Citigroup Response to

ESCB-CESR Consultative Report on the Standards for Securities Clearing and Settlement Systems in the European Union

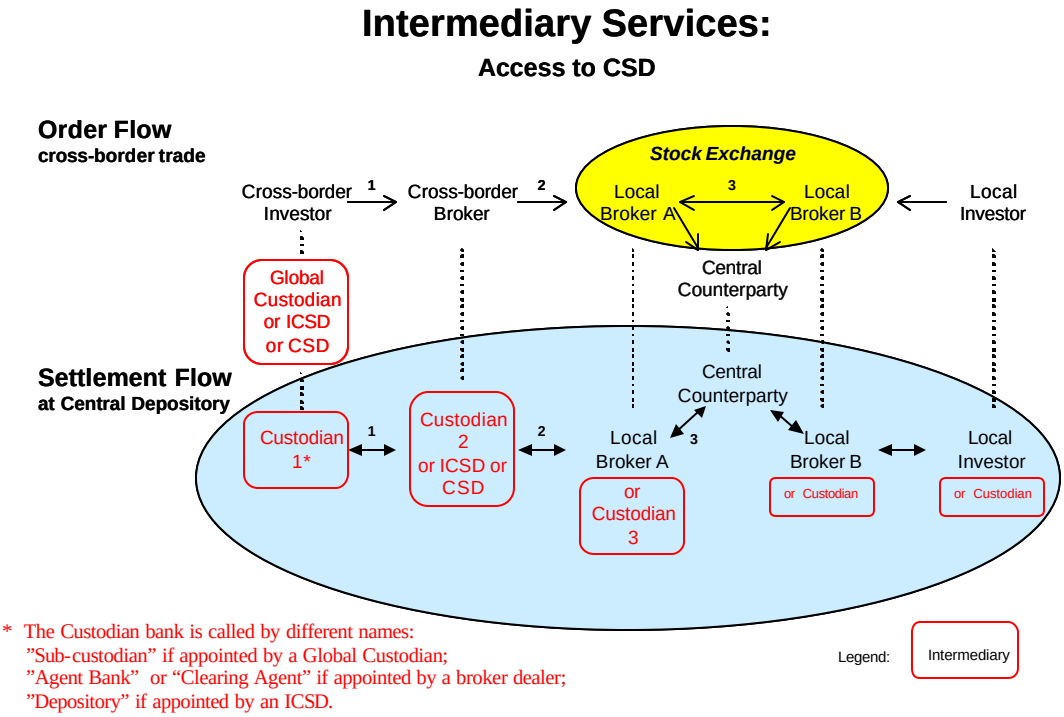
SUPPORTING DOCUMENT

October, 2003

citigroup

SUPPORTING DOCUMENT

TABLE OF CONTENTS



- The top part of the diagram illustrates the order flow: how one order from a Cross-border Investor passes through two intermediaries (Cross-border Broker and Local Broker) before it is executed on an exchange.
- The lower part of the diagram illustrates the settlement flow within the CSD: each party in the trading process has the option of using a different intermediary to effect settlement within the CSD. The intermediary service providers either have direct accounts in the CSD (Custodians 1, 2 and 3 above) or they use another intermediary (a Global Custodian uses a Sub-custodian).
- Clients instruct their intermediary service providers to transfer securities on their behalf by providing the following information for the transaction: security, quantity, cash amount, counterparty, trade date (not mandatory in some markets) and settlement date.
- Market participants can access the CSD via direct participation (in the above example, the Local Investor, Broker A and Broker B). Even if they qualify for membership, they may still choose to outsource operations and access the CSD via a Custodian.
- Some National CSDs and ICSDs provide their members access to other infrastructures. In doing so, they act as intermediaries and serve the same function as Global Custodians (1) or Custodian Banks (2).
- National CSDs provide their members access to foreign CSDs via one of two ways: appointing a custodian (1) or becoming itself a direct member of the foreign CSD (2). ICSDs provide their members access to non-Eurobond securities in the same way. When CSDs access each other, the arrangement is called a "link", whether it is via appointing a custodian or direct account in the foreign CSD. When ICSDs access each other, it involves each ICSD holding an account with the other; the arrangement is called the "bridge".

SECTION 2: LEGAL RIGHTS OF CSD PARTICIPANTS AND CUSTOMERS OF CUSTODIANS

The nature of an interest registered in a person's name at a CSD is legally distinct from an interest registered on the books of a custodian or other intermediary.

CSD is the "Root of Title" The issuer generally has to negotiate with the CSD/ICSD to secure eligibility of the issue for deposit with the CSD/ICSD. The function of a CSD in most jurisdictions is to provide the definitive record of ownership of the property constituted by the security (or the "root of title"). Only the persons with definitive entitlement of this type have the entire property right: to sue the issuer for non-payment, to vote, to exercise set-off rights, to defeat the claims of unregistered claimants to the same item of property, and so forth.[1]

Where a security is held by a custodian, the custodian's role is usually that of nominee. Although the CSD's register shows the custodian as legal owner, the custodian will exercise the "primary" ownership right that the record at CSD level brings in favour of its customer. The customer's rights are thus "indirect" rights in that the customer depends on the custodian.

