

Euronext and Clearnet response to CESR/ESCB call for contribution

1 General

This reply to the Call for Contributions is the joint response of Euronext and Clearnet.

Good progress has been made in recent years in the field of clearing and settlement, and over the coming months it is hoped to see the enactment of the legislative conditions essential for the open, free, market for capital which is so vital for Europe's competitive future.

It is to be hoped that in future there will be greater co-ordination between the European institutions. In fact, many of the questions raised in the Call for Contributions are impossible to fully answer until the Commission has determined its own policy in the light of the responses to the awaited "Communication".

Euronext and Clearnet have benefited from the Investment Services Directive and the Settlement Finality Directive in supplying clearing and settlement services. The implementation of these directives at member state level has been uneven. Two changes which would lead to improvements are :

- Greater transparency of regulatory requirements, and
- Formalised monitoring of implementation of directives.

2 Nature of recommendations

For actors in the market who deal on a cross-border basis, the legal validity of transactions is the most important issue, and certainty is the essential element which is currently notable by its absence. If the recommendations and standards are to add any certainty, then they should be binding at the level of national law. It would thus seem that such recommendations are more a matter for the Commission than for the CESR or ECB, who would be able to create disciplinary offences rather than take action which may affect the validity of the transactions.

However, any actions which may be taken by the CESR or ECB in the field should increase transparency, allowing actors to compare the consequences of a certain course of action in all of the jurisdictions.

Clearnet holds the view that the functions of a clearing house should be covered by the Capital Adequacy Directive. Banks and investment firms compete with clearing houses (see the debate on internalisation of orders) and are subject to the same type of risks. Clearnet acknowledges that the risks for a clearing house are concentrated to an unusual degree, but banking supervisors are used to dealing with exceptional cases. The systemic issues raised by the central position of the Clearing House in the markets are already constantly analysed by regulators, and it is hoped that the Call for Contributions will lead to increased dialogue between the regulators and the markets to ensure best supervisory practice.

Brussels

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In order to ensure the level playing field between the CCPs, there should be a single set of capital requirements imposed on Clearing Houses, wherever they are located in Europe. Clearnet would propose that the CAD requirements would set the appropriate level, as noted above, but believes more importantly, that the rates should be transparent so that users can fully assess their risks.

3 Addressees

The operator of the Settlement System or Clearing House may set standards, but should do so after a dialogue with customers and users, to ensure their consistency at a high level and their practicability.

4 Scope

When establishing the scope of their work, CESR and the ECB should avoid duplication with that of the Commission.

A key principle should be that that entities performing or providing a specific function or service should be submitted to the same or equivalent regulatory framework irrespective of the form or the nature of the entity.

The CESR and ECB should also constantly have regard to the cross-border impact of any actions they may perform.

a) Settlement

The standards for the clearing, settlement and depository functions should indeed be distinct.

As far as concerns keepers of records of holders of securities entitlements, there is a distinction between, on the one hand CSDs and registrars, and on the other, custodians. The first category has a 'public' role and the latter a more commercial role. ICSDs may perform both tasks, but where they do so, there should be clear delineation between the 'public' and the commercial aspects.

b) Collateral Management and Property Law Collateral Management

Clearnet has been designated as a Settlement System under the Settlement Finality Directive. Nevertheless, since arrangements for clearing transactions tend to involve a chain of relationships, a number of problems still remain: even if Clearnet may be protected when it takes or realises collateral deposited by a members, it is essential that its members have the same protection regarding the collateral deposited by their clients.

Clearnet welcomes Articles 4 and 5 of the draft Collateral Directive which respectively remove the formalities from the provision of collateral (e.g. registration) and from its execution (e.g. notice period or court approval). These will ultimately allow Clearnet to accept collateral in more member states.

Implementation of the Investment Services Directive and, to a lesser degree, the Settlement Finality Directive has been haphazard. In the field of collateral management significant risks may arise in particular if the latter or the Collateral Directive is not properly implemented.

Assuming as an example that in one member state a statutory provision remains on the books which requires a third party to approve the realization of collateral – and the record keeper refuses to transfer the entitlement to the collateral taker upon a default. In such a case, what action can the collateral taker take to enforce its security? There will inevitably be a delay in which it will be out of pocket, even if a court eventually finds in its favour.

Clearnet is of the view that implementation of the directives has to be monitored. Now that it has become a formalised institution, the CESR would be well placed to carry out this role jointly with the Commission, with the latter having the power to deal with non-compliant member states. The CESR ought to publish a summary as to how finality has been ensured in each member state.

Transfer of Property

Clearnet welcomes the initiatives at a European level on establishing common rules for the transfer of property (Settlement Finality Directive, Collateral Directive). In this area too, greater transparency would be helpful, particularly as to timings for finality, and again the CESR may have a role. Once there is transparency, players in the market will see the need for harmonisation, and commercial pressures may force changes, perhaps without the need for legislation at the European level.

Segregation of Client Assets

It has become apparent that there are differences in the rules for segregation of client assets in the member states. The CESR would be the ideal forum for ensuring harmonisation of these rules.

5 Objectives

The objectives ought also to consider access to finance through the network of Central Banks, as this has an impact on the level playing field. Other objectives include harmonisation and standardisation of back office procedures, and of the requirements for reporting of tax information.

