Citigroup Response to

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

October, 2003

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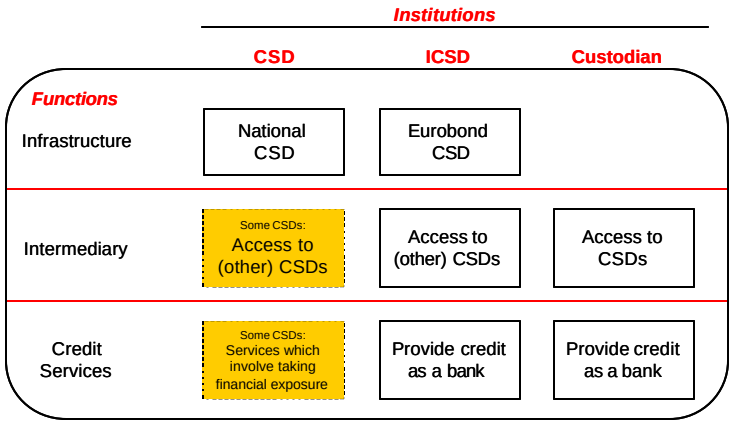
Executive Summary

Citigroup is active in the business of providing securities services for clients in all EU Member States and over 70 markets worldwide. As custodian, our clients include institutional investors, corporations, broker dealers, global custodians, international central securities depositories ("ICSDs") and national central securities depositories ("CSDs").

Citigroup welcomes the ESCB-CESR Consultative Report on Standards for Securities Clearing and Settlement Systems in the EU as a valuable and constructive step forward in promoting the safety and uniformity of the infrastructure underpinning securities clearing and settlement in Europe. In particular, Citigroup welcomes the Standards for harmonising regulation of essential settlement infrastructures such as CSDs.

Functional approach. The effectiveness of a risk-based functional approach to regulation hinges upon the selection of the most appropriate "functions" that will enable achievement of the desired objectives. We believe a functional distinction between infrastructure and intermediary is better able to achieve the objectives of a risk-based regulatory approach. In addition, since the Standards provide for credit risk-taking by infrastructures, it is essential that services which can involve financial exposure also become a relevant "function" for risk-based regulatory purposes:

Relevant Functions for Risk-based Regulation



"Systemically Important" and "Dominant" Custodians Citigroup has serious concerns about the inclusion of "systemically important" and "dominant" custodians within the scope of the Standards as if they were themselves infrastructures.

The Standards broadly divide into three categories: market recommendations; Standards applicable because of a perceived systemic threat; and Standards applicable because of a monopoly position. In the latter two categories, a distinction should be drawn between custodians and infrastructures:

- Citigroup considers that the existing regulatory framework for custodians already represents adequate protection to investors and market stability against systemic threat posed by custodians. Citigroup welcomes the Standards as bringing operators of market infrastructure up to the same level of rigour.

- Citigroup also considers that the existing EU competition law framework provides adequate protection for consumers in the field of intermediary services. Citigroup welcomes the Standards as recognising that market infrastructures, as essential facilities, require an ex-ante regulatory framework to assure market users (including intermediaries) that such infrastructures cannot abuse their position.

To include custodians within the scope of the Standards but not other segments of intermediaries seems unjustified. Even where intermediaries have large market share, there is no automatic implication that such intermediaries are inadequately regulated, or pose a systemic threat, or are competing unfairly. Such issues are already tackled under the existing regulatory framework.

Moreover, there would be dangers if providers other than operators of essential market infrastructure were designated as "systemically important", including moral hazard and the creation of conditions which could make certain providers unable to compete. This will result in reduced competition and a higher concentration of risk.

Internalised Settlement and Systems Citigroup believes that grouping of custodians alongside infrastructures is based on certain misconceptions as to the functions carried out by different participants in the settlement process, as the same term could carry very different meanings. Specifically:

- "**Internalised settlement**" or book-entry settlement carried out by custodians is perceived as the same as title transfer functions of CSDs, when it is not. Title transfer can ultimately take place only at the level of a CSD; custodians as intermediaries cannot offer finality in the same way. Investors cannot choose to "settle" across the books of a custodian instead of using the CSD. "Internalised settlement" is not a service which is provided as an alternative to settling through a National CSD. Settlement by a custodian on its books should not give rise to greater systemic risk concerns than other activities undertaken by a bank or where a custodian uses segregated accounts at the CSD. See Supporting Document Section 1 for an overview of intermediary functions of a custodian; Supporting Document Section 2 on the legal nature of "settlement" offered by CSDs and custodians; Supporting Document Section 3 for examples of the different meanings of "clearing", "settlement" and "internalisation" which have no doubt caused significant confusion.

- Custodians are somehow perceived as operating "**systems**" for the settlement of transactions in securities, when they are not. The only "systems" involved in securities clearing and settlement are the CCPs and the CSDs across which ultimately all changes of title to securities must take place.

  The suggestion that custodians could be "system operators" may stem from the role of ICSDs which have two functions: (i) an infrastructure for the Eurobond market; and (ii) an intermediary for certain types of non-Eurobond securities where there could also be a significant volume of book-entry settlement. Because ICSDs do both these activities it is easy (but wrong) to conclude that all book-entry transfers are associated with the risks of CSDs.

In conclusion, we consider that the Standards should acknowledge that custodians have a different role in clearing and settlement from that of infrastructures, and that the Standards should apply only to infrastructures.

Citigroup is very willing to discuss or clarify any aspect of this response, and would welcome an opportunity to participate in the final formulation of the Standards.

Response

1. INTRODUCTION

The Working Group (the "**Group**") established by the European Central Bank ("**ECB**") and the Committee of European Securities Regulators ("**CESR**") published its Consultative Report on the Standards for Securities Clearing and Settlement Systems in the European Union in August 2003 (the "**Report**"). The Report sets out proposed standards (the "**Standards**") on a risk-based functional approach, to apply "to all relevant functions related to securities clearing and settlement business, without regard to the legal status of the institutions concerned"[1]. A second document, The Scope of Application of the ESCB-CESR Standards (the "**Scope**") explains the proposed extension of certain Standards beyond CSDs[2] and CCPs to encompass custodian banks.

This paper sets out Citigroup's[3] response on the general regulatory approach, the application of certain Standards to custodians, and the details of the Standards.

This paper does not comment on the application of Standards to CCPs.

2. A "FUNCTIONAL APPROACH" TO REGULATION REQUIRES AN APPROPRIATE DEFINITION OF THE RELEVANT FUNCTIONS

A starting point for any discussion on the functional regulation of service providers is clarity about the structure of the industry and the roles of the key players: infrastructures (such as CSDs) and intermediaries (such as custodians).

2.1 Infrastructures

CSDs are institutions which were primarily set up to immobilise physical securities or dematerialise them so that transfer of ownership between securities holders can be efficiently achieved by electronic book entries for an entire market ("**securities settlement system**"). CSDs are the "public notaries" for securities. They have often been considered as semi-public entities whose status was defined by legislation, and typically (although not always) were non-profit entities. The entries in the names of an account holder on a CSD's electronic system have become the definitive record of title.