Direct vs Indirect Holders The nature of the distinction between the "direct holder" of securities registered on the CSD's books and the "indirect holder" of securities holding via an account with a custodian is best illustrated by the systemic consequences of a book-keeping failure by the CSD or custodian.

Consider the hypothetical effect of destruction of a CSD's records. If the CSD fails, the holder's rights are created or destroyed: if there is no definitive record, the holder has no title to transfer, cannot vote, cannot sue the issuer and so forth. If the CSD rectifies its error the consequences will be to create such rights. If the CSD attempted to recreate its records, there is a risk that, owing to error or fraud, more securities may be in existence at the end of the recreation process than before the destruction of records. All the "new" holders are equally validly entitled. This has a fundamental effect on the value of the securities created.[2]

By contrast, if a custodian's record-keeping fails, the number of securities in existence cannot be affected. The consequences of a reconciliation error by a custodian will depend on the terms of business between the custodian and his client, and may raise questions of priority of entitlement and loss-sharing, but no question of more securities coming into existence could, even in theory, arise.[3] The only issue is who is entitled to

---

[1] These issues are those referred to in Barriers 13, 14 and 15 of the Second Giovannini Report, which calls for harmonisation of legal standards on such questions between EU member states.

[2] It is believed that during the recent civil unrest in Chechnya, the CSD's records were destroyed with consequences similar to those described.

[3] It should also be mentioned that the proposals to improve the certainty of account-holders' rights in respect of securities held via intermediaries may have the effect of reducing this distinction.

enjoy the rights registered at CSD level in the custodian's name, not whether those rights exist.

Interest in securities held indirectly The rights of participants in the CSD/ICSD will depend on the legal regime applicable to that CSD/ICSD or settlement system. Customers of the participants who are intermediaries further down the chain, and the end customer, do not have a relationship between themselves and the issuer, only between themselves and their intermediary. The nature of each such relationship is governed by the agreement between the immediate contracting parties.

Typically, investors who hold securities through an intermediary in an omnibus account have a combination of personal and proprietary rights: the personal right to the delivery or transfer of the securities and a proprietary right in the form of co-ownership in the pool of securities held by the intermediary.

Settlement by custodians Transfer of securities from Customer 1 to Customer 2 of a custodian can occur on the books of their common custodian without the transfer being recorded in the CSD or ICSD if both customers' securities are held in the same omnibus account at the CSD. The effect of the book-entry is to transfer Customer 1's rights against the common custodian to Customer 2.

If the securities are held in segregated accounts at the CSD, the transfer will take place in the CSD and Customer 1's rights against the common custodian is likewise transferred to Customer 2.

If Customer 2 uses a different custodian, the transfer will take place in the CSD and Customer 2's rights are still against a custodian, its intermediary.

Therefore, whether settlement takes place in the books of a custodian or the CSD does not change the legal nature of the holdings of a customer engaging a custodian.

Prominent Exceptions It should be mentioned that the details of the legal rights and responsibilities at CSD and custodian level do differ from one country to another. The above description is generalized to illustrate the key features which are typically found in most countries.

The CREST system in the UK and the Euroclear System are often cited as examples of infrastructures – CSD and ICSD respectively. However, as they differ from the norm in most countries they may therefore cause confusion in the use of the generic framework described above. The sections below describe various commonly encountered phrases and descriptions, and some of the (atypical) features of the UK and Belgian legal systems.

The UK CREST is neither a holder nor a custodian of UK securities. Nor is it a securities intermediary standing between its members and the issuer. Instead it is similar to but distinct from a registrar who holds the primary record of ownership of the relevant securities (in the UK, registrars also record title to securities). Legal title is conferred, or

transferred, when the issue or transfer of securities to a member of CREST is recorded in CREST's register.[4]

The terms "direct" and "indirect" also have specific meanings in the UK market. "Direct holdings in registered securities" means an investor's holding of registered securities as evidenced by registration of the investor in the issuer's books and by a physical certificate. "Indirect holdings in dematerialized securities" means an investor's holding of securities in an account with a nominee.

The Euroclear System In respect of participants in the Euroclear System, Belgian Royal Decree No. 62 of 10 November 1967 provides that the rights of participants in Euroclear are not merely contractual rights against the system. Title to the securities deposited in the system does not pass to Euroclear but remains with the participants holding accounts with Euroclear who have a proprietary interest in a jointly owned pool of securities.

[4] Under Regulation 24 of the Uncertificated Securities Regulations 2001 (SI 2001 No. 3755), as amended by the Uncertificated Securities (Amendment)(Eligible Debt Securities) Regulations 2003 (SI 2003 No. 1633).

SECTION 3: CONFUSING TERMS

Certain words commonly used in the area of clearing and settlement have many different meanings. Much of the perception of complexity arises from the confusion over the meaning and implication of these terms: "clearing", "settlement", and "internalisation". We give some examples of common usage of these terms to illustrate how the confusion over words with multiple meanings could have lead to market and regulatory confusion.

