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Mr Elias Kazarian
European Central Bank
Kaisserstrasse 29
60311 Frankfurt am main
Germany

Via e-mail : elias.kazarian@ecb.int

Dear Elias

JOINT WORK OF CESR AND THE ECB IN THE FIELD OF CLEARING & SETTLEMENT

CREST welcomes the intention of the European Authorities to establish clearing and settlement standards which are appropriate for the advanced financial economies in the EU. CREST agrees that the CPSS/IOSCO recommendations are a useful starting point; and also agrees that, because of the wide variety of countries in the global audience to which the recommendations were addressed, those recommendations do not necessarily represent an adequate basic level of risk control for the advanced market economies in Europe.

CREST also welcomes the intention to address the issues raised by the Giovannini Group in its recent report. CREST believes that the majority of such barriers to harmonisation require action by parties other than CSDs, Exchanges or Clearing Houses, and encourages CESR and ECB to identify specific parties who have responsibility and authority to make the necessary changes to reduce industry costs.

However, CREST also notes that there are currently a number of initiatives which are focussed on clearing and settlement – in particular; G30, the European Commission and the Giovannini Group, ISSA, the Thomas Murray exercise and the current CESR/ECB study (which in turn uses the responses from the BIS/ISOSCO survey). These concurrent initiatives consume significant resources within clearing and settlement organisations, adding to the costs of the services for all customers. The establishment of standards and recommendations will, we suggest, only have

real value if the standards are rigorously monitored and "enforced" in some way (even if this only means the publication of those who have met and failed to meet the standards – and the reasons why).

We now turn to the specific questions that you ask of us.

2.1 Nature of the Recommendations

CRESTCo considers it likely that recommendations in relation to harmonisation will require legal instruments, whether at national or European level, because many areas for harmonisation required are firmly within the responsibility of national or European government.

CRESTCo does not consider it appropriate for there to be legal instruments in relation to standards in clearing or settlement systems. This is because the nature of the recommendations or standards will inevitably be at a level of specific detail. The specifics should be able to change, to reflect technical progress both in markets, and in the infrastructure which services them. It would not be reasonable to expect legislative authorities to make time for a relatively frequent programme of updates in governing legislation. It follows that any framework legislation needed (it is not obvious to CREST that any is needed) should be couched in broad terms, designed to give national regulatory authorities appropriate powers.

However, as mentioned above we believe that ECB/CESR should seek to "enforce/publicise" compliance with any standards. So we suggest that the standards are constructed within a compliance framework.

2.2 Addressee

It will be easier to decide who the appropriate addressee is once the standards or recommendations have been finalised.

Where the Group offers "minimum standards", it seems clear that the appropriate audience are the regulators who authorise relevant systems to operate, and can thus enforce compliance.

Where the Group produces broader recommendations which are not mandatory, then CRESTCo believes that these recommendations should be addressed to the system operators, for the system operator to respond. Ultimately, customers – particularly where the customers have an effective role in governing the chosen system – will decide whether they wish their chosen system to incur

the cost (to be recovered from customers) of complying with recommendations which are not minimum standards.

2.3 Scope

CREST is surprised that the scope of the Group's work is still so vague that the Group feels the need to consult on the topic. But we accept that scope is a difficult area, the answer to which depends on what CESR/ECB intends to achieve from the current initiative.

It is a difficult issue whether the standards and recommendations should be drawn up to cover all providers of clearing and settlement services. In a very real sense, there is a continuum of providers, starting with those which provide an essential utility service (domestic CSDs) where there is little prospect of a failing system being quickly replaced by competitors; through the ICSDs; to commercial providers of settlement services such as custodians and outsourcing agencies (e.g. Pershing in the UK).

There are two areas on which the ECB/CESR should focus:

1. The increasingly blurred distinction between the custodial services offered by ICSDs and by commercial custodians, and whether the prudential and systemic regulation applied to both categories are consistent given the convergence of services.