Settlement of domestic securities, like trading and clearing, has historically been organised on a national basis, with a single CSD ("**National CSD**")[4]. All market participants have to settle their securities ultimately at the National CSD. There is no national market where competing entities have been set up to be CSDs for the same

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[1] Consultative Report, Paragraph 4.

[2] Consistent with the Report and Scope, the term CSDs in this paper covers both National CSDs and international CSDs.

[3] Citibank, N.A. and Citibank International plc.

[4] Sometimes multiple CSDs are set up for different securities types, e.g. equities versus fixed income. However, each security would belong to only one CSD. The only exception is Eurobonds, where each issue belongs to both ICSDs.

securities. CSDs can therefore be considered a key infrastructure and a natural national monopoly, vital to the European financial markets.

Despite the systemic importance of CSDs, no EU-wide regulation exists today. CSDs do not in fact perform an activity falling within the scope of the mandatory regulation under the Consolidated Credit Institutions Directive ("**CCID**")[5] or the Investment Services ("**ISD**")[6]. Some Member States may have imposed stringent national requirements on CSDs, but there is a wide variety of regulatory categories, each with different requirements as to capital adequacy, risk management, standards of governance and restrictions on controllers. In some countries (such as the UK) a system can choose between a variety of possible regulatory treatments[7].

CSDs would in many cases be subject to the Lamfalussy "Minimum Standards For Netting Systems"[8] and, depending on the nature of their services, the standards for the use of EU securities settlement systems in European System of Central Banks (ESCB) credit operations, set out in the European Monetary Institute's 1998 paper on the EMI Standards ("**EMI standards**")[9].

Unfortunately these arrangements, while useful, are not applied on a uniform basis and are not legally imperative under the current EU legislative framework. A more solid and uniform EU wide regime for managing the risks is desirable.

In respect of counterparty risk arising from activities permitted by the Standards, such as securities lending and credit extension, CSDs are not subject to any uniform EU regulatory regime. We believe it is appropriate for the Standards, and in accordance with a "functional approach", to impose regulatory requirements on CSDs in respect of their credit-extension activities which, if undertaken in conjunction with any other regulated activity, would require that entity to be subject to the regulatory requirements applicable to banks or investment firms under the CCID or ISD.

2.2 Intermediaries

Custodian banks (such as Citigroup) originally provided physical safekeeping ("custody") and asset administration services (such as dividend collection) for their clients' securities certificates held in vaults. Since the immobilization or

[5] Directive 2000/12/EC of the European Parliament and the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions.

[6] Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field.

[7] For instance, it can be a recognised clearing house or a recognised investment exchange (section 285, Financial Services and Markets Act 2000 (FSMA)), it can be a listed settlement system for "relevant contracts" (section 301, FSMA), or a "service provider" under FSMA.

[8] Lamfalussy Standard 3 provides that "Multilateral netting systems should have clearly defined procedures for the management of credit risks and liquidity risks... These procedures should also ensure that... limits are placed on the maximum level of credit exposure that can be produced by each participant."

[9] The ECB made clear in the EMI standards that a securities settlement system should have proper risk management procedures to minimise exposure to risk and this will be crucial in relation to the ESCB and the collateral arrangements connected with euro liquidity. While the EMI standards do not specify the quantum of any requirements, the ECB would monitor very closely the arrangements whereby banks wishing to have euro liquidity provide securities as collateral to central banks.

dematerialization of securities in CSDs, a large number of custodians in each market compete to provide clients access to these market infrastructures, because clients either do not qualify or choose not to be direct members of the CSDs. Unlike a CSD whose primary function is to hold records of title and to perform transfers of title, a custodian's primary function is an intermediary and asset administrator. Although transfer of securities holdings between two clients on a custodian's books do occur, it is erroneous to equate such transfers with the "function" of a CSD. Section 1 of the Supporting Document accompanying this response illustrates the various capacities in which custodians act as intermediaries.

CSDs in almost all countries operate the definitive record of legal ownership of securities, whereas custodians merely hold title for customers. (For further elaboration of this key distinction see Supporting Document Section 2.) A transfer from one account to another at the CSD level has different legal consequences from a transfer occurring at the level of the custodian's books, and therefore involve different risks.

The Report does not explain why, or how, the existing regulatory regime applicable to custodians is inadequate given the nature of their activities. Nor does it explain why credit and settlement risks associated with securities settlement should be regulated in a different manner to similar risks inherent in other business undertaken by a custodian bank. The sophisticated capital and other regulatory requirements developed by EU (and worldwide) regulators would, in effect, be deemed inadequate for any extension of credit connected to securities settlement.

2.3 **Mixed-function systems**

ICSDs such as Euroclear and Clearstream are commercial enterprises established in the late 1960s to serve as international CSDs for Eurobonds, "stateless" debt instruments which do not have a "national" CSD. Over time, these Eurobond CSDs began providing their members services in other markets, and thus expanded into providing intermediary services for non-Eurobond securities such as government bonds and equities. Regardless of the volume of book-entry transfers in these non-Eurobond securities within each ICSD, their service is of an intermediary nature because the ultimate root of title to these securities is at the National CSDs.

Our view is that the infrastructure roles (CSD functionality) of such mixed-function systems ought to be separated from their intermediary (access to other CSDs) roles, and different regulatory requirements should apply to match these different functions. We would support the application of a regulatory approach traditionally applied to custodians to any intermediary, including the intermediary functions of a mixed function system, where suitably divided off from key infrastructure roles (see further our comments on Standard 9, where we explain our views on "ring-fencing" in more detail).

2.4 **Credit extension**

To facilitate settlement, credit is provided to market participants by a number of competing custodian banks in each national market and by ICSDs both in their function as Eurobond infrastructures and as intermediary for non-Eurobond securities. Since the Standards endorse the provision of credit by CSDs (under Standard 5 Securities Lending

and Standard 9 with regard to explicit credit extension), it would be appropriate to treat credit services as a relevant function in a risk-based regulatory approach regardless of the legal status of the institution providing the service.

2.5 **"Internalised settlement" is inappropriate as the foundation for risk-based functional regulation**

It is not clear why the mere fact of a custodian bank settling a transaction across its own books fundamentally changes its risk profile so as to require additional regulation in the form of the Standards. See Supporting Document Section 2 which explains the difference in legal status (and therefore risks) of book-entry settlement in a custodian's books versus at a CSD.

"Internalised settlement" is not a special service offered by the custodian: it merely acts on its customer's transfer instructions in respect of securities held in safe custody, and is not a different service from delivery to another custodian in accordance with a customer's transfer instructions. A very significant volume of such activity in fact results from a custodian's customers re-aligning securities holdings between entities of the same corporate family who are using a common custodian.

Where the transaction is between two customers of the same custodian, it is possible for the transaction to be settled across the books of that custodian without any corresponding entries being made at the CSD level provided the custodian records both customers' securities in the same account (an "omnibus account") at the CSD level. The ability of the custodian to do this will depend on the rules of the CSDs, which are not consistent. Some CSDs require (e.g. Greece), some forbid (e.g. Poland), customer specific accounts at the CSD level.