Clearing

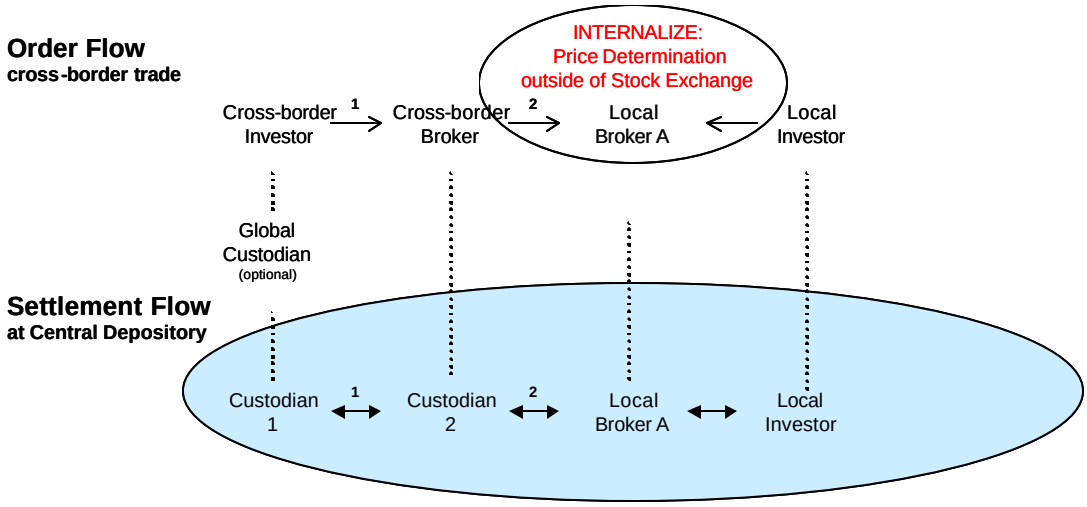
Although this paper does not address clearing (as the service offered by CCPs), the term is a useful example of how one word can be used very differently by different institutions.

Used By	To mean
Brokers	• Settlement • A broker "self clears" when it is a direct member of a CSD. • It appoints a "clearing agent" when it outsources settlement to an agent bank.
US Brokers, in "Correspondent Clearing"	• A regulated business whereby a member of the stock exchange executes trades for smaller brokers ("correspondents"), and provides a full set of client and back-office operations services.
(Some) Agent Banks	• Providing the services of an agent bank to a broker, and/or providing the services of a general clearing member in markets where there is a CCP.
Bank for International Settlements	• "The process of transmitting, reconciling and, in some case, confirming payment orders or security transfer instructions prior to settlement, possibly including the netting of instructions and the establishment of final positions for settlement. Sometimes the term is used (imprecisely) to include settlement".
Clearstream, Euroclear	• The word “clear” in their names suggests that the ICSDs provide clearing services. One name previously used by Euroclear is “Euroclear Clearance System”.
Clearnet, Clearing 21	• The services offered/functions performed by a central counterparty.

Settlement

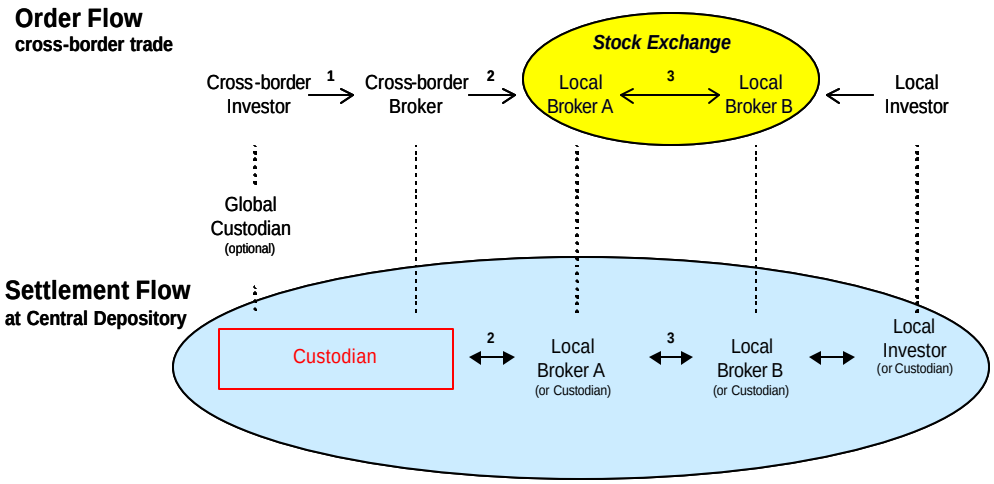
Used by	To mean
Market participants	• Exchange of securities and payment on terms agreed between buyer and seller.
Custodian banks	• Delivery or receipt of securities, which can be against payment or free of payment, as instructed by a client. • A custodian's "settlement" department would normally monitor clients' incoming instructions, transmit them to the CSD or sub-custodian, monitor pending instructions until securities have been successfully transferred to the counterparty as instructed, and report to the client the status of the transaction. In an "internal settlement" which involves moving securities positions between two client accounts, the required steps are still the same, except that if the securities are held in the same omnibus account at the CSD, the instruction does not need to go to the CSD. • A statement such as, "Custodians don't settle" means that custodians pass client instructions to the CSD, and it is the CSD which "settles" by transferring title. In this sense, custodians merely transmit data between client and CSD.
CSDs	• Transfer of securities from the account of one CSD member to another, as instructed by the respective account holders. • Depending on the CSD, securities movements may or may not be synchronised with (or conditional upon) payment, which occurs in the banking system.
Bank for International Settlements	• The completion of a transaction through final transfer of securities and funds between the buyer and the seller.
ESCB-CESR Working Group	• Transfer of title at a CSD. • The transfer of securities from one client to another on the books of a custodian, without requiring the transfer instructions being forwarded to the CSD, when both clients' holdings are kept in one omnibus account held by the custodian at the CSD.

