness of risks. » (page 58)

*« Recommendation 18. promote fair access to securities clearing and settlement networks and services. **Many infrastructure providers operate as effective monopolies within the markets they serve, either because they have been granted such status through legislation or market convention, or because it would not economically be viable for an alternative organization to attempt to compete within the existing market structure**. It is therefore critical that providers that are effective monopolies allow access to users on a fair basis; otherwise some users may be effectively excluded from the market or forced to conduct business through an intermediary that is a direct user of the infrastructure provider. In either case, the level of competition in the market will be reduced overall, disadvantaging both actual and potential participants in the market and ultimately end-user investors and issuers. For this reason, barriers to fair access need to be removed. » (page 120)*

Giovannini Group recommendations

The Giovannini Group - Second Report on EU Clearing & Settlement Arrangements, April 2003, pages 25 et 28

« The Communication defined the objective in terms of three sub-objectives, i.e. cost-effectiveness, effective competition and minimised risk. »

« The issue of pressure to innovate arises to the extent that the consolidation process leads towards monopoly - like situations in the provision of clearing and settlement services.

« In an unregulated monopoly, there is a serious risk that a single provider would abuse its dominant position to the detriment of its members/participants. In a monopoly, the incentive for investing in innovation would depend on three main factors. First, the contestability of the market which, in turn, depends on the dominant technology. Second, the existence of appropriate governance mechanisms to ensure that owners and management of systems take into account the need of the users of the systems. Third, effective regulatory mechanims that put fair constraints on pricing policy and profit maximisation. »

*"**From the perspective of efficiency, there is a much stronger case for consolidation of entities performing essential core functions, like the maintenance of the integrity of the issue ; and functions with large scale economies, like netting, clearing and settlement. These functions do not involve the provision of credit facilities.***

*In contrast, value-added banking functions are not essential to the clearing and settlement process, and **concentration risk is reduced if these functions are provided by multiple banks in a competitive environment**. Public policy makers will have an interest in ensuring that whatever the business model of any consolidated entity, it respects the balance of risk, efficiency and fair competition".*

European Parliament recommendations - Report on Clearing & Settlement

Generoso Andria - Résolution du Parlement Européen sur la communication de la Commission au Conseil sur les Mécanismes de compensation et de règlement / livraison
janvier 2003 - P5_TA-PROV 2003(0014)

[...]

5 [...] invite la Commission à étudier minutieusement l'exemple américain et à fournir une évaluation de ses points forts et faibles afin de déterminer si cette architecture pourrait s'appliquer à l'Europe;

10 estime qu'un autre objectif devrait consister à éliminer les distortions de concurrence ou les différences dans le traitement d'entités qui effectuent des opérations similaires de compensation et de règlement-livraison et qu'une infrastructure européenne de compensation et de règlement-livraison pleinement intégrée suppose que les droits d'accès aux systèmes soient généralisés, transparents, non discriminatoires et, surtout, effectifs;

11 propose, pour les services "principaux" de règlement-livraison, une formule qui serait gérée, sous l'angle juridique, comme un service qui soit la propriété des utilisateurs et régi par les règles applicables à une entité sans but lucratif, compte étant tenu des investissements nécessaires, de manière à générer des coûts moindres sans fausser la concurrence, les agents étant dans le même temps les supports économiques de cette structure; estime qu'une telle formule sera à même de favoriser un abaissement des prix, une amélioration de la qualité des services et un renforcement de l'innovation, tout en permettant aux forces du marché de consolider l'architecture en place, des dispositions législatives appropriées étant mise en place en cas de risque

*12 **propose que les dépositaires centraux de valeurs mobilières fournissent des services d'infrastructure de règlement livraison national et transfrontalier et de dépositaire central de titre sur une base exclusive, les services "à valeur ajoutée" devant être assurés par une structure partagée ou soumise à surveillance qui resterait distincte, également du point de vue logistique; propose que ces entités soient limitées dans l'exercice du risque à la prise de risque opérationnel, à l'exclusion de tout risque bancaire et qu'elles soient organisées et supervisées afin de garantir que le risque de contagion entre les diverses fonctions soit inexistant; demande à ce que les autres services soient assurés de façon clairement séparée et soumise à surveillance de façon à éviter toute distortion de concurrence;***

13 invite instamment la Commission à conclure rapidement son enquête sur les questions de concurrence liées aux systèmes de compensation et de règlement-livraison afin de s'assurer que la politique de concurrence de la Communauté est respectée dans ce secteur, en ce qui concerne les pratiques de tarification discriminatoire, d'accords exclusifs et de tarification excessive."