When it is possible, "internalised" book-entry settlement occurs only on an incidental basis, arising out of circumstances over which a custodian would have no control. An investor does not determine what products or with whom he trades depending on whether his counterparty happens to also be a client of his custodian bank. "Internalised settlement" is not an elective service which is provided as an alternative to settling through a National CSD.

It is therefore not correct that merely because custodians could be described loosely as carrying out some "internal settlement services" they are "systems" carrying out the same function as CSDs.

2.6 **Custodians do not operate "systems"**

The Report does not define what is meant by a "system" but the relevant Standards are said to apply to those custodians who "have their own settlement infra-structure 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 settlement and clearing systems". While custodians may be able in some cases to achieve a transfer of securities from one customer's account to another's this does not indicate that custodians have set up title registers in order to do so.

Custodians are not "systems". A "system" is more than a technology platform or the ability to provide book-entry settlement. We believe that a "system" is an infrastructure which enables participants to carry out activities with each other (be they trading, clearing or settlement activities) on a regular basis rather than as something incidental. We believe that a "system" is an infrastructure, without which the market cannot function.

An entity's ability to perform book-entry settlement should not be the criterion that determines whether it is a "system". If that was the case, then whether a custodian was a "system" or not would depend on the rules of the CSDs: if the CSDs allowed the custodian to operate segregated single-customer accounts, then the custodian would always need to make transfers within the CSD and would not be a "system"; if the CSDs only permitted the custodian to operate an omnibus customer account, it could cause the custodian to become a system.

We would urge the Group to compare the position of custodians with that of banks in settlement of payments (i.e. where no securities transaction is involved). The roles of intermediaries and infrastructures in relation to cash payments are identical to those in the field of securities settlement: banks deal with customers and provide access to payment systems. Where, by chance, two customers (one a payer and one a payee) happen to use the same bank, it is not necessary for a payment transfer to take place across the relevant central bank (the "root of title" to cash) - funds can be transferred internally. Banks' cash customers likewise cannot choose to settle payment transfers by internalised settlement. There is no suggestion that banks which are "able" to carry out internalised transfers of cash payment ought to be treated as "payments systems" or regulated differently from "other" banks.

3. SYSTEMIC RISK AND SYSTEMICALLY IMPORTANT CUSTODIANS

Systemic risk may be defined as "the risk of a sudden, unanticipated event that would damage the financial system to such an extent that economic activity in the wider economy would suffer. To qualify as 'systemic', shocks must reverberate through and threaten the financial system, not just some small part of it. They may originate inside or outside the financial sector and may include the sudden failure of a major participant in the financial system; a technological breakdown at a critical stage of settlement of payments systems; or a political shock such as an invasion or the impositions of exchange controls in an important financial center. Such events can disrupt the normal functioning of financial markets by destroying the mutual trust that lubricates most financial transactions [10]".

The Report explicitly addresses a number of the standards to both CSDs and custodian banks who are very active in the field of clearing and settlement and who are viewed as operating systemically important systems.

It is not clear why the Group believes internal settlement by a custodian could give rise to greater systemic risk concerns than where a custodian holds segregated accounts only at the CSD. Custodian banks are already subject to uniform EU wide regulation in

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10 The G30 Report on Global Institutions, National Supervision and Systemic Risk, 1997.

respect of all material aspects of their business which can give rise to internally-generated failure of their settlement functions:

- In respect of "systemic risk" which could arise from any **financial failure** on the part of a "systemically important" intermediary or its customers, the regulatory capital regime applicable to a custodian already takes into account the nature and extent of such risks which are inherent in the provision of intermediary and banking services. In this context, the size of a custodian's business is only relevant if it cannot meet any increased regulatory capital requirements.

- In respect of "systemic risk" consequences of any **operational failure** on the part of such an intermediary, regulators already require details of systems to be used by custodians and can undertake checks of such systems to ensure they are sufficiently robust to undertake the proposed business. In addition, custodians will in due course have to comply with regulatory capital requirements in respect of operational risk under the Basel II proposals.

Other factors which may influence systemic risk are of external origin and thus outside the control of the regulated institution. These factors are principally concerned with the effect of insolvency proceedings of a customer, which can have seriously disruptive effects on settlement finality and certainty of contractual arrangements. Additional regulation would not reduce these external risks.

We cannot see why the existing regulatory arrangements which apply to custodians (systemically important or not) are considered insufficient. We believe that the regulators who are already responsible for oversight of custodians' functions are fully aware of the importance of systemic risk and factor this into their supervisory activities. The case for an additional layer of regulatory standards in relation to securities settlement activity is not set out in the Report and cannot, we believe, be substantiated.

We also found it difficult to understand how the Standards would apply so as to identify systemically important institutions without causing moral hazard (i.e., irresponsible behaviour due to being perceived as too big to fail) or other disruptive consequences. We think it is undesirable for "systemically important" commercial institutions to be publicly identified: this is bad for competition and not conducive to effective risk management.

The Standards suggest that systemic importance should be assessed on a market-by-market basis. However, it is not clear whether the Group expects an institution identified as systemically important in relation to one market to comply with the Standards in respect of the other markets it operates in even where it may have a fairly minor share of those markets.

In conclusion, Citigroup considers that the Standards should not apply to custodians on ground of systemic important custodians. If there is an argument for improving the standard of supervision of custodians to cover additional issues newly recognised as posing systemic risks, we are receptive to such matters being regulated. But there is an existing regulatory framework for that and we see no need for a new one to be created.

4. ESSENTIAL FACILITIES AND UNDERTAKINGS IN A DOMINANT POSITION

One of the objectives of the Standards is to promote the competitiveness of European markets by fostering efficient structures and market-led responses to developments. We agree that competition needs to be protected in the case of access to key infrastructures that are essential facilities; and that it is appropriate to impose Standards ("ex-ante regulation") to ensure that these entities do not abuse their monopoly and do not prevent, restrict or distort existing competition in related services. However, the existing, healthy competition among intermediaries would be stifled, if not lost, if unnecessary regulation is imposed in relation to custodians who are the providers of clearing and settlement related services.

A careful analysis needs to be made as to which functional entities need to be subject to ex-ante regulation, so as not to include entities such as custodians who, we accept, could have a significant share of a market, but which are already subject to sufficient constraints as a result of both existing financial regulation and competitive market dynamics, making it unnecessary for them to be subject to additional regulations.

Infrastructures involved in clearing and settlement are not only systemically important, but also have a dominant (monopoly) position by virtue of the fact they are a key infrastructure. However, we fundamentally disagree with the concept that custodian banks have a dominant position in any market - certainly not in relation to clearing and settlement services.

It is important to be clear that the concepts of "systemic importance" and "dominance" are completely different. Clearly 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 provide guidance as to its meaning. Supporting Document Section 5 provides a more detailed explanation of the competition law concepts that are applicable in this context.