2. The isolation of credit risk in (I)CSDs. CREST also believes that an entity such as a CSD which is the sole record in relation to the segregation of client assets should, where possible, avoid credit risk of any sort. This is because the segregation of balances, particularly for an entity which is entirely or substantially responsible for record keeping for all the assets in a particular class (e.g. a domestic equity market). is an extremely significant source of potential systemic risk for the relevant market. It is unduly risky to add a further layer of credit risk on top of that existing record keeping risk. Accordingly, CRESTCo believes that where a credit institution is responsible for keeping records of the ultimate ownership of assets in such circumstances, it should be subject to tougher minimum standards than an entity which does not take credit risk. It follows therefore that the ICSDs should be subject to tougher minimum standards than the majority of domestic CSDs.

CRESTCo does not believe that it is appropriate for the regulators to set minimum standards for registrars**.** The UK and Ireland, for which CREST provides domestic settlement services, are the main registered security markets in terms of volume and value in Europe. The approach taken is

that the requirements placed on CREST by law, and monitored by CREST's regulators, ensure that CREST has to set standards for registrars, and monitor their adherence to those standards, in order to meet the conditions necessary for CREST to continue to be authorised and approved to operate. These standards relate to such matters as the speed of registration of electronic transfers within CREST (which now occurs irrevocably at the point of settlement), and the speed and accuracy with which physical holdings are dematerialised, and electronic holdings rematerialised in accordance with investors' instructions. CREST monitors registrar performance against demanding public standards, and levies sanctions where appropriate for breaches of standards. CREST considers that this approach is an efficient way of meeting regulatory objectives in relation to the role of registrars in securities markets.

We do not see a case for the authorities to regulate other activities of registrars, such as handling distributions and other corporate actions. Registrars are subject to normal commercial disciplines in relation to their contract with the issuing company which employs them, and to the rights of the investor against that issuing company; the UK and Irish experience is that this discipline is extremely effective in ensuring careful and timely performance of registrar obligations.

We agree that all securities should be within the scope of the ECB/CESR work, as well as derivatives on these securities, and other financial products, such as open-ended instruments. We can see no argument for any form of differentiation between one financial product and another.

CREST strongly believes that there should be special recommendations in the standards in relation to cross border activity. This simply reflects the different complications that arise.

2.4 Objectives

CREST agrees with the objectives. We believe these objectives should apply to a wide definition of "security clearing and settlement systems", to include both credit institutions which provide clearing and settlement services, and pure custodians (see 2.3 above).

CREST would however stress the value of innovation, transparency and open access, which are perhaps best promoted by a competitive model. It follows that the ECB/CESR should talk more specifically in terms of a competition objective, rather than referring to creating a level playing

field. Again, in the interest of clarity, it might be useful if you speak in terms of "harmonisation" rather than "integration".

2.5 Access conditions

We are not particularly aware of access conditions by market users to specific service providers which are discriminatory. We do however believe that there is considerable disincentive to competition in terms of discriminatory rules of a different sort – we think specifically of the rules and/or laws which apparently oblige transactions on a German stock exchange to be settled in Clearstream Frankfurt Such limitations clearly restrict choice, and hamper competition – and thus damage the proper functioning of markets.

2.6 Risks and weaknesses.

We believe the CPSS/IOSCO work has identified the main categories of risk and weakness. This should be the starting point for the current work.

The legal risk issues are complex, and need to be addressed in detailed, and doubtless lengthy and expensive, work between experts. CREST believes that the most fertile way of addressing these risks is not through the harmonisation of law (which will take a very long time, if it ever occurs) but in general through the creation of sound domestic law interests, for the benefit of the investor in a particular jurisdiction, in securities issued in other jurisdictions (cf The CREST Depository Interest model of international settlement).

CREST agrees that segregation of assets and the reconciliation of positions are important issues for custody (see section 2.3 above).