"Internalisation" - Trade



- Trade internalisation involves a broker matching a buy and sell order from two customers, without putting the trade through to an exchange to find a counterparty for the customers.
- Some issues related to this practice are:
    - Transparency and investor protection: how the investors are assured of the "best" price, and whether a customer is given a choice of where his trade is executed.
    - Liquidity drain from organized exchanges: if a large volume of trades is done within brokers' books, the exchange can no longer claim to be the ultimate authority for price determination, and investors who wish to trade on the exchange has access to a less liquid market.
- A trade that is internalised does not mean that the settlement of that trade is also internalised. The customers of the broker could be using different settlement providers to settle the transaction.

"Internalisation" – (Book-entry) Settlement



- "Internalised settlement" or book-entry settlement requires:
    - Two parties to have selected the same custodian;
    - The custodian to maintain an omnibus account at the CSD where both clients' securities are held.
- As the custodian is not a party to the trade but only act on the instruction of the clients, transparency and investor protection issues do not arise.
- Whether market participants use the same or a different custodian, their legal rights to the securities are still the same – they hold securities indirectly through their custodian and must enforce their rights through the custodian.
- Market participants holding securities in their own accounts in the CSD generally (i.e., depending on the law applicable to the specific CSD) has different legal rights, as the CSD is the ultimate root of title.
- "Internalised settlement" performed by a custodian is of a different legal nature and involve different risks than the core settlement function of a CSD.
- Market participants tend to trade with different counterparties, each with different settlement service providers or arrangements. Book-entry settlement is not an elective option for the client or the custodian; it is incidental in nature.
- If the volume of book-entry settlement is large, the CSD's revenues and profitability can be impacted because there are fewer transactions to settle. There is no impact on stock exchange liquidity as this activity is independent from trading.

SECTION 4: DVP

DVP at CSD Level (Model 1)

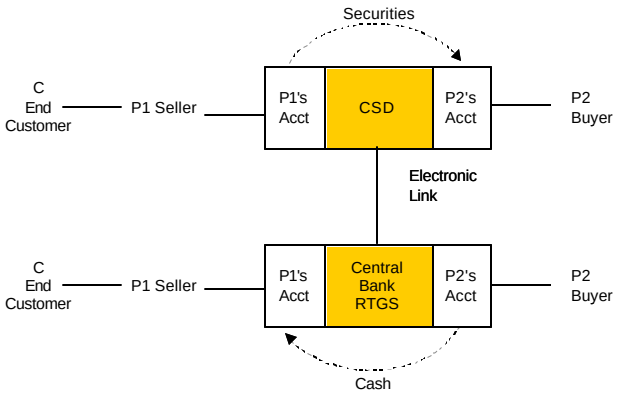
Although DVP is a simple concept it is very difficult to achieve in practice. There are both legal and operational barriers to achieving DVP:

- *Legal barriers* - the objective of finality and irrevocability run counter to national policy considerations behind the insolvency displacement and tracing rules that render transactions reversible in certain circumstances in the event of insolvency or fraud. The Settlement Finality Directive seeks to redress this risk within settlement systems.

- *Operational barriers* - real time simultaneous delivery of securities and payment of cash is dependent on robust and instantaneous electronic links between the relevant settlement and payment systems. In practice this is still difficult to achieve.

Standard 7, Key Element 4 stipulates that, "The length of time between the blocking of the securities and/or cash payment and the moment when deliveries become final should be minimized." The closest fit is DVP Model 1, which involves real time gross delivery and payment.

CSDs / Settlement Systems Adopting Model 1



But in practice DVP under Model 1 is dependent on:

- Both parties (P1, P2) being members of the CSD and having central bank accounts.

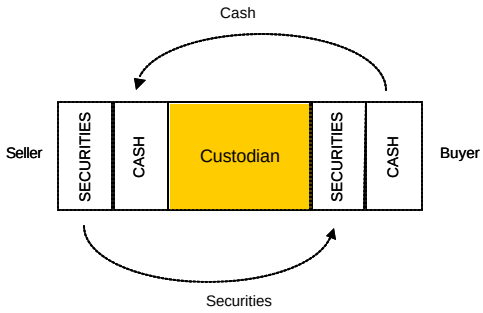
- The electronic link would have to effect instantaneous securities and cash transfers - very few, if any, capable of doing so.

- Where C is involved it doesn't get central bank money and takes the risk of its intermediary (P1)'s failure. Depending on the relevant jurisdiction, and the status of P1, C may get the benefit of client money rules or deposit guarantee schemes, as applicable.

“DVP” at Custodian Level

The operational barriers could be eliminated by the book-entry settlement in a custodian's books where it merely credits and debits the buyer and sellers cash and securities accounts. However, as set out below there are still legal barriers to achieving true DVP.

Book-entry Settlement at Custodian



In theory, “DVP” in a custodian’s books can effect simultaneous book-entry transfers of securities and cash.