5. IMPLEMENTATION OF THE STANDARDS

The manner of national implementation of the Standards is uncertain given that there is no clear mandate in any EU Directive for legislation along these lines. Citigroup believes that some of the Standards should, in fact, be clearly enforceable in respect of entities which are not already subject to equivalent regulatory requirements in different countries. For instance, custodians are already subject to equivalent regulatory requirements in respect of their intermediary and credit services and Citigroup believes that strict enforcement of similar regulatory requirements (as set out in the Standards) in respect of other entities such as infrastructures who provide similar services is desirable. It may, however, be helpful to distinguish between those Standards which should be implemented as "best practice" and those which are strict requirements and the relevant regulators must incorporate into the formal regulatory regime applicable to the relevant entity.

We believe that the strength of our case that custodians or other intermediaries should not be subject to the Standards is borne out by the practical difficulties of applying the Key Elements of the Standards to entities which do not, in fact, operate infrastructures. We explain these issues in more detail in our comments on the specific Standards, but would mention as examples the following:

- Standard 1 (legal): custodians cannot alter the legal arrangements applicable to clearing and settlement, which are imposed by national legislation and the rules of CSDs.

- Standard 3 (settlement cycles): custodians cannot alter settlement cycles, which are imposed by the rules of the relevant markets and the CSDs which serve them.

- Standard 7 (DVP)[11]: custodians cannot achieve DVP unless the underlying title and cash transfer systems have first enabled DVP to occur.

- Standard 8 (finality)[12]: custodians cannot give clients finality unless the underlying title transfer at CSD level has occurred with finality.

- Standard 10 (cash settlement): custodians cannot demand that their customers are given access to central banks; they are themselves cash settlement agents, they do not employ them.

- Standard 14 (access): custodians cannot grant access to their services to any applicant.

- Standard 17 (transparency): custodians cannot divulge business-sensitive information to competitors or the market.

In other respects the standards could apply to intermediaries without such practical difficulty. But in these cases it is our experience that the existing rules of regulators of custody business already apply requirements which appear to be similar to those set out in the Standards. We see no need for such rules to be reiterated in relation to custodians (by contrast to CSDs which have no such uniform EU-wide regulatory benchmark as yet).

6. CONCLUSIONS

The infrastructure functions of CSDs should be regulated according to the risks inherent with such systems. Providers of settlement infrastructure should be subject to consistent and transparent regulation and oversight which should focus on the activities undertaken and risks incurred. Regulatory and oversight standards for settlement infrastructure providers should be harmonised and uniform EU-wide standards should be implemented. We welcome the Standards as a substantial step towards achieving this.

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[11] See Supporting Document Section 4 as to the true nature of DVP offered by a CSD and a custodian.

[12] See Supporting Document Section 4 as to the true nature of DVP offered by a CSD and a custodian and the relevant settlement finality.

The intermediary and credit provision services of a CSD/ICSD should be subject to the same regulatory requirements as other credit institutions providing such services and should not benefit from any legal or regulatory privileges accorded to CSDs/ICSDs in their role as market infrastructure providers. We also believe that a risk-based functional approach to regulation should require the infrastructure functions of a CSD/ICSD to be "ring fenced" from its intermediary and credit provision services and each function (infrastructure, intermediary and credit provision) should be regulated according to the risks specific to that function.

Regulation of custodians as infrastructure (on the basis that they may at times facilitate settlement of transactions in equities across their own books) is not justifiable or appropriate, irrespective of the volume of such activity.

Citigroup believes that the solutions to the issues identified in this paper should take the following form:

- Standards which require legislative and regulatory initiatives – Standard 1 (Legal Framework), Standard 18 (Regulation, Supervision and Oversight) - should be strict requirements. Standard 1 should specify the work required by regulators and legislators to minimise legal risks (see Second Giovannini Report[13] in respect of Legal Barriers).

- Standards addressing the mechanics of settlement - Standard 2 (Trade Confirmation and Settlement Matching), Standard 3 (Settlement Cycles) and Standard 16 (Communication Procedures, Messaging Standards and STP) - should be restated as "best practice" recommendations for infrastructures and their participants (as users such as custodians can only be expected to offer their customers the service which is being offered to them by the relevant infrastructure).

- Standards relating to risk management issues for settlement providers and their customers/users - Standard 5 (Securities Lending), Standard 7 (DVP), Standard 8 (Timing of Settlement Finality), Standard 9 (Risk Control/ Collateral), Standard 10 (Cash Settlement Assets), Standard 11 (Operational Reliability), Standard 12 (Protection of Customers' Assets) and Standard 19 (Risks in Cross-system Settlement) - should be compared to the regulations to which infrastructures and intermediaries are already subject and should only apply to each type of function insofar as the existing applicable regulatory regime falls short of the relevant Standard. It is then appropriate for the Standards to be addressed to the regulators of such activity, so that existing regulations can be "topped up" as necessary to alleviate the relevant systemic risk.

- Standards which impose safeguards on essential facilities to ensure that they do not abuse their dominant position - Standard 13 (Governance), Standard 14 (Access), Standard 15 (Efficiency), and Standard 17 (Transparency) – should be restated as strict requirements applicable to infrastructures.

[13] The Giovannini Group - Second Report on EU Clearing and Settlement Arrangements, April 2003.

- Standards which are designed for specific infrastructures - Standard 4 (Central Counterparties), Standard 6 (CSDs) – should be addressed only to these entities.

Appendix

1. LEGAL FRAMEWORK

1.1 Scope of Standard

(a) We agree that Key Element 2 should apply to CSDs as hard law.

(b) Key Elements 3, 4 and 5 should be addressed to the relevant legislators and regulators.

1.2 Comments and recommendations

Key Element 1 - Citigroup unreservedly supports the removal of legal uncertainty surrounding clearing and settlement processes. The sources of legal uncertainty are, however, not generally ones which are amenable to private action by persons other than legislators. We do not think there is anything to be achieved by addressing the standard to custodians.

Key Element 2 - The fundamental difference between an infrastructure and a custodian is that the former is indispensable to the market it serves. Even custodians who are able to facilitate settlement across their books must ultimately have a direct, or indirect (via another intermediary) account with the ultimate CSD. Therefore it is necessary to ensure that infrastructures' rules and contractual arrangements apply in a fair and equal manner to its participants.

A custodian negotiates the terms on which it provides services to a customer bilaterally, subject to any mandatory legal and regulatory terms required, and the terms agreed will differ depending on the nature of the relationship between the parties. If a customer does not wish to contract with a particular custodian it has the option of contracting with another custodian or even with the relevant CSD. Accordingly, while the approach set out in Key Element 2 may be suitable for infrastructures, it makes little practical sense for custodians.

Key Elements 3, 4 and 5 - These refer to the legal framework the system operates in and the protections available in the event of participant or system operator's insolvency. As recognised in the Second Giovannini Report, these are issues to be resolved by legislators and regulators not market participants.