The example of the United States of America : DTC

Securities Depositories are included within the definition of *"clearing agencies"* in section 3 (a) (23) of the Securities Exchange Act and regulated by the SEC (Securities and Exchange Commission).

It is not required that *clearing agencies* do not engage in other businesses but, in order for the SEC to register a *clearing agency*, it must review the rules of the *clearing* agency and determine, among other things, that:

- the *clearing agency* is open to participation to all banks, broker-dealer, investment companies, and so forth,
- the rules of the *clearing agency* ensure a fair representation of its participants in the administration of its affairs,
- the rules of the *clearing agency* provide for equitable distribution of costs among participants,
- the rules are designed to protect investors and the public interest and are not designed to allow unfair discrimination in the admission of participants or among participants in the use of the *clearing agency*.

Created in 1973, DTC holds 99% of all stocks (besides treasury bonds) in the United States. Three other central securities depositories hold the remaining 1%, and the Federal Reserve holds the Treasury bonds.

The example of the United States of America : DTC

- DTC was chartered as a *limited purpose trust company* by the New York State Banking Department. A *limited purpose trust company* is permitted to engage solely in the fiduciary functions specified in its charter and is not authorised to engage a general banking business.
- Most securities trades (other than government bonds and options) are cleared and settled by the *National Securities Clearing Corporation* (NSCC), which is an affiliate of DTC. In a securities transaction, NSCC will process the trade and DTC will be instructed electronically to move securities from the selling broker 's account to NSCC 's account at DTC, and then from NSCC 's account to the buying broker 's account at DTC. NSCC currently utilises Fed Wire, the wire system that is maintained by the Federal Reserve, in which funds are transferred from the account of one commercial bank at the Federal Reserve to the account of another commercial bank at the Federal Reserve.
- DTC was chartered as a *limited purpose trust company* because such a charter makes it eligible to become member of the Federal Reserve System and as such, to have direct access to payment and securities clearing and processing facilities of the Federal Reserve.
- The stockholders of DTC consist of the institutions that are participants in DTC and those stockholders elect a board of directors that appoints a management team.

The example of the United States of America : DTC

- Although US regulation allows free competition between Central Securities Depositories, DTC is today in a de facto monopoly position.
- DTC is a utility:
  - user-owned, user-governed,
  - charging fees based on costs, with a non profit orientation,
  - activity limited to core services,
  - no right to engage in a general banking activity (risks) in order to access the Federal Reserve systems,
  - no distribution of dividends but policy of end-of-year rebates in order to pass any profits back to the users.
- Access for non US applicants is based on the enforcement of US rules and agreement of the home country supervisor to exchange information with the SEC. The rules include a minimum capital requirement (10 times higher than for a US applicant), release of immunity on assets, US court and jurisdiction, abidance by US accounting rules.

CESR Market Participants Consultative Panel meeting

November 11th, 2003

euroclear

Position on ECB/CESR

- We support the ECB/CESR objectives
  - enhancing safety, soundness and efficiency of securities clearing and settlement in EU
  - promoting and sustaining integration in the European financial markets by a single set of standards and a clear regulatory framework
- Consistent regulation across providers of settlement services is a key step towards better risk reduction and stability of financial markets in Europe
- We support the proposed ECB/CESR standards, with some adjustments

Functional regulation

- We strongly support functional regulation as it is key to the stability of financial markets and to fair competition
- Functional regulation requires that the standards should:
  - target systemically important providers of settlement services, i.e., CSDs, ICSDs and agent banks that handle substantial amounts of cross-border settlement on their books,
  - focus on systemic importance in the area of settlement (e.g. standards should not be applied to global custodians as they do not handle significant settlement activity),
  - be applied consistently (otherwise there may be a shift of settlement activity from CSDs and ICSDs to agent banks),
  - focus on systemic importance at EU level, not at national level