BUT in practice:

- Seller and Buyer take risk of custodian failure after internal book-entry "DVP". Depending on the relevant jurisdiction, they may get the benefit of client money rules or deposit guarantee schemes, as applicable.
- Seller and Buyer generally take intra day risk of failure by their counterparty as custodians can't offer settlement finality.

SECTION 5: THE CONCEPTS OF ESSENTIAL FACILITIES AND DOMINANCE

1. The Difference between Systematically Important and Dominant

In this Section we will be developing arguments as to why we believe that it is appropriate to have certain Standards applicable to CSDs and CCPs, which we consider to be key market infrastructures (or in competition terminology "essential facilities"), while these particular Standards should not be imposed on custodians, who are subject to competition, regardless of how significant their market share may be in a particular market.

For a variety of reasons many aspects of financial markets are monopolistic and as such there are clear arguments why the existing monopoly infrastructures should be subject to *ex-ante* regulation. The same cannot be said for commercial entities that are subject to competition, regardless of the fact that certain of these commercial entities may be sufficiently important operators to raise a question as to whether they are systemically important, and should adhere to additional financial standards.

It is important to be clear that the concepts of "systemic importance" and "dominance" are completely different. The concept of systemic importance is intended to address financial concerns relating to capital reserves and risk management, and therefore is intended to designate those entities which have a high potential for endangering stability of markets or the financial system. Dominance on the other hand is a concept taken from competition law where there is a significant body of case law and Commission decisions that provides guidance as to which financial institutions could be caught by this concept.

Based on Article 82 of the EC Treaty (and equivalent national law provisions) the concept of dominance is notably applied in an *ex-post* analysis as to whether a particular entity has been abusing its dominant position. Furthermore, within dominance there is an increasing recognition in the jurisprudence that a distinction can be made between entities which may have an absolute monopoly, as in the case of essential facilities, and dominant enterprises which, although they may have some competitors, are not subject to effective competitive constraints. The concept of dominance is, however, not only limited to *ex-post* analysis but can be relevant in an *ex-ante* situation, such as under the EC Merger Regulation[5] to prevent the creation or strengthening of a dominant position through a merger or a joint venture and equally in certain industries where former national monopolies are being opened up to competition (e.g. under the *EU Telecoms Framework Directive*).[6]

The purpose of imposing *ex-ante* obligations on undertakings designated as having a dominant position (or in the case of telecoms "significant market power"), is to ensure that undertakings cannot use their market power either to restrict or distort competition on the relevant markets, or to leverage such market power onto adjacent markets. This

[5] Council Regulation 4064/89 of 21 December 1989 on the Control of Concentrations between Undertakings (as amended).

[6] Directive 2002/21/EC of the European Parliament and the Council of 7 March 2002 on a common regulatory framework for electronic communication networks and services (the Framework Directive), OJ L108/33 24/4/2002.

would be particularly relevant to the extent that commercial, for-profit, entities have acquired monopolies that were previously operated as public utilities but which may now be used to leverage their owners' revenues in other commercial areas that are subject to competition. These *ex-ante* obligations will therefore usually be a mixture of structural and behaviour obligations which focus on such matters as ensuring appropriate governance structures are in place; access and information. In other words the very issues dealt with by the Group's proposed Standard 13 (governance), Standard 14 (access), Standard 15 (efficiency) and Standard 17 (transparency).

Therefore, before imposing *ex-ante* regulation addressing dominance concerns on a variety of entities there needs to be greater understanding as to which entities are in fact dominant and should be regulated, particularly as over regulation can stifle competition and disincentivise companies from improving their products and services.

2. Establishing which Market Participants are Dominant in Clearing and Settlement Related Markets

(a) *The definition of dominance and essential facilities*

The European Court of Justice has defined a dominant position under Article 82 as:

> "…a position of economic strength enjoyed by an undertaking which enables it to hinder the maintenance of effective competition on the relevant market by allowing it to behave to an appreciable extent independently of its competitors and customers and ultimately of consumers"[7]

Important to note is the fact that Article 82 does not prohibit dominance as such, only the abuse of dominance, as the court of justice held in *Michelin*:

> "A finding that an undertaking has a dominant position is not in itself a recrimination but simply means that, irrespective of the reasons for which it has such a dominant position, the undertaking concerns has a special responsibility not to allow its conduct to impair genuine undistorted competition on the common market"[8]

We agree that certain clearing and settlement services are best carried out by a monopoly and in fact, in order to reduce costs, it would be better to consolidate the various national systems that exist (either through interoperability or mergers); but it is also necessary to ensure that once established these monopolies continue to have regard for the needs of their users and do not have an unfettered ability to increase fees or impose discriminatory access conditions.

Furthermore the European Commission and the Courts have defined the concept of an essential facility, where refusing to give access to an essential facility would amount to an abuse of a dominant position under Article 82. An essential facility has been defined as:

---

[7] Case 322/81 *Michelin v Commission* [1983] ECR 3461, paragraph 30.

[8] a bid paragraph 57.

"a facility or infrastructure, without access to which competitors cannot provide services to their customer."[9]

Under existing EU competition law, a product or service cannot be considered "necessary" or "essential" unless there is no real or potential substitute. What constitutes an essential facility will therefore depend upon the presence of technical, legal or even economic obstacles preventing the would be user of the facilities from competing in the relevant market[10]. This is clearly the case in relation to CSDs, given their unique role as the "root" of title to securities.