Key Element 6 - The Settlement Finality Directive ("**SFD**") does provide some protection in the event of insolvency: however, Key Element 6 only envisages CSDs and CCPs having the benefit of the SFD (which in theory is not correct). The explanatory memorandum also notes that as the SFD "provides legislation that supports most of the legal issues listed above, all CSDs and CCPs that operate a settlement system governed by the law of an EEA Member State should be designated under that directive". However, if similar obligations are imposed on custodians as on CSDs, the Standards should clarify that a custodian can also benefit from the provisions of the SFD.

2. TRADE CONFIRMATION AND SETTLEMENT MATCHING

2.1 Scope of Standard

We agree with the proposed addressees of this Standard. However we believe that this Standard should be restated as a best practice recommendation.

2.2 Comments and recommendations

Key Element 3 requiring T+0 confirmation by indirect market participants appears to overlook the different jurisdictions and time zones the investors and service providers may be located in.

3. SETTLEMENT CYCLES

3.1 Scope of Standard

We agree this Standard should apply to CSDs. We do not agree that it should apply to custodians: custodians do not operate "systems" and cannot dictate market practices.

3.2 Comments and recommendations

Harmonisation of settlement cycles and operating days and hours is a matter determined by infrastructures (e.g. CSDs). It is not clear why this Standard is addressed to custodians or how custodians could in practice comply with it. Even where custodians are systemically important that does not put them in a position to impose new timing rules on their customers[14].

Indeed if a custodian, by chance, has two customers whose transaction can be settled by internal book transfer, this does not indicate that the custodian can require its customers to settle according to any particular timescale. The next trades undertaken by these customers may involve counterparties who use different custodians (or no intermediary at all) and would have to settle through the CSD. To "impose" a particular timetable for settlement would be commercially unworkable and may lead to reconciliation errors or other regulatory breaches if the custodian's records are altered at a time different from that applicable to the CSD.

4. CENTRAL COUNTERPARTIES

4.1 Scope of Standard

No comment.

4.2 Comments and recommendations

No comment.

5. SECURITIES LENDING

5.1 Scope of Standard

[14] Barrier 7, Second Giovannini Report notes that the European Central Securities Depository Association should take the initiative in the harmonisation of operating days and hours, in co-ordination with central banks, stock exchanges and users of systems.

We believe this Standard should be restated as a best practice recommendation. Insofar as infrastructures are involved in non-core activities which involve credit risk such as securities lending, we believe those activities should be ring-fenced from the infrastructure so as to assure participants of safety and soundness and so protect against anti-competitive behaviour.

5.2 Comments and recommendations

Securities lending as defined in the Standards can serve different purposes (for instance to cover fails, to facilitate strategic borrowing/short selling, or to enable collateralized borrowing as in a repurchase agreement). As an aim of the Standards is to make the market more safe and secure, it would not seem logical to allow CSDs to actively undertake such risks without additional safeguards in the form of ring-fencing: compare Standard 6 which requires CSDs to avoid risk-taking. It may be more prudent for intermediaries who have risk management techniques to address such risks and who specialise in securities lending to compete for the securities lending business to CSD participants. This would also avoid concentration of risk in the CSD.

See further our comments on Standard 9 in relation to ring-fencing and collateralisation.

6. CSDS

6.1 Scope of Standard

We agree with this Standard and that it should apply to CSDs.

6.2 Comments and recommendations

This Standard, unlike others, rightly recognises that "as CSDs are the only place where ultimate settlement occurs for immobilised/dematerialised securities, they should avoid taking risks to the greatest practicable extent". We fully support this analysis. We consider that similar reasoning should underpin the other Standards, which do not appear to acknowledge the special role of CSDs to the same extent.

The Standard also emphasises the need for "safeguards" to "be defined so as to ensure business continuity even under stressful circumstances" and states that "CSDs should demonstrate that they are well protected against operational risks … should have plans … so that market participants will continue to have access to CSD services even if the CSD becomes insolvent".

This Standard clearly assumes that CSDs have to be particularly risk averse and secure systems given their systemic importance to the financial markets yet it does not refer to similar requirements on, or importance of, custodians who are "systemically important" by virtue of carrying out a high level of "book-entry settlement". This suggests that the Group recognises the fact that custodians, irrespective of the level of their internal book-entry settlement activity, are not as systemically important as CSDs. It therefore seems inappropriate for the other Standards to apply to such custodians, particularly where they are already subject to regulation which is more tailored to their activities and importance from systemic risk perspective.

7. DELIVERY VERSUS PAYMENT (DVP)[15]

7.1 Scope of Standard

We agree that this Standard should apply to CSDs. However, for the reasons set out below we do not believe it is feasible to apply it to custodians.

7.2 Comments and recommendations

As stated in the Explanatory memorandum, there are different ways to achieve DVP. The Standards do not mandate a specific method, so long as principal risk is eliminated. It would be useful to make this a specific requirement in the Standard and Key elements instead of using the term “actual DVP”, which may be open to various interpretations.

This Standard assumes that "achievement of DVP by a settlement system also enables the settlement system's participants to offer their customers DVP". However given that Standard 6 acknowledges that ultimate settlement can only be achieved at CSD level, and given that the Standards appear to recognise the limited likelihood of SFD protection being available for custodians, custodians have little or no control over provision of "actual DVP" with finality to their customers.

A further barrier to custodians offering their customers DVP is the fact that the intermediary institution where the customers cash accounts are held could fail and the customers would then left with a claim against the failing bank rather than rights to a segregated pool of cash. The book entries of the custodian can, therefore, never achieve final and irrevocable transfer of securities (or of cash in central bank money).

Clearly in cases where a custodian can exceptionally achieve a book-entry transfer of securities between the accounts of two customers, an element of "actual DVP" is achievable. However, the limits on this should be recognised:

- If "actual DVP" requires the cash leg to be settled in central bank money, the custodian has no ability to control the transfer of cash across the relevant cash payment system.
- Since it is fortuitous whether a customer's trade can be settled by internal book transfer, custodians will be dependent on DVP processes arising at the CSD in relation to many trades, which custodians cannot alter unilaterally.

To impose DVP standards on custodians would lead to increased, not decreased, risk since custodians would in effect be asked to iron out the inconsistencies between DVP practices arising at the level of CSDs. This may be a service which custodians are willing to undertake for a fee and with appropriate risk-mitigating steps, but should not be a regulatory requirement.

For these reasons we do not see how it is practical to apply the Standard to custodians, even where they have a systemically important role.

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[15] See Supporting Document Section 4 as to problems in practice with attaining DVP

8. TIMING OF SETTLEMENT FINALITY

8.1 Scope of Standard

We agree that this Standard should apply to CSDs. However, for the reasons set out below it is not appropriate for it to apply to custodians.

8.2 Comments and recommendations

This Standard provides that "the timing of settlement finality means the time at which the deliveries of securities and cash become both irrevocable and unconditional". In light of our comments on Standard 7 (paragraph [8.14] above) it is not clear how this Standard is intended to apply to custodians. That is, a custodian performing settlement across its own books can only do so if both the transferor and the transferee have sufficient securities/funds to meet their obligations under the transaction. Legislative and regulatory intervention to extend to custodians the benefits which are currently only applicable to CSDs is a prerequisite to a custodian being able to offer "true" settlement finality.

