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VP's response to the ESCB/CESR consultative report on Standards for Securities Clearing and Settlement Systems in the European Union.

VP welcomes the publication of the ESCB/CESR Consultative Report: "Standards for Securities Clearing and Settlement Systems in the European Union" and hereby sends its comments focusing on specific areas in the report.

VP has some initial and overall concerns which by way of introduction are stated as initials remarks after which VPs comments to the questions raised in the additional paper "The Scope of application of the ESCB-CESR standards" and VP's comment to some of the standards follows.

Initial remarks

It is of particular concern to VP that these standards will not be just another regulatory set of standards imposed on CSDs alongside with standard such as the existing CPSS-IOSCO standards and standards imposed on CSDs by ECB. In VPs opinion the ESCB-CESR standards should be drafted in such a way that they are able to replace those other standards and should not be supported by additional standards. The one CSD regulating standard.

In overall it is also of concern to VP how it will be secured that these standards will be consistently implemented across Europe since this will only be secured by the interpretation of the national regulators and not by any supranational authority. Regulatory consistency is essential to deliver a single European capital marked.

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The scope of the standards

In regard to the questions raised in the additional paper "The Scope of application of the ESCB-CESR standards" issued by ESCB/CESR, VP comments are set out below.

Should the extension be to all custodians, or should it be limited to systemically important providers of securities clearing and settlement services?

The marked for securities settlement services in Europe is complex. In many European markets local agent banks function as intermediaries providing clearing and settlement services for participants and the volume of internalized trades could grow further following the latest text of the Investment Service Directive.
The market has become very focused on cross-border settlement activities and since the introduction of the euro in 1999 the need for market participant to have access to settlement services across Europe have pronounced. Also the marked demands a more integrated service offering for both domestic and cross-border transactions and the environment for settlement service providers has become much competitive.

The fact that different providers offer the same settlement services and the fact that the marked has grown highly competitive indorses for the same regulation - directed towards regulating settlement services - to apply to all those providers that offer the same settlement services. If this was not the case it would create the likelihood of regulatory arbitrage between such providers and the purpose of the regulation then seems to be missed. The end-investor will have as much interest in being protected against the failure of the participant – working as an intermediary and offering settlement services – as against the CSD offering the same kind of services. The functional approach therefore is the most suitable instrument for risk mitigation in Europe regulating those providers that offers the same services.

It is therefore VP's principal opinion that the ESCB/CESR standards should apply in the same manner to all entities that provide securities clearing and settlement services and it should not just apply to CSD's – in other words a functional approach is in the opinion of VP the right way. However, it is not VP's opinion that the standards should apply to all entities regardless of the amount of services provided. The standards only need to apply to those institutions who pose a significant risk to the functioning of the financial markets either domestically or on a cross-border basis.

This approach is also completely in line with the approach chosen by the three US Regulators for strengthening the resilience of critical financial markets and for minimizing the systemic effects of a wide scale disruption in post 11th environment (Interagency Paper on sound Practices to Strengthen the Resilience of the U.S. Financial System).

What are the criteria along which the systemically important system could be defined? What would you consider to be the essential elements that should be apart of such a definition?

The criteria's mentioned in the ESCB/CESR paper seems accurate and relevant (magnitude of the activities, number of linked systems, nature of number of the custodians clients, the possibility of being replaced in the case of failure). The judgment based hereon should be made by the national regulators.

Do you agree that systemically important providers could be defined as institutions with a business share of [5%] at EU level or [25%] at domestic level (or lower, at the discretion of the national authorities) in each relevant marked?

Using such thresholds requires the regulators to define accurately the relevant market against which they are measuring an institution. It is VP's opinion that such a threshold should be defined, at the discretion of the national authorities having a more in debt knowledge of the relevant market.

Do you agree that three relevant markets can be considered – bonds, equities and derivatives?

This might be the case, but it must – as the previous question – be decided by the national authorities.

Which of the ESCB/CESR standards should apply to all systemically custodians?

First, the ESCB/CESR papers use three different phrases to describe players in the market;

1. systemically important custodians
2. systemically important providers of securities clearing and settlement services, and
3. custodians with a dominant position

However, little clarity is provided in defining these phrases or in giving examples of institutions which might fall in to each categorisation. VP assume that some agent banks may fall into all of the above categories, but that CSDs and ICSDs at least fall into the second category. VP also assume that all custodians with a dominant position will be systemically important, but that not all systemically important custodians will necessarily occupy a dominant position. VP would urge ESCB/CESR, in its final report to provide examples in this area and to specify precisely the standards which would apply to each category. VP would also ask the ESCB/CESR to leave questions of market dominance to the relevant competition authorities.

VP believes that the main aim of the standards – and the reason why they were extended to other systemically important custodians – is to avoid systemic risk and to enhance the safety, soundness and efficiency of securities clearing and settlement in Europe. Consequently, VP believes that the standards should be re-focused on this core objective.

In principle VP believe that the standards in all should be applied to commercial custodians. However, in the case that this result is not feasible or practical obtainable, we believe that the focus at least must be on those standards which do most to reduce risk. Consequently, the following standards, at least, should also apply to "systemically important providers of securities clearing and settlement";

- Standard 1 – a sound legal framework is essential for all providers of services to end –clients, not just systemically important institutions.

- Standard 2 – as the provider of services to end-clients, custodians are in a position to influence the timeliness of their clients confirming trades, and to facilitate central matching of market bargains.