An undertaking which is in possession of an "essential facility" is by definition in a dominant position on any market for that facility, although the contrary is not always true (i.e. not all dominant entities are essential facilities). Quite apart from any existing regulatory differences the settlement and notarial services carried out by the CSDs are very different from the intermediary services offered by custodians. We believe this distinction is recognised by DG Competition as expressed in relation to its views on Clearstream, and we believe that their unique functions amount to essential facilities which need to be subject to *ex-ante* regulation.

(b) ***Main criteria for defining the relevant markets***

In order to determine whether an entity holds a dominant position or is an essential facility requires an assessment of what constitutes the relevant market, in order to assess whether there is any effective competitive constraints on the price-setting behaviour of the producer(s) or service provider(s) concerns. This therefore requires an analysis of the products that make up that market, and the assessment of the geographical scope of that market[11] (the terms "products" and "services" are used interchangeable in the context of this analysis).

In relation to financial services there have been various EC Commission decisions, notably under the EC Merger Regulation which have considered market definition in this sector and in broad terms have distinguished between three categories of activities: retail banking, wholesale banking and financial services related to the exchange.[12] In its decision relating to the merger between State Street Corporation and Deutsche Bank Global Securities, the Commission considered the provision of global custody services.[13]

Finally, the Commission is currently considering market definition in relation to settlement as part of its inquiry into Clearstream Banking AG. Clearing Banking AG is the German CSD which is owned by Clearstream International and now owned by

---

[9] *Sea Containers/Stena Sealink*, OJ 1994 L15/8, paragraph 66.

[10] Case C-7/97 *Oscar Bronner v Mediaprint* [1998] ECRI-7791 paragraph 44.

[11] See *Commission Notice on the Definition of the Relevant Market for the Purposes of Community Competition Law*, OJC 372 on 9/12/1997.

[12] Commission Decision of 11 April 1995 Case IV/M.573 *ING - Barings*; Commission Decision of 23 November 1995, Case IV/M.643 *CGER-Bank/SNCI*; Commission Decision 96/454/EC of 24 June 1996 Case IV/34.607, *BNP/Dresdner Bank*.

[13] Commission Decision of 16 January 2003, Case Comp/M.3027 *State Street Corporation/Deutsche Bank Global Securities*. This decision is discussed in more detail subsequently.

Deutsche Börse. The Commission's preliminary findings, set out in its Statement of Objections sent to Clearstream, takes the view that Clearstream Banking is the dominant supplier of clearing and settlement services for securities issued according to German law. Its reasoning is based on the following:

> "This dominance [of Clearstream Banking AG] stems from the fact that securities issued in accordance with German law in order to have those securities traded are issued in Clearstream Banking AG, the German central securities depositary. The clearing and settlement services provided by the issuers CSD for the securities that it safe-keeps must be distinguished from the processing of securities trades by financial intermediaries, such as banks. Intermediaries rely on being able to settle their trades with the Depositary where the securities have been issued."[14]

In other words the European Commission is making a distinction between primary clearing and settlement services, in which the CSD in question (the issuer CSD) has a dominant (monopoly) position which can be distinguished from the intermediary services provided by custodians. The Commission's objections regarding Clearstream banking relate to its refusal to supply clearing and settlement services and its discriminatory behaviour - in other words access issues which the ESCB-CESR Working Group is seeking to address with its Standard 14 and which would equally be easier to monitor any potential discriminatory behaviour by having greater transparency and better governance (issues addressed by Standards 17 and 13).

(c) ***Why CSDs are infrastructures which are essential facilities***

We believe that CSDs are legal or de facto monopolies and that, given their crucial role in the financial markets, they amount to essential facilities without which other financial institutions cannot operate in markets that are closely related.

According to settled European case law, the relevant product/service market comprises all those products or services that are sufficiently interchangeable or substitutable, not only in terms of their objective characteristics, by virtue of which they are particularly suitable by satisfying the constant needs of consumers, their prices or their intended use, but also in terms of the conditions of competition and/or the structure of supply and demand on the market in question. [15]

With CSDs, traditionally each national market in Europe has had its own monopoly CSD providing settlement and custody services, often by operation of law. One of the key functions of a National CSD is to provide ultimate root of title to the domestic equities, which is why it has always been necessary to have a single CSD to which the title can be traced, rather than having multiple registers where there would be a significant risk of

---

[14] Commission Press Release of 31 March 2003, *Commission raises competition concerns about the behaviour of Clearstream Banking AG*, IP/03/462.

[15] Case C-333/94 P, *Tetrapak v. Commission* [1996] ECR I-5951, paragraph 13. The test of sufficient substitutability or interchangeability was first laid down by the Court of Justice in Case 6/72, *Europemballage and Continental Can v. Commission*, [1973] ECR 215, paragraph 32 and Case 85/76, *Hoffman La-Roche v. Commission* [1979] ECR 461, paragraph 23.

discrepancy and errors arising. Given the current state of regulation and the fragmentation of the European market we would argue that the relevant geographic and product market is still defined on a national level such that, for example, Euroclear France has a monopoly position with regards to French equities, while CREST has a monopoly position in the UK with regards to UK equities. Although to a certain extent, at the time of making an investment decision, the option of purchasing a French or a UK equity may, for certain investors, mean these are competing products, once this investment decision has been made settlement in these equities can only take place in the domestic CSD (see also the Commission views on Clearstream quoted above in paragraph 2 (b). Dual listed equities can be settled in more than one CSD, but the securities are held ultimately in the home CSD.

