Madrid, 30th of October 2003

IBERCLEAR's views on the ECB-CESR consultative report on

"*Standards For Securities Clearing And Settlement Systems In The European Union.*"

First of all, IBERCLEAR welcomes the report as an impressive task in adapting the very general recommendations stemming from the CPSS-IOSCO report. The latter was a report focussing on worldwide systems. As a result, the CPSS-IOSCO report had to be very broad based so as to encompass those systems of developing countries.

The European Union systems, due to the development already achieved, needed a more exigent and restrictive report. We also welcome the intention to implement standards and not only recommendations.

We also agree with the idea of following a functional approach for risk mitigation purposes instead of the traditional institutional approach followed in the past. In relation to this, we agree with the answers given by the ECSDA to the specific questions concerning the scope of the standards. However, we disagree with this view when addressing competitive issues.

We would like to supplement the comments already made by the ECSDA, with whom, generally speaking, Iberclear agrees. From our point of view, the ECB-CESR report deals with risk issues as well as competition issues, although their own report states that only risks are tackled. We do not share this opinion. IBERCLEAR believes that the ECB-CESR report also tackles competition issues for which the final model of the "CSD business" is the main issue at stake. As a matter of fact, the ECB-CESR report mentions as an objective: "Point 4 - To promote the competitiveness of European markets by fostering efficient structures and market-led responses to developments".

In our view, competitiveness between the efficient structures requires a level playing field among them that, at present, does not exist. In order to achieve the desirable level playing field, we only see two possibilities: (i) either to harmonise all players, which will mean they all acquire "banking" status and compete against each other along the entire value chain of post-trading activities; or (ii) to define the different functions along the value chain and establish a specific level playing field for each specific function. We will return to this point later on.

Firstly, the European Union has started down a completely new road with regards to the central registering, clearing and settlement business. Traditionally, this sensitive sector has

been regulated by following a restricted institutional approach, an approach which has been implemented, not only in the USA but all over the world.

On the other hand, at this point, we have to recognise that the situation in Europe is not at all comparable to the American one. In Europe, there are two ICSDs that do not exist in any other part of the world. ICSDs have a two-fold role: a traditional CSD role for international securities (and since 1999, as a result of purchasing various national CSDs extended their roles and influence domestically). But at the same time, ICSDs have an intermediary role for those markets all around the world for which they do not control the traditional CSDs. This intermediary role is very close to that of the agent bank role and, indeed, ICSDs compete with agent banks for the cross-border transactions.

Additionally, there are many different CSDs in the European Union owing to history and differences still in place due to legal, tax and market practices issues.

Secondly, we can count the different players in the European settlement field:

1. CSDs: most of them not allowed to bear credit risks even though some of them were banks (but very limited in their banking services).

2. ICSDs: two-fold role as we explained earlier.

3. Agent banks.

The ECB-CESR report follows a functional approach for risk issues as well as for competition. We can understand the functional approach from the perspective of risk and consequently we fully support the ECB-CESR approach in extending most of the standards, not only to securities settlement systems, but also to systemically important institutions (i.e. the scope of the standards).

We acknowledge the US regulators initiative. The American regulators define "core clearing and settlement organisations" as firms that play a "significant role in financial markets". However, American regulators only apply these terms to risk issues, following a strict institutional approach as far as infrastructural issues are concerned (i.e. the DTCC as the unique clearing and settlement institution, while agent and custodian banks compete for the non-core activities of this business).

Thirdly, the functional approach which is applied to infrastructural issues (e.g. governance, competition, supervision…) could have two very different interpretations as we have explained earlier:

1. The interpretation that all players included in the settlement field should compete on a level playing field. This would imply that the three groups of different players would therefore need to be regulated, controlled and supervised in the same way. Standard number 9 appears to follow this interpretation.

2. The alternative version is that the functional approach must separate core services from non-core services (i.e. value added services) and regulate, control and supervise them both differently. Standard number 6 seems to follow this alternative interpretation.