Main comments on standards

- We welcome that full collateralisation of credit exposure is not required (standard 9)
  - it is not practical for any bank (not all customer assets may be pledged)
  - standard 9 still has an excessive bias for full collateralisation; other risk mitigation management tools should be taken into account
  - relation with Basel II rules is to be clarified
- The category "custodians with a dominant position" creates confusion with existing competition law rules
  - should not be dealt with by ECB/CESR
  - rules on Governance (standard 13) and Access (standard 14) are ill-suited for agent banks
- Operational risk management and contingency (standard 11) deserve focus
  - greater standards of safety to be met (e.g. three data centres)
  - capitalise on work performed in Basel II

Implementation

- Early and speedy implementation of standards should be ensured through incorporation in regulator's rule books
- Standards should be applied in a uniform way across all countries and institutions concerned
- ECB/CESR to ensure monitoring and transparency of implementation of standards

‘BEST EXECUTION’

CESR Market Participants Consultative Panel
11th.November 2003
Sonja Lohse

‘BEST EXECUTION’

1. **ISD ART. 19**
- The proposals
- Comments
2. **CESR**
- Current Conduct of Business Rules
- ISD mandate
3. **WHERE SHOULD THE FOCUS BE?**

Nordea

ISD proposal (Council Political Agreement and Parliament First Reading)

- Best execution requires that Price, Costs, Speed, Likelihood of execution and settlement, Size, Nature of any other consideration relevant are taken into account (Council & Parliament).
- Client specific instructions must be followed (Council & Parliament).
- There must be effective arrangements for complying with best execution requirements, e.g. an Execution Policy including the venues the firm has access (Parliament) / information in respect of each class of instrument on different venues and the factors affecting the choice of venue (Council).
- Clients must be informed about the Execution Policy, changes in it and give a prior consent to it (Council & Parliament).
- Prior consent to execution off-market (Council).
- Firms must be able to demonstrate to the client that they have executed in accordance with the Policy (Council).

Nordea

Comments / In General

GOOD

- The objectives of the best execution obligation.
- The definition based on multiple criteria.
- The importance of client specific instructions.
- Parliament focus on retail clients.

BAD

- If the best execution obligation will be formulated in a too absolute manner.
- If this additional layer of protection is extended to professional investors.
- If best execution creates a bias against alternative execution venues by requiring a separate consent.

CESR

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…. Cont.

GOOD

- Parliament text regarding disclosure to clients, because it limits the information to retail clients.
- That regulators monitoring focus is on the Execution Policy; its existence and applicability.

BAD

- Art 25 will have a negative impact on best execution.
- If the over-all deadline is pushing the solutions through too hastily.

Nordea

Comments / Absolute vs. Best Effort

GOOD

- Both Parliament and Council text shift the focus from the result to system, by introducing of the Execution Policy.

BAD

- If best execution will be defined on an absolute basis instead of on a best-effort basis.
- Council definition of what should be in the Execution Policy is too detailed and prescriptive.
- Article 19 does not give legal certainty to clients and firms.

Nordea

Comments / Execution Policy

GOOD

- Execution Policy
- To include price, costs, speed, likelihood of execution and settlement, size, nature of any other consideration relevant in the policy.
- No need to renew the consent every year
- Consent can be obtained on a general basis (but not clear in the Council version whether it requires a separate document).

BAD

- The requirements regarding venues are too detailed.
- To require that the execution policy should be defined with respect to each class of security.
- To require separate contracts for the execution policy.
- Overly rigid disclosure obligations

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CESR Conduct of Business Rules today

- Best possible result with reference to price, costs, size, nature of the transaction, time of reception of order, speed and likelihood of execution and trading venue
- Relevant market is the one offering the most favourable trading conditions. The trade can be executed in another venue if this serves the best interest of the client.
- If acting as a principal the client must be informed and the appropriate price justified.
- Orders must be executed in accordance to client instructions.
- No front-running.

Nordea

CESR'S IMPLEMENTING MEASURES

According to the ISD Draft, the focus should be on:

- Factors that may be taken into account for determining best execution or the calculation of best net price prevailing in the marketplace for the size and type of order and type of client, taking particular account of whether the client is a retail investor or a professional client (Parliament);

- Procedures which, taking into account the scale of operations of different investment firms, may be considered as reasonable and effective methods of obtaining access to the execution venues which offer the most favorable terms of execution in the marketplace. (Parliament)

Nordea

….. Cont.

- Criteria for determining the relative importance of the different factors that may be taken into account for determining the best possible result taking into account the size and type of order and the retail or professional nature of the client (Council).