- Standard 3 – custodians should clearly have to manage any move to shorter settlement cycles.

- Standard 5 – custodians should ensure that their arrangements for securities lending are sound, safe and efficient.

- Standard 9 – custodians should employ robust risk mitigation measures when extending credit for settlement purposes. While full collateralisation may be the preferable way for addressing counterparty risks, the ESCB-CESR standards should also consider additional

measures to manage those risks when full collateralisation is not possible.

- Standard 10 – custodians should take steps to protect their customers from potential losses and liquidity pressures arising from the failure of the cash settlement agent (usually the custodian itself).

- Standard 11 – VP believes that operational risks are the greatest threat to systemic stability, and that systemically important custodians should also meet the same robust standards as employed by CSDs and ICSDs. Basle II does not cover the specific risks which are involved in clearing and settlement.

- Standard 12 – VP agrees that systemically important custodians should protect customers' securities against the claims of entities in the custody chain

- Standard 15 – VP notes that, as currently drafted, this standard on efficiency should only apply to custodians with a dominant position. VP believes that all systemically important custodians should focus on cost effective settlement services.

- Standard 16 – VP believes that this standard should be explicitly applied to all systemically important custodians.

What would be the implications of extending the scope of the standards to cover systemically important providers of securities clearing and settlement services?

VP believes that, if applied and implemented consistently and simultaneously across all providers of systemically important settlement services, the implications of extending the standards will be:

- a reduction in systemic risk across European markets;
- a higher level of transparency across all such providers of settlement services; and
- a consistent and level regulatory playing field.

Comments to some of the proposed standards

Standard 1 Legal framework

In regard to standard 1 it should be noted, that the recommendation that the law governing the system and the law governing the contractual aspect

of the relationship with participants should be identical. This appears contrary to the possibility of the free choice of the law governing a contract which is expressly provided by the Rome Convention and also recognized by The Hague Convention.

Standard 4 CCPs
It should be recommended that ESCB awaits the publication of the forthcoming CPSS-IOSCO standards on CCPs before reviewing this standard

Standard 6 Central Securities Depositories
The way standard 6 is currently drafted gives rise to concerns in the way that it seems to reflect the view that CSDs should not take risks in any of their functions. This does not seem to be coherent with choice of introducing a risk based functional approach to the regulation of settlement activity. In VPs opinion regulators should work with each provider of settlement services to ensure that the risk of any existing or potential business activities are adequately controlled and mitigated. This principle should apply to all providers of settlement services – and not only CSDs – according to the functional approach in order to mitigate risk where relevant, to obtain a level playing field and not erode risk mitigation by creating the possibility for regulatory arbitrage between providers of settlement services.

The request to avoid taking risk to the greatest possible extend may not be achievable since all CSDs are exposed to operational risk, and are also exposed to an element of custody and legal risk in the cross-border services which they offer their customers. Regulators should be vigilant that the risks taken are commensurate with the management expertise of, and the capital held by the CSD, but they should not seek to exclude risk.

In paragraph 78 it is said that CSDs are required to have plans prepared to allow market participants access to CSD services even if the CSD becomes insolvent. It seems very unclear to VP what is meant hereby. If it hereby is suggested that each CSD should place a guarantee that access is possible in the event of insolvency this does not seem practicable since the economical consequences of this is enormous which would be shared by the participants of the system. Also there seems to be a contradiction with national insolvency law whereby liquidator might not be bound by any such guaranty. The system will be operative also in the event of insolvency and liquidator may choose to continue the operation of the system if legally possible.

However, to ensure access in the event of insolvency it requires coordination with national authorities in order also to ensure the legal possibility of access in the case of insolvency. One way forward might be to coordinate plans

with the national authorities who could be granted the right - in a direct or more indirect way – to replace the operator of the system in a temporary period until a future solution were to be settled.

Standard 11 Operational reliability

It is especially important that this standard also apply to custodians that operate systemically important systems. VP is of the opinion that financially stability is particular depending on risk mitigation of operational incidents caused by either internal or external treats. Consequently, ESCB/CESR should focus on the consistent application of standard 11 across marked for settlement services also bearing in mind that Basel II does not cover systemic risks from the settlement process, but focuses on operational risks and the capital required to support them.

Standard 12 Protection of customer's securities

VP believes that client's assets should always be segregated from proprietary assets. It is also VPs opinion that segregation between each client's assets, in principle, is the best and most safe way to protect client's assets from others insolvency – single investor accounts. However, VP recognizes that the underlying legal framework in each member state is of the most importance when assessing how each customer's securities are protected when held ultimately in a CSD.

Requiring segregation upstream throughout a custody chain may run contrary to the PRIMA principle as adopted in several EU instruments and in the Hague convention. In a relayed link securities are held with the Issuer CSD for Middle CSD who in turn maintains a securities account for the investor CSD. Requiring segregation on the level of the Issuer CSD between holdings of the investor CSD and the Middle CSD would be in contradiction with the principle that the law applicable to proprietary aspects of securities holdings is the law of the relevant intermediary.

Standard 14 Access

There seem to be an inconsistency between this standard and Article 32 of the Investment Services Directive. This standard permits denial of access on the ground of "risk control" whereas the ISD states that access can be refused on "legitimate commercial grounds". In VP's opinion there should be consistency between the two.

Med venlig hilsen
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