Fourthly, in our opinion, the ECB-CESR report tries to reach a state of equilibrium between the two former interpretations. This could result in further confusion concerning the final model of the EU's ultimate settlement and central registering businesses which would need to be implemented in Europe.

1. From our standpoint, the first interpretation would need us to regulate CSDs, ICSDs and agent banks exactly in the same way, with the same limits and supervisors, and would result in the following consequences:

    a) Forcing all players (CSDs, ICSDs and agent banks) to be banks and to compete amongst each other for all services along the settlement activities value chain.

    b) Opening the current monopolistic business to free competition between CSDs, ICSDs and agent banks not only for value added activities but also for core activities.

    c) If all players were banks (see point "a" above), this would imply that all players would be under the control of the banking supervisor in those countries (such Spain) in which supervisors are currently split.

    d) Granting EU membership to all players, including CSDs, which are currently not entitled to it.

2. The functional approach, understood as regulating core and value added functions separately, is consistent with the regulation followed in other financial markets such as banking activities and insurance companies. As we understand the situation, banking activities are regulated following a functional approach (the function of taking deposits) and why the institutions allowed to enter into this sector must be credit institutions specifically regulated as such. This permits not only commercial banks, but also saving banks, cooperative banks and other cooperative credit institutions to compete openly and fully between each other.

    This alternative interpretation applied to core settlement activities would not lead us necessarily to a monopoly provided that it is not limited to offer these services exclusively to the current national CSDs in terms of their national securities. There could be other CSDs competing for the same securities with other CSDs or even other companies entering into this sector to compete against the traditional CSDs (being ICSDs buying CSDs or even agent banks creating CSDs companies or buying

existing CSDs). The only prerequisite for allowing competition is the removal of barriers to entry which would lead to systems being interoperable.

The value added function must therefore be one of open competition amongst players with "banking" status (be it ICSDs or agent banks). The level playing field in this instance must be fully respected by, for example, establishing an independent, reliable and safe core infrastructure.

To sum up, our interpretation of the functional approach is that core services must be regulated separately from value added services. We support the view that core services must be offered by institutions on the basis of equality. We therefore advocate a "CSD" status that could theoretically be obtained by any player (i.e. current CSDs, ICSDs or agent banks). However, once an institution is given the "CSD" status, strict regulation and control must be applied to all of them in order to maintain the necessary state of equilibrium – that of the level playing field.

From our interpretation, Standard number 6 could be considered logical. "As CSDs are the only place where ultimate settlement occurs for immobilised/dematerialised securities, they should avoid taking risks to the greatest practicable extent". This should be applicable for any institution having a "CSD" status.

Also, we believe that core activities must be able to cover widest framework possible to the point where the boundary, which distinguishes banking activities, meets that of the value added activities. We can cite some core activities mentioned in the ECB-CESR report such as the central recording of the amount of each security issued by the issuer, facilitating the exercise of securities holders' rights and corporate actions by connecting issuers and investors (through intermediaries), ultimate settlement agent… We would also like to add a very important activity such as settlement in central bank money for domestic transactions as well as highlight the registering or notary function of the CSDs.

Also, we fully endorse the view that "the risks involved in offering CCP services are particularly difficult to manage and therefore require exceptionally high levels of risk management that may even necessitate separating the CCP services into a distinct legal entity". Here, the report follows our understanding of a functional approach. Our only thought is that maybe this approach could also be deemed necessary as far as value added activities are concerned.

Eventually, the three different functions (i.e. core settlement activities, value added services and CCP services) could coexist inside a holding company. The DTCC could be the model for separating CCP and CSD functions, although there is a clear risk of contagion among firms within the same group (i.e. "the so-called piercing of the veil" principle).

This interpretation could also lead to the tackling of post-trading risks stemming from three different functions: 1.) from central counterparty clearing function (i.e. addressed to

institution with the CCP status), 2.) from value added services in the settlement field (i.e. addressed to ICSDs and agent banks) and 3.) from ultimate settlement and central registering services (i.e. addressed to institutions with CSD status).