- Factors that may be taken into account by an investment firm when reviewing its execution arrangements and the circumstances under which changes to such arrangements may be appropriate. In particular, the factors for determining which venues enable investment firms to obtain on a consistent basis the best possible result for executing the client orders (Council)

- Nature and extent of the information to be provided to clients on their Execution Policies (Council)

CESR

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WHERE SHOULD CESR'S FOCUS BE?

- Not to require an excessively detailed and prescriptive context of the Execution Policy, to avoid cost driving solutions and procedures.
- Develop regulatory monitoring on the basis of (i) is there an Execution Policy in place (ii) is it being applied correctly.
- Too focus the best execution requirements on retail customers.
- To trim the disclosure requirements to a reasonable level.

… To keep the balance between investor choice and investor protection.

Execution-only Trading in the UK

A presentation to CESR Market Participants Panel

11th November

Donald Brydon

What is an execution-only trade?

When an individual wants to buy or sell shares or other investments without any advice as to whether it is suitable

- **Some of these are professional investors**
- **The vast majority are people with shares as a result of**
  - **-privatisations, such as BT, Water, Gas, Electricity Companies**
  - **-demutualisations of building societies (e.g Halifax)**
  - **-company share schemes**

How are execution-only trades undertaken in the UK?

- **Via the Internet**
- **By Telephone**
- **In person (for example in a Bank branch)**
- **Via a funds supermarket**
- **By post**

What are the advantages of an execution-only service?

- **Cost –** execution-only trades can be as little as €15
- **Speed –** trades are executed immediately and the price quoted is the price obtained regardless of any turbulence in the market
- **Choice –** there are over 50 firms in the UK offering an execution-only share dealing facility as part of their services. Funds supermarkets are a growing phenomenon across Europe
- **Consumer protection –** further details later

How many execution-only share trades are undertaken in the UK?

(millions of trades)

	2000	2001	2002	2003*
Online	**2.93**	**2.54**	**2.20**	**2.82**
Other	**10.18**	**7.95**	**6.26**	**5.69**
Total	**13.11**	**10.49**	**8.46**	**8.51**

* Projected - based on actual figures from first two quarters of 2003

- Some 2 million UK investors also prefer to buy UCITS without advice

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What is the current regulatory requirement?

Current UK rules require firms to take "reasonable care" to ascertain the best price for the customer order in the relevant market and execute that order at a "no less advantageous" price "as soon as reasonably practicable". (Best execution and timely execution rules)

This means in practice that share firms execute their orders with regard to the price on the London Stock Exchange via specialist market makers (so-called Retail Service Providers) and in the vast majority of cases obtain a better price than that on the LSE. Firms will check with at least 1 but normally 2 RSPs to get the best price available for their customers and most orders are now executed electronically

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Proquote Trader

This is a Proquote Trader Screenshot; please note that Indicative/Test Data is show for the RSP quotes

Regulatory protections for execution-only clients (1)

- **Detailed FSA Conduct of Business Rules covering areas such as Best Execution and Timely Execution**
- **Rules on financial promotions and a requirement that all communications are clear, fair and not misleading**
- **Terms and conditions detailing the service and charges in advance of dealing**
- **Appropriate risk warnings in place**
- **Custody and client money rules to safeguard client assets**
- **Complaints mechanism, Ombudsman, Compensation Scheme**

Regulatory protections for execution-only clients (2)

- **Firms undertake so-called "Know Your Customer" checks on clients in respect of Money Laundering and also credit reference checks**
- **Many brokers have trading limits in place above which clients would need to provide evidence that they had funds available**
- **Firms are required to keep information relating to a customer order for at least 3 years**

Regulatory protections for execution-only clients (3)

- **UCITS are subject to product regulation, including strict investment limits designed to diversify investment and lower risk**
- **UCITS are required by UCITS directive "to provide information necessary for investors to make an informed judgement of the investment proposed to them"**

Article 18 of the ISD

Conduct of business obligations when providing investment services to clients

- **The European Parliament clearly separated out execution-only from ongoing suitability requirements but the text of the Council's redraft of Article 18 is unclear**
- **The requirement in the revised 18.4b is that execution-only service cannot be undertaken unless "the service is provided at the initiative of the client or potential client"**
- **Firms must be able to advertise their service to potential clients, to offer an execution-only service to clients or potential clients and to offer new investment opportunities to clients on a non-advised basis**

These are essential to the future of execution-only business!!