6 a) Access conditions: Settlement

One of the issues is whether a participant has the right to become a member of e.g. a CSD also in case of economically not viable turnover. Our view is that the CSD, although a 'public' service should be able to work on an economic basis, so long as any parameters are non-discriminatory economic parameters. A custodian can apply this principle in the context of the business objectives.

b) Access conditions: Clearing Passport for Clearing Members

Clearnet's Belgian, Dutch and French regulators have co-operated to a remarkable degree to provide a "proxy passport" for the supervision of its Dutch and Belgian Clearing Members. With greater progress in the creation of the single market, however, this independent initiative ought to have been unnecessary.

There seems no basis for excluding the provision of clearing services by an investment firm from the passport-able activities under the ISD. From the point of view of the client, a clearing member acts as a quasi-banker for the trading member. The clearing

activities carried out by the clearer (risk assessment/account keeping/payment of margin) do seem to not be of such a peculiar nature as to warrant the exceptional step of being excluded from the activities covered by the directive.

Access for Clearing Houses to Regulated Markets

Supervisors of regulated markets have a direct interest in the clearing arrangements for such markets. However, the principle of home state regulation may produce a clash when applied to the clearing of markets – the home state supervisor of the market will insist on the proper performance of transactions, but only the home state supervisor of the Clearing House can fully oversee its clearing activities.

Cooperation between regulators is of paramount concern, and for Clearnet, the Belgian, Dutch and French Regulators have formed the Clearing Co-ordination Committee to determine the requirements for Clearnet to clear each of their domestic markets.

The Committee was set up in the absence of any provisions at the European level, and is a pragmatic solution to the issues raised. The circumstances will always differ for each instance where a Clearing House is located in a different state to the regulated market which it serves. The supervisors of the market and of the Clearing House need to reach agreement, via a memorandum of understanding or otherwise, on the procedures for oversight, on a case-by-case basis.

Clearnet welcomes the move in the Commission's revised orientations for the ISD towards opening the markets of Europe to clearing houses based in other Member States. It is now proposed that the supervisor of a regulated market may only object to the market using a CCP in another member state where it is "demonstrably required to maintain the orderly functioning of the regulated market or the soundness of the central counterparty". It is hard to imagine a clearing house offering its services to any market if there was the remotest possibility of such a danger arising. The new proposal seems effectively to require the Clearing House home state regulator to be the supervisor, but nevertheless to Clearnet it seems imperative that there be a high degree of coordination between the supervisors of the regulated market(s) and those of the Clearing House.

7 Risks and Weaknesses.

In answer to the questions raised at paragraph 2.6:

- The most relevant factors to risks and weaknesses are the legal framework for cross border finality and the processing of cross border corporate actions. In addition different market practices create uncertainty as to standards, as embedded in national rules and regulations. As a result harmonisation will be difficult to achieve. Furthermore, the systems of market participants will require enhancements to implement harmonisation.
- A global European plan of approach should be set to implement harmonisation, to be monitored by a special cross border task force.
- Segregation of assets and proper reconciliation is indeed fundamental to custody business. This also applies for the position administration in clearing and settlement/custody. The latter is in most national jurisdictions already in place.
- The settlement risk for in particular cross border exchange transactions is as described in paragraph 2.6.

- Operational risk mainly covers aspects related to the continuation of the processes at the set times. Back-up and disaster recovery plans as part of a disaster escalation procedure are key to minimising operational risk and the impact on the capital markets.

8 Connectivity/Clearing.

Connectivity between Clearing Houses and settlement systems seems set to be included in the requirements under the revised Investment Services Directive. Clearnet is working on its "Platform Interface" project which is intended to allow Clearnet to connect to CSDs and ICSDs. The complexities in this field are immense, particularly with the different rules for finality of settlement in the different depositories and the various procedures for dealing with corporate events. Nevertheless, Clearnet is convinced that its commercial interests coincide with the proposals for the Directive.

9 Settlement cycles.

A settlement cycle will be determined by the effectiveness of cross border and global settlement capacity. Shorter settlement cycles require harmonization on main issues as stated above not only for Europe, but also for the American markets. The choice is the balance between increased number of fails and the associated costs and penalties and the costs of maintaining for a longer period of time financial buffers as protection against default. Multiple settlement runs a day for clearing transaction is in contradiction with maximizing netting impact on settlement and the corresponding money flows over a day. Multiple intra-day settlement runs are important for intra-day settlements of OTC trades and speedy settlement of fails. Different settlement cycles for different products for exchange transactions only increase the complexity of systems.

10 Structural issues

Euronext believes that the provider-run and "for profit" structures work better because the competition among service providers results in the delivery of efficient systems at the best possible price. Moreover, the control and support of shareholders forces for-profit organisations to continuously improve the range and quality of the services they provide. In this respect, Euronext would like to underline that the worse situation would be to set up a single clearing agency and a single settlement agency for all EU financial markets, organised under a user-run non-profit structure. The lack of competition and the lack of pressure on users to update systems, would weaken the markets in Europe, when compared to those elsewhere. The dominant position of such structures would result in additional costs (due to inefficient systems) and so act to the detriment of the EU financial markets.

In this context, Euronext should like to mention that the close links that exist between clearing houses and market operators might be very beneficial. Market operators that want to innovate indeed need to obtain tailor-made services from clearing houses, which are eased by the existence of close links between such entities. In particular, without interconnectivity, for markets operating an anonymous central order-book with a CCP service, it is necessary that the CCP deals with both legs of each transaction in order for the novation process to be possible on an anonymous basis.

Euronext believes that competition among all types of clearing and settlement infrastructures is beneficial to financial markets, provided that there is a level playing field in Europe. The same applies to provider of trading services, competition is beneficial as long as it is in a level playing field. As mentioned earlier, the same function should trigger the same regulation.