CREST also believes that transactions – in particular open transactions – need to be carefully reconciled. This is in part to control the risk of settling transactions which should not be settled – but also, in practical every day terms, to control operational risk and reduce operational cost.

Additionally, CREST would like to stress the importance of controlling the risks that arise in relation to benefits on securities. This is a potent source of operational risk, and on occasion can create very substantial financial exposure for the custodian as intermediary if it mishandles the passing of instructions (in relation to an optional corporate action) from customer to issuer or registrar.

The ability of customers to manage such risks through real-time interaction with their chosen settlement system is extremely important.

We broadly agree that you have identified the main items in relation to settlement risk.

CREST firmly believes that clearing and settlement of cross border transactions requires final irrevocable intra day (indeed, real time) DvP in each significant market.

In relation to operational risk, it is important that all systemically important systems should provide a high standard of risk management in relation to the following items:

- unexpected volume peaks;
- resilience of communication systems between the system and its important customers, and any other important hubs to which it relates (for example a stock exchange trading system);
- resilience to the failure of any computing components, hardware or software;
- careful procedures for managing the introduction of new or altered software, to reduce the risk of operational problems; and
- arrangements designed to minimise the risk that terrorist action could lead to a prolonged outage – to cover vulnerabilities in relation to staff as well as premises or computer equipment.

2.7 Settlement cycles

We do not believe that there is a need for further shortening of settlement cycles in Europe. The need for ever shorter settlement periods is removed by the presence of a central counterparty which is on risk at the point of trade (as in the UK). We have discerned no demand from customers to further reduce settlement cycles – they believe, and we agree, that there are better ways of reducing risk at lower cost (such as improving corporate action and proxy voting processing, and introducing settlement netting).

We also do not believe that settlement cycles need to be mandated in each market for all trading activity. In the UK, those trades that are struck on the London Stock Exchange's (LSE) SETS platform settle for T+3, but firms have the choice of also trading (still under the rules of the LSE) through a range of Retail Service Providers (RSPs – market makers) for periods from T+0 to T+25.

2.8 Structural issues.

These are highly complex questions, which CREST would wish to be involved in debating directly with you.

CREST's view is that in the case of the core task of maintaining base records in electronic form of holdings, transfers and cash movements, in all (or substantially all) of a domestic market is a utility business and should be subject to utility pricing. Where the service provided is contestable (eg credit provision and full-service custody) then such services should be provided competitively.

CREST believes that end users of the markets should be able to choose freely between being a customer of a custodian (eg, BNP Paribas or even Euroclear bank) or being a direct member of the utility infrastructure.

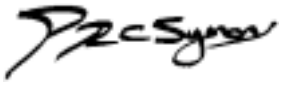
CREST believes that there may need to be public policy intervention (or at least a public policy position) to ensure that credit institutions do not limit access to the underlying utility infrastructure, where they own such infrastructure – whether this access is by other utility infrastructures, or by competing custodian providers of services. This is to prevent abuse of market power by such custodians which own utility providers.

CREST further believes that a best solution for European settlement would be for CSDs and ICSDs to be obliged to open up access to customers who should have a real choice as to where they wish to settle and should not be compelled to purchase other services from the (I)CSD which they could obtain elsewhere (eg credit provision). An analogy would be the action that regulators have taken to oblige what were monopoly national telecom companies to open up access to their customers to competing providers such as mobile phone networks or competing telephone providers from abroad. Acceptable standards for real time interaction between CSDs already exist – just as they do for telecoms. The missing element is a willingness by some participants to open up their markets to access by customers of competing suppliers.

We believe that policy action in this area would introduce competition into the market place, which would stimulate innovation and high service quality at a reasonable price; moreover, this competition would lead to market–driven consolidation where appropriate.

We look forward to continuing this dialogue with you over the coming weeks.

Yours sincerely



Paul Symons
Head of Retail and Public Affairs

Cc Verena Ross (FSA)
Ian Werner (CRESTCo)
Toby Davies (CRESTCo)