If the Standard is, contrary to our recommendation, applied to custodians, custodians will in effect be required to underwrite the finality of settlements at CSD level. Consider a situation where an investor's purchase of securities has been settled at CSD level and the custodian through which the investor holds the securities has credited the investor's account. If the CSD-level settlement can be unwound (e.g. because the CSD is a non-EU system or for some other reason does not comply with the Standards) the custodian, obliged by the Standards to give the investor immediate "finality", would be left with a reconciliation mismatch and potentially other regulatory breaches.

For those reasons we do not consider it practical that Standard 8 be applied to intermediaries.

9. RISK CONTROLS IN SYSTEMICALLY IMPORTANT SYSTEMS

9.1 Scope of Standard

We agree that this Standard should apply to CSDs. However, for the reasons set out below it is not appropriate for it to apply to custodians, which are already subject to rigorous risk controls and regulated in that regard.

9.2 Comments and recommendations

9.2.1 *The Standard should not apply to custodians*

The extension of this Standard to EU custodians highlights the need to take into account the existing regulatory regimes applicable to CSDs and to custodians. Custodians are already subject to sophisticated regulatory requirements developed by EU member states and world wide regulators over a number of years to reflect the risk profile of the activities undertaken by such entities and the risk mitigation techniques which are acceptable to regulators (e.g. netting and collateral). A fundamental drive in the development of capital requirements for such institutions was the concerns about systemic risk posed by their activities and the Large

Exposure rules already address risks arising from concentration of exposure to a single entity, or group of entities.

In contrast, it is appropriate for the Standards to set out risk management requirements for CSDs who are not currently subject to any uniform EU regulatory capital requirements. Citigroup welcomes the Standards as laying down good ground rules for such regulation.

9.2.2 ***The Standard's approach to credit risk should be reconsidered***

We believe that in respect of CSDs the Standards should go further and impose the same regulatory capital requirements on any entity operating as infrastructure which undertakes non-core infrastructure activities (such as securities lending and credit extensions) as are currently imposed on credit institutions undertaking such activities. As an interim measure it may be appropriate to permit CSDs to rely on full collateralisation where they do not as yet have the ability to continuously assess the financial health of its participants, or are poorly capitalised, or are required to be fully collateralised by virtue of their participation in the ESCB's credit operations for the TARGET system.

Furthermore, the circumstances in which a CSD should be permitted to undertake such risks should be set out, given the findings in the second Giovannini Report that credit extension is not a necessary feature of settlement for a CSD and that concentration risk is reduced if banking services are provided by a multitude of banks in a competitive environment. Ideally, such non-core activities should be undertaken out of an entity separate from the ring-fenced infrastructure entity to minimise risk to the core infrastructure provided.

By contrast, the extension of credit by custodians raises no such concerns. Custodians are already specialists in credit risk management and fully and properly regulated according to EU-wide standards. No case has been made for additional regulation of credit institutions on the ground that the existing regulatory framework is insufficient.

Key Element 3, which implies that custodians "should not run credit risks", is misconceived - credit risk management is a fundamental adjunct to a custody service. We do not see how such a restriction could be compatible with Standard 5, which calls for removal of barriers to securities lending.

We believe that the right approach to credit risk under Standard 9 is as follows:

- The distinction between infrastructures and intermediaries should be explicitly acknowledged.
- Infrastructures should be carefully (and restrictively) regulated in relation to non-core activities such as "explicit" extension of credit, preferably by ring-fencing (see below).
- "Implicit" extensions of credit by infrastructures should be risk-managed in a manner similar to that contemplated by Standard 9.

- Custodians and other intermediaries should be free to extend credit within their existing regulatory frameworks and risk controls, without the application of inappropriate measures designed for "operators of systems" which carry out entirely different functions.

9.2.3 ***Collateral is not the only solution to credit risk issues***

Intermediaries provide support for clearin g and settlement in the financial markets by making available credit. This is a necessary function, since the smooth operation of the markets depends upon settlements proceeding according to schedule without having to wait for cash or securities which are en route from elsewhere. Intermediaries which are custodians are typically regulated banks which have highly sophisticated techniques for assessing and managing the risks associated with granting credit. According to the circumstances, it may be appropriate to lend unsecured or it may be preferable to take collateral; or there may be other balances available to the intermediary as cash cover; or there may be guarantees, non-financial security or other credit support. The risk associated with the granting of credit is taken into account by the intermediary's regulator, and the amount of capital required depends, under regulatory rules, on the credit risk mitigation technique employed.

In such a context it is not necessary to stipulate that collateral must be provided where credit is advanced in connection with clearing or settlement services.

We would also comment on the emphasis apparently placed by the Report on collateral as the acceptable tool for reducing credit risk. In our view, collateral converts credit risk but does not eliminate it:

- by taking securities to sell in an event of default, the collateral taker takes market risk on the securities; if there is a shortfall the uncovered credit risk remains.

- Some collateral techniques are vulnerable to attack, e.g. under bankruptcy laws (for example, collateral provided very close to or after formal commencement of insolvency proceedings generally has to be returned unutilised to the liquidator).

For these reasons we do not regard collateral as a "magic recipe" for removing credit risks. When used in conjunction with a full risk analysis and as part of a credit risk mitigation strategy we agree that it is useful and effective. For intermediaries a more flexible approach is necessary, allowing combinations of techniques such as netting, guarantees, counterparty assessment, covenants and so forth as well as collateral.

We note that the Group states that competition issues are not within its mandate: however, it should not ignore the anti-competitive consequences of imposing a full collateralisation requirement on custodians. Such a requirement would encourage market participants to use banks which are not systemically important in order to avoid the cost of posting collateral, particularly where the relevant

CSD does not extend credit and only the use of a custodian who is deemed systemically important would result in such costs.

9.2.4 ***Ring-fencing is appropriate for mixed function systems but not intermediaries***

Another adverse consequence of a requirement to collateralise relates to the suggestion in paragraph 109 of the Report that systemically important custodians should segregate their clearing and settlement operations from other functions, to "ensure that their activities not related to settlement do not endanger the ability of the institution to provide settlement services".

The custodian's clients benefit from the range of services being provided to them, the economies of scale enjoyed by the custodian in many areas, including in operations and business continuity arrangements, technology and compliance costs, and the capital requirements imposed on the custodian taking into account its net exposure to the customer. Requiring custodians to de-link their limited settlement activities from their own business would be an expensive option which may result in such custodians exiting the market or preferring to maintain segregated customer accounts at the CSD level and effecting settlement at the CSD level. This would result in additional costs to the custodian and its customers and may place additional strains on the systems of the CSD. It would also concentrate risk in a smaller number of custodians who continue in the market and the CSD.

Even where an intermediary is of systemic importance, there is no investor-protection or systemic rationale for walling off the clearing and settlement services provided by a custodian.

- In the first place, clearing and settlement services are inseparable from ordinary custody functions. When an investor instructs his custodian to transfer securities this is an ordinary part of custody operations. It is impossible to imagine custodianship without transfers.