We would therefore argue on the basis of existing regulation and electronic links that domestic CSDs have a monopoly in the relevant Member State in which they operate. This is the case despite the fact that, for example, several of the National CSDs have now been acquired by Euroclear given that for the moment they are still separate corporate entities subject to their national regulators. Moving forward Euroclear proposes to consolidate the various CSDs together with its ICSD into a Single Settlement Engine.[16] We would argue this is merely combining the various national monopolies to create a single commercial entity which has both a dominant position at a European level, in relation to cross border transactions, and various monopolies in relation to settlement of national equities. Therefore, rather than waiting for any potential abuses to arise it is therefore eminently sensible for regulators to consider *ex ante* regulation of CSDs in line with some of the Standards that are being recommended by the ESCB-CESR Working Group relating to governance, access and transparency.

(d) ***Why Custodians are not Dominant***

As the Group will be well aware, there are numerous financial institutions which provide their customers with a variety of services enabling them to settle their financial transactions (whether this is at a national or cross-border level). These services will include providing a large variety of different types of customers with access to CCPs and CSDs, as well as custody services in respect of financial instruments traded.

(i) ***The applicable market definitions***

In its decision on the *State Street Corporation/Deutsche Bank Global Securities* merger the European Commission had to consider what the relevant market was in relation to custody services provided by the parties. Whereas previously the Commission had discussed custody services as one relevant segment within the financial services of the banking sector overall, in this transaction it was called upon to consider whether a distinction should be made between global and domestic (or sub) custody services given that State Street was acquiring sole control of Deutsche Bank's global securities business, namely its sub-custody activities in mainland Europe, Asia and Latin America. The Commission therefore considered whether global custody should be defined as the service provided to investment entities which own or manage investments from a variety of international markets and whether domestic (or sub) custody services should be

[16] Euroclear's proposals.

defined (as proposed by the parties) to be those services provided to institutions and/or individual clients which require only "domestic assistance". Nevertheless the Commission noted that such delineation failed to take into account the fact that custody services are by their very nature services which are provided locally, at the location where the securities are held. It therefore stated that it felt:

> "global custody services may not therefore be clearly distinguishable from a collection of domestic custody services".[17]

Nevertheless, given that this particular merger did not raise any serious concerns the Commission did not have to rule definitively as to whether the relevant market was a series of domestic custody services or global custody services. Under either approach the Commission estimated that State Street and Deutsche Bank's combined market shares were around [15-25%] and that its three main competitors, JP Morgan Chase, The Bank of New York and Citibank NA had between [10-20%] market shares under either approach[18]. Therefore the Commission noted:

> "Such figures clearly indicate that no single dominant position can arise from this transaction, and this has been confirmed by market investigation, as all three competitors are credible alternatives to the parties and switching of custody supplier is easy."[19]

Albeit in a merger context the European Commission has therefore very clearly ruled that in relation to custody services the major banks that provide both global custody services and sub-custodian services are subject to competition and there is no single firm that has dominance as there exist credible alternatives and customers can switch. Custodians therefore do not have either a legal or de facto monopoly. Indeed given that all custodians are subject to EU harmonised financial regulations the legal environment ensures that there is a level playing field for competitors to operate in when offering custodian services as banks.

(ii) ***Competitive constraints that apply to Custodians***

Given the availability of competitive alternatives, both from existing custodians offering either global or sub-custodian services currently in the various markets, and the fact that entry barriers for custodians who are not active in a particular national market are generally low, we believe that it is wrong for the Group to propose that some of its standards apply to "custodians with a dominant position" given that it is highly unlikely that any custodian would have a de facto dominant position. Should any custodian acquire dominance as a result of further consolidation in a market, we believe it would be more appropriate for the creation of such dominance to be dealt with at the time of such a transaction under the applicable merger control laws.

---

[17] Paragraph 10 of the Commission decision of 16 January 2003, Case COMP/M.3027 - *State Street Corporation/Deutschebank Global Securities*.

[18] For reasons of confidentiality only a market share range was provided in the published decision.

[19] Idem paragraph 17.

Many of the custodians' clients will be financial institutions who are not able to access the CSD directly because they do not meet that entity's membership criteria, or it may be that they outsource securities operations to a custodian to achieve higher efficiency, or it may be that carry out an insufficient volume of trades which require CSD services and they therefore choose not to apply for membership of the relevant CSD but rather use the services of a custodian as and when required.

In order to provide their intermediary services, the custodians or agent banks will typically be members of the National CSD. Membership of these entities means that the custodians have satisfied that relevant entity that they meet the membership criteria, which usually impose stringent financial and operational requirements, as well as having the necessary connectivity and accounts with those institutions. As such the custodians are already subject to significant prudential regulation.

While it is true that in relation to certain product and/or geographic markets there may be custodians that have a significant share of national business - in that at present they carry out intermediary services for a significant proportion of the trades settled in a National CSD - this does not mean that these custodians are in a dominant position. As seen from the quote above, a custodian bank would only be dominant if it could actually act independently of its customers (in this instance investors and other sub-custodians) and its suppliers (the relevant CSD). This is clearly unlikely to be the case.

