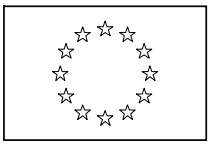

COMMISSION OF THE EUROPEAN COMMUNITIES

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# COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

## Clearing and settlement in the European Union
## Main policy issues and future challenges

**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT**

**Clearing and settlement in the European Union**
**Main policy issues and future challenges**

Clearing and settlement are the processes by which securities market transactions are finalised and are integral to the functioning of the financial system. In the context of completing the internal market for financial services, it is crucial to have efficient (i.e. cost-effective, competitive and safe) clearing and settlement arrangements for the EU as a whole. The existing clearing and settlement arrangements within the EU are largely efficient in respect of domestic securities transactions. However, these arrangements are national-based and do not combine to provide efficient post-trade processing of cross-border transactions. Without provision for efficient cross-border clearing and settlement, the full benefit of an internal market for financial services cannot be realised.

Much of the inefficiency in EU cross-border clearing and settlement derives from fragmentation due to national differences in technical requirements/market practice, tax procedures and laws applying to securities. Moreover, in the absence of a common regulatory approach to clearing and settlement activity, concerns over operational and prudential risks may also act as an impediment to the development of cross-border activity. The creation of an integrated clearing and settlement environment is, therefore, an essential pre-condition for efficient post-trade processing of all securities transactions within the EU. To this end, the Commission has identified two main policy objectives.

The first objective is to remove barriers to the finalisation of individual cross-border transactions in the form of national differences in technical requirements/market practice, tax procedures and laws applying to securities. The Commission considers that the removal of barriers related to technical requirements will be primarily in the hands of the private sector. Nevertheless, national and EU authorities can play a role in removing these barriers by encouraging harmonisation through the development of standards. The remaining barriers will require public intervention, as in the case of defining the legal system that is applicable to securities transactions and holdings in the EU.

As the removal of barriers alone would not necessarily result in a fair and competitive environment, the second objective is to remove competitive distortions or unequal treatment of entities performing similar clearing and settlement activities. A fully integrated EU clearing and settlement infrastructure would require that rights of access to systems be comprehensive, transparent, objective and, above all, effective. Market participants should not be constrained in making investment decisions by the location of counterparty, securities or infrastructure. There should be generalised access (i.e. by all markets, infrastructure providers and market participants) to all necessary systems. A first step in achieving this objective is envisaged in the proposed revision of the Investment Services Directive, which provides for the possibility of choice of systems for post-trade activity. The parallel application of competition policy can be used to reinforce these measures.

Integrated and competitive EU clearing and settlement arrangements must be consistent with high standards of market integrity and financial stability. To this end, a common view is required on an appropriate regulatory and supervisory framework for the providers of clearing and settlement services. This is the motivation behind the complementary initiative by securities regulators and central banks, to develop common standards. The implementation of these standards should go along way to reducing the concerns of regulators about use of systems in other Member States. However, common standards may prove to be insufficient to provide a fair and stable framework for cross-border use of clearing and settlement systems. If this were the case, some high-level principles (e.g. defining relevant functions, authorising providers and governing their ongoing supervision) could be enshrined in law at EU level. Provisions relating to any capital regime, default rules, and/or the risk management techniques for these institutions could also be addressed in this context.

This Communication does not discuss the merits of different architectures or models for providing pan-EU clearing and settlement services. The choice of architecture should be determined by the market, subject to legitimate public-policy constraints (e.g. adequate competition, appropriate investor protection and minimised systemic risk.) However, it is essential to create an environment in which market forces can deliver the most appropriate architecture for an efficient clearing and settlement infrastructure for the EU.

This Communication is the first step toward developing a policy on clearing and settlement in the EU. Comment from all interested parties is invited by 31 August 2002. Comments should be sent to DG MARKT F2, European Commission, B-1049 Brussels. E-mail address: markt-clearing-settlement@cec.eu.int

# I INTRODUCTION

Efficient, structurally sound financial markets are more competitive and more attractive to issuers and investors globally[1]. If the EU financial market is to compete on a global scale, it must be deep, liquid, efficient, safe, transparent and cost-effective. An assessment of the attractiveness of a market will be affected not only by direct costs of using the markets and systems, but also the functionality provided, and less direct considerations such as efficient use of collateral. If the costs of using European clearing and settlement systems are too great, or if the infrastructure does not support the desired functionality, then market participants might not invest in those markets or use other, potentially more risky, methods to achieve the finalisation of cross-border transactions. Investors clearly need access to the markets that they wish to invest in. For example, they need to be able to buy and hold equities issued by firms in any member state at a reasonable cost. Excessive cross-border costs must be eliminated, and increased legal, or other, risks arising from inefficient clearing and settlement minimised, in order to attain a truly integrated securities market in the EU.