- Secondly, regulators of custodians are already conscious of the systemic implications of failure of custodians, and the issues are factored into their supervisory activity. No evidence has been put forward suggesting that the existing regulatory framework is insufficient or that the integrated approach to custodians' activities introduces an unacceptable threat to the financial system. To the contrary, the report of the G30 recognised the need to improve the ability to offer integrated services such as stock-lending with clearing and settlement.

- Thirdly, even if a failure of a systemically important custodian were to occur, it would not affect the title of the investors in the securities they hold. Under the law in its present state, root of title is held at the CSD level. The intermediary holds the securities registered in its name as nominee or trustee for the investor, not in its own right. Failure of record-keeping by the custodian does not have the effect of creating or destroying the investor's property rights, in contrast to such a failure at the CSD level.

As far as mixed function systems are concerned, different arguments apply. It is important for the integrity of the infrastructure that a robust firewall exist between the infrastructure function (the CSD) and the risk-taking operations of the intermediary.

We agree with the philosophy explained in paragraphs 104-110 of the Report, which can be summarised as: the integrity of clearing and settlement infrastructure should not be threatened by non-core activities conducted by the system operator.

We believe that, once the distinct functions of intermediaries and the "systems" are understood, the right solutions to the risk issues identified by the Group will be clear. This is to ensure that ring-fencing is applied to mixed-function systems; and to recognise that intermediaries, duly regulated as credit institutions and custodians, already have robust risk management arrangements, but as they do not comprise "systems" do not raise the concerns over integrity which arise in relation to market infrastructure.

10. CASH SETTLEMENT ASSETS

10.1 Scope of Standard

We agree that CSDs should always offer their members who are eligible for a central bank account the option to use the central bank as the cash settlement agent. However, we believe that the eligibility criteria for institutions being granted central bank cash accounts should not be lowered to accommodate this. We do not understand the intentions behind the application of the Standard to custodians, which cannot offer clients "central bank money".

10.2 Comments and recommendations

This standard does not readily translate to a custodian which, as an intermediary, merely provides access to a CSD and, in carrying out its settlement functions on behalf of a selling investor, receives cash on behalf of its client. A custodian providing such services (settlement bank) cannot offer the client "central bank money" unless the client is itself eligible to open an account at the central bank - a matter which is not within the custodian's control.

Standard 10 makes the distinction between a *cash settlement agent* which acts as the bank for a settlement system and *settlement banks* which act for the users of the settlement system. Key Element 3 and Paragraph 117 of the Report state that "when a CSD or bank is used as the cash settlement agent, steps must be taken to protect the system's members from potential losses and liquidity pressures that would arise from its failure *in accordance with the credit risk mitigation approach set out in Standard 9"*. However, Standard 9 is intended to mitigate the risk of failure of the member of the CSD, or of the customer of a custodian and requires the entity extending the credit to obtain collateral from the entity to whom credit is extended. It does not address the risk of failure on the part of the entity extending the credit which we assume is the concern under paragraph 117. Such failure may result from activities unrelated to their functions

as cash settlement agents and it is not clear how this risk could in fact be mitigated and by whom, other than by the relevant regulator.

Key Element 4 - we believe the relevant regulators should be charged with monitoring the financial condition of the cash settlement agents. The custodian would, in the process of calculating its own regulatory capital requirements, calculate its exposure to the settlement agent. However it is not reasonable, or appropriate, for custodians, or even CSDs, to bear the responsibility for monitoring the financial condition of other regulated institutions.

We conclude that the Standard should be directed only to CSDs, and that there is no need for the Standard (as opposed to the usual regimen for credit institution regulations) to apply to settlement banks.

11. OPERATIONAL RELIABILITY

11.1 Scope of Standard

We believe that this Standard should apply to CSDs but should be restated as best practice guidelines. As set out below we do not believe it is necessary for the guidelines to extend to custodians.

11.2 Comments and recommendations

We believe that it is important for core infrastructure to be sufficiently robust to ensure it is able to provide a continuing service to the market and to meet set standards in respect of outsourcing. However, custodians are not core infrastructure and are already subject to regulatory requirements in respect of their operations including the need to ensure they have sound administrative and accounting procedures and adequate internal control mechanisms. National regulators generally require that as part of the authorisation process the custodian can demonstrate it has such systems and controls as are appropriate to its business[16]. In addition, national regulators generally require the management of a regulated entity to ensure that the outsourced function is carried out to a proper standard and the integrity of the bank's systems is maintained.

In due course, on Basel II taking effect, custodians will also have to comply with the regulatory capital requirements and qualitative risk management pillars in respect of operational risk, which will cover in detail matters addressed in the Key Elements of Standard 11.

We note that there is no equivalent standard/requirement for credit institutions engaged in cash settlement as intermediaries, and do not understand why intermediaries engaged in securities settlement functions should be subject to more strenuous regulation.

12. PROTECTION OF CUSTOMERS' SECURITIES

12.1 Scope of Standard

[16] E.g. Chapter 3 of the Senior Management Arrangements and Systems and Controls section of the FSA Handbook in the UK.

We agree that CSDs should be subject to this Standard to bring their regulation in line with the regulation of custodians holding client securities. It is not necessary or appropriate to extend the scope of this Standard to custodians.

12.2 **Comments and recommendations**

Custodian banks are already subject to regulatory requirements developed to protect customer assets by requiring segregation of such assets. All the issues referred to in the Key Elements of Standard 12 are covered by existing regulatory requirements applicable to credit institutions and investment firms. There is no need for the additional rules which the Standard would represent.

We agree that CSDs should be subject to a similar requirement under Standard 12.

13. **GOVERNANCE**

13.1 **Scope of Standard**

We agree that infrastructure should be subject to this Standard. However, custodians are already subject to governance regulation under the current regulatory system, and in their case there is no public interest purpose to be served by adding additional requirements.

13.2 **Comments and recommendations**

We agree that, given CSDs are an essential facility for which there is no alternative, they need to be subject to governance arrangements which ensure that they fulfil their public interest requirements and promote the objectives of not only their owners but their users as well. As set out in the Key Elements for this Standard, objectives and major decisions should be disclosed to their owners and to users (including potential users) and public authorities. Given that these are monopolies, there is no constraint on their behaviour other than through governance and transparency. Their owners and, more particularly, their users need to have some mechanisms to positively control key issues such as fees, access criteria and resource allocation.

On the other hand, as we have noted above, custodians are not an essential facility, nor do they have a dominant position. Therefore to the extent that an individual custodian bank is not providing a service which is in the interests of its users, users can and will switch to another custodian. As in the case of custodians, competitive market dynamics will ensure that no abuse takes place; it would therefore be inappropriate to impose governance arrangements over and above those already imposed by the financial regulators as to its management. Furthermore, given that many custodians are customers of other custodians for particular services, it would be inappropriate for them to be part of the governance structure and have access to their competitors' strategic decisions and commercially sensitive information. There already exist suitable regulatory controls regarding the governance of credit institutions (see for example, articles 6, 7, 8, 16 and 17 of the CCID).