(iii) ***A custodian cannot act independently of its customers***

In relation to customers, some of these customers will be custodians themselves who do not have membership of a particular CSD - despite the fact that they may well have membership of other National CSDs. As regulated financial institutions it is therefore highly likely that, if they so desired, they could easily become members of a particular CSD. Other customers will include major investors who may equally be members of certain national infrastructures, but not others and who choose to instruct a custodian to act as their intermediary. Clearly it is highly unlikely that any custodian would be in a position to act independently of either of these categories of customers given that these customers have alternative means with which to access a CSD. In first instance there are numerous other custodians that are equally members of the CSDs that can, and do offer the same intermediary services to these customers (who exactly these custodians are will depend to a certain extent from market to market). Equally, as indicated, many of these customers are already members themselves of certain infrastructure entities in particular Member States and therefore is quite conceivable that they could meet, relatively easily, the membership requirements of the relevant CSD for which a custodian currently provides them intermediary services.

(iv) ***A custodian cannot act independently of its suppliers***

Equally custodians, such as Citigroup, cannot act independently of the CSDs in those markets for which it provides intermediary services. Given the special function of CSDs, which is to provide the ultimate root of title to securities, no custodian can offer intermediary services without being a member of the relevant CSD.

(v) ***"Internal Settlement" by Custodians***

There seems to be a perception that merely because custodian banks could be described loosely as carrying out some "internal settlement services" they operate in the same market as CSDs. EU competition law makes it clear that products or services which are only to a small, relative degree interchangeable with each other do **not** form part of the same market.[20]

The Standards refer to the fact that some custodians:

> "have their own settlement infrastructure for their clients and networks of sub-custodians, allowing them to clear and settle transactions in house (internal settlement) rather than having to forward them directly to the local or foreign clearing and settlement systems".[21]

It is true that on an incidental basis, when it happens to be that both counterparties to a particular trade are a custodian's clients, then the particular custodian can settle the trade through its own in-house book-entry settlement. Clearly given that this book-entry settlement is very much on an incidental basis, arising out of circumstances over which a custodian would have no control (given that an investor does not determine what products or with whom he trades with depending on whether counterparty happens to also be a client of his custodian), this is not actually a settlement services which is provided as an alternative to settling through a National CSD, nor would the possibility of book-entry settlement taking place exercise any competitive constraint on the activities of the CSDs.

Secondly, although the book-entry settlement can happen across the books of the relevant custodian and not be reflected by any entries in the CSD, this can only be done in those jurisdictions where the National CSD allows custodians to have an omnibus account. The rules of the CSD dictate what a custodian can or cannot do in this regard. If all custodians were to segregate holdings at client level at the CSD so that no book-entry settlement between customers would happen without a corresponding entry in the CSD's books, such an arrangement may not be readily offered by the CSD at a reasonable cost, due to capacity, information processing, operations and other constraints.

3. Conclusions: Ex-ante Regulation for Essential Infrastructures only

Citigroup agrees with the need to have the Standards relating to such important issues as access, governance and transparency, but feels that these are only appropriate when applied to entities that are essential facilities given that they are not subject to the normal competitive market dynamics which might otherwise ensure that they operate in a fair and transparent manner. We, therefore, welcome *ex-ante* regulation for CSDs, and, in

---

[20] Case C-333/94 P, *Tetrapak v. Commission* [1996] ECR I-5951, paragraph 13 and Case 66/86, *Ahmed Saeed* [1989] ECR 803, paragraphs 39 and 40. In Tetrapak, the Court confirmed that the fact that demand for aseptic and non-aseptic cartons used for packaging fruit juice was marginal and stable over time relative to the demand for cartons used for packaging milk was evidence of very little interchangeability between the milk and non-milk packaging sector, idem, paragraphs 13 and 15.

[21] Paragraph 11 of the Standards.

their Eurobond ICSD capacity for Euroclear Bank and Clearstream Bank (but not in relation to their intermediary services).

Ex-ante regulation should not, however, apply to custodian banks who provide intermediary services (i.e. access to the various essential facilities). Custodians do not have a legal or de facto monopoly on any of the services they provide in Europe; therefore, they are clearly not essential facilities. Equally, individual banks are highly unlikely to have a dominant position in relation to intermediary services related to any clearing and settlement markets. In all markets custodians are subject to competition from other existing custodians, potential entrants, intermediary services provided by CSDs, and equally from existing customers who could seek to access the CSD(s) directly.

Even if a particular custodian bank is a market leader in a Member State, or if one were to become a market leader, we doubt that as the market is currently structured, they could be found to have a dominant position. As such it would be wholly inappropriate to impose *ex-ante* regulation of custodian banks. Custodian banks are already subject to considerable financial regulation as financial credit institutions. This is based on harmonised EU legislation which not only ensures there are sufficient financial safeguards, but also ensures that there is a level playing field in terms of the restrictions under which all custodians offer their services. Within the ambit of their regulatory requirements custodians offer competitive services to a variety of customers.

So long as there is competition in intermediary services, custodian banks should not be subject to *ex-ante* regulation. If markets were at some future date to become anti-competitive, it would be given to market participants and/or regulators to take ex-post measures under competition law to stop such behaviour, i.e. private action in the national courts and/or complaints to the EC Commission or national competition authorities.