If the Standard were applied to custodians, we anticipate that custodians would exit the market. Disclosure of strategic business matters (as suggested by Key Element 3) would

stifle innovation and dampen profitability. It is unlikely that profitable custody business could thrive in such a climate.

14. ACCESS

14.1 Scope of Standard

We agree that infrastructures should be subject to this Standard. However, the Standard is wholly unsuitable for custodians, which do not operate monopoly infrastructure but compete for business in an open market.

14.2 Comments and recommendations

We fully agree that CSDs should have objectively and publicly disclosed criteria for participation that permits fair and open access. As can be seen from the EU Commission's investigation into the German CSD, Clearstream, access to CSDs on non-discriminatory terms is clearly very important in order to ensure that competition can exist in upstream markets such as intermediary banking services where the various custodians compete. There already exists a considerable body of EU case law that confirms that key infrastructure providers must have fair access criteria and appropriate appeal mechanisms in place. The key elements proposed for Standard 14 are broadly in line with this case law as applicable to key infrastructures and associations.

The Standard should not apply to commercial operators who are subject to competition. Given that custodians do not have a dominant position nor, more importantly, are they an essential facility, there should be no need to impose a Standard as to the terms on which they provide access to their services. Indeed the converse is true given that custodians in providing intermediary services enable a large variety of customers ranging from large multi-nationals and other financial institutions to small domestic investors to access CSDs which they may not necessarily be able to do in their own right. In relation to competitive services, it is up to the custodians to determine who they provide access to, and at what price, and this should be a commercial judgment they take which should not be restricted legally. Provided that access to the CSDs is provided on objectively justifiable criteria, which will include provisions covering the financial risks taken by the custodians on behalf of their customers, there is no reason why access conditions to custodian banks should be regulated.

It would be impossible for custodians to reconcile the Standard with existing regulatory requirements and sound business practice.

- Existing legal and regulatory rules require custodians to carry out suitability and customer-acceptance checks for anti-money-laundering and anti-terrorism purposes as well as for customer/investor protection. It is not compatible with such restrictions to allow open access to any customer to a custodian's services.

- No custodian will be willing to allow open access to its services to competitors, particularly as (in light of Key Element 3 to Standard 13 and Standard 17) users of the services would be given access to strategically sensitive data.

If the Standard were imposed, we envisage that few (if any) custodians would wish to stay in the market; increasing withdrawal would lead to added market share for the remaining participants. We are concerned that, notwithstanding our view that custodians are not from a legal perspective "dominant" participants, the regulatory authorities would treat the remaining participants as "dominant", leading to further withdrawals from the market.

15. EFFICIENCY

15.1 Scope of Standard

While we believe that interoperability is important in terms of providing access to CSDs, allowing for greater direct access across Member States, we do not think it is something that should be imposed on custodians.

15.2 Comments and recommendations

Given the market dynamics it is possible for custodians to develop as both national operators and international operators that offer access to a national market. Regardless of how large their share of a particular market is, we do not think it is necessary to impose interoperability between the various custodians as this would merely involve multilateralism which would only increase significantly costs for the various market participants. It should be sufficient to have interoperability and fair access to the CSDs, so that any custodian who chooses to offer access into the national market of a particular CSD can seek access and ensure interoperability. Whether a particular custodian bank has a direct link with other financial institutions will therefore be part of its own commercial strategy and will influence its own competitive position in the market(s). It is then up to end users to decide which particular services they require from a custodian as to whether they use it or a competitor.

Furthermore, to the extent that there is harmonisation and interoperability between CSDs and other key providers of security services which are critical for clearing and settlement, such as trade confirmation, messaging services and network providers, this will of itself provide a more level playing field and reduce costs in related markets where competition is available and possible (such as intermediary and credit services).

16. COMMUNICATION PROCEDURES

16.1 Scope of Standard

No comments.

16.2 Comments and recommendations

No comments.

17. TRANSPARENCY

17.1 Scope of Standard

While a certain degree of transparency is necessary in relation to those entities which are essential facilities, such as CSDs, it is wholly inappropriate for entities that are subject to

competitive market forces to be regulated to the same degree and provide the same level of transparency.

17.2 **Comments and recommendations**

Whereas previously many of the National CSDs were not-for-profit organisations owned and controlled by their users, in the last few years there has been a significant shift into private ownership and an amalgamation between different commercial entities that provide clearing and settlement services and related services. We would argue that regardless of who owns these CSDs, given their key role as an essential facility with specific risk issues, they should be ring fenced entities that are capable of being regulated separately from any commercial activities they may also offer that are subject to competition. In relation to their regulated monopoly activities it is clear that these should be subject to certain transparency requirements to ensure that regulators can supervise their activities appropriately, both in terms of risk and so that competition authorities and users can monitor that there is no cross subsidisation between profits made on their monopoly activities and those subject to competition.

On the other hand, given that custodian banks do not provide monopoly services which are essential for other market participants, it is wholly inappropriate for them to be subjected to the same transparency requirements which would give competitors access to commercially sensitive information and could thereby facilitate collusive behaviour. This would be anti-competitive and contrary to Article 81 and 82 of the EC Treaty.

We would also highlight that the comments made under Standard 13 would apply here even more forcefully.

18. **REGULATION, SUPERVISION AND OVERSIGHT**

18.1 **Scope of Standard**

Custodians are already subject to a uniform EU wide regulatory regime. We welcome the introduction of an EU wide regulatory regime for CSDs.

18.2 **Comments and Recommendations**

We refer to our comments under Standard 1 above.

19. **RISKS IN CROSS-SYSTEM LINKS**

19.1 **Scope of Standard**

We agree that this Standard should apply to CSDs. However, we do not believe it is appropriate for it to extend to custodians.

19.2 **Comments and Recommendations**

CPSS-IOSCO Recommendation 19 applied only to CSDs establishing links with other CSDs on a cross-border basis. Standard 19 seeks to extend its application to custodians and to "cross-system" links (i.e. links between systems in the same jurisdiction). The Standard also refers to "CSDs that establish links" and refers to links whereby one CSD becomes a participant in another CSD and "such links permit participants in either CSD

to settle trades in securities from multiple jurisdictions through a single gateway operated by its domestic CSD or by an international CSD". In light of these statements it is difficult to see how this Standard could apply to custodians.

When a custodian becomes a participant in a CSD in its own jurisdiction it cannot be said to have formed a "cross-system link" with that CSD. It is merely a participant subject to the same rules and regulations as other participants in that CSD. Similarly, a custodian's membership of a CSD in another jurisdiction does not result in a "gateway" for participants in that CSD to settle trades via the custodian.

It is also difficult to see how a custodian becoming a customer of another custodian constitutes a "cross-system" link.

This Standard should, therefore, be restricted to CSDs.

We accept that there are issues related to links between CSDs, because links involve CSDs becoming mixed function systems. As to our rationale for this, see section 1.2.3. We therefore agree that special regulatory treatment is desirable.