The nature of the problems in this area has become clearer recently. The subject of clearing and settlement has been touched on indirectly in the Commission's two consultations on upgrading the ISD. The initial report of the Giovannini Group[2] describes the current European clearing and settlement landscape[3] and a further report, examining possible developments in the clearing and settlement architecture will be produced later this year. The Group of Thirty (G30)[4] are currently preparing recommendations on how to minimise risk and maximise efficiency in the operations of these systems. The European System of Central Banks (ESCB) and the Committee of European Securities Regulators (CESR) have launched a joint Working Group to discuss issues of common interest in the field of clearing and settlement.[5] In particular, they are considering the adoption of common standards for clearing and settlement entities in Europe, based on the CPSS-IOSCO[6] Recommendations[7] and the standards of risk management developed by the European Association of Central Counterparty Clearing Houses (EACH).

Using the information available through these various exercises, this consultative document explains overall Commission policy on this subject and possible courses of action. Comments are invited from the European Parliament and the Council, national regulatory and supervisory authorities, other EU level and national organisations and federations, market practitioners, institutional investors, infrastructure providers and all other interested parties. Comment is welcome both on the general policy approach and on the specific questions highlighted in the text.

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1 The Lisbon European Council stressed the importance of establishing within the Union, by 2005, a fully integrated and efficient single financial market. The Stockholm European Council Conclusions also underlined the crucial role played by financial markets in the overall economy of the European Union.

2 A group of experts that advises the Commission on capital market issues.

3 Cross Border Clearing and Settlement Arrangements in the European Union (November 2001) in European Commission Economic Paper No.163 (http://europa.eu.int/comm/economy_finance/giovannini/clearing_settlement_en.htm)

4 A high level consultative group on international economic and monetary affairs.

5 The Commission is an observer on the Working Group.

6 Committee on Payments and Settlements Systems of the G10 central banks and International Organisation of Securities Commissions.

7 Recommendations for Securities Settlement Systems, Report of the CPSS-IOSCO Task Force on Securities Settlement Systems, November 2001. These have been accepted globally by central banks and securities markets regulators as representing minimum standards for systems involved in the finalisation of transactions.

## II WHAT IS CLEARING AND SETTLEMENT & WHY DOES IT MATTER?

Clearing and settlement functions are the processes by which transactions in securities or derivatives are finalised – so that the buyer receives the financial instrument and the seller receives the corresponding payment.[8] Colloquially these are sometimes said to be the pipeworks of financial markets. The process involves several components, not all of which will necessarily apply to each and every transaction:

– *Confirmation* of the terms of any trade;

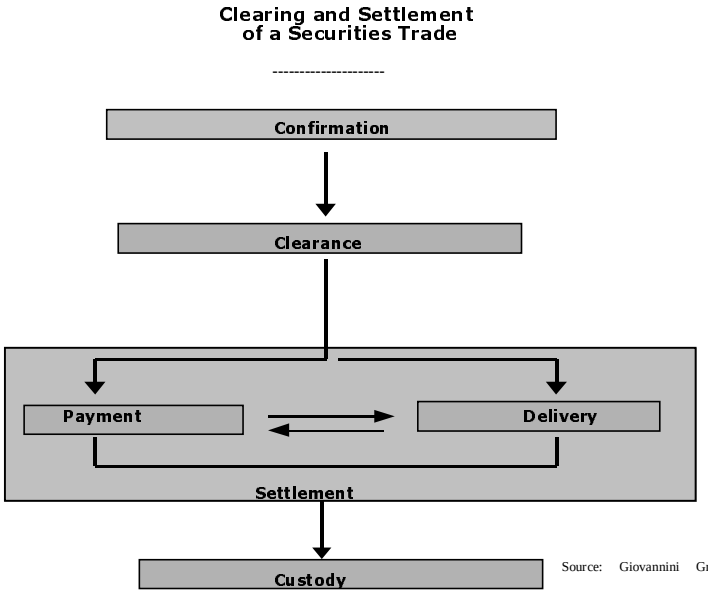
– Calculation of the obligations arising for the parties involved – the process of *Clearance*, which can result in net or gross obligations;

– A *Central Counterparty* can interpose itself between the two parties to a trade, becoming the counterparty to both sides of the transaction;

– *Delivery* of the securities involved, accompanied by a corresponding *payment*, in order to achieve *settlement*.

– The safekeeping and administration of securities in *Custody*;

– *Registration*, where applicable, of ownership of securities on a legal record.




Efficient post-trading processes are essential to allow market participants – issuers, investors and intermediaries – to operate effectively in an integrated EU financial market. Accordingly, efforts to improve pan-EU clearing and settlement arrangements must be made in parallel with implementation of the Financial Services Action Plan.

Moreover, central counterparty, clearing and settlement systems are important for the stability of the financial system: securities settlement systems hold the assets that are used to secure payments in the large value payment systems and as collateral in monetary policy operations; central counterparties are a single focal point for risk in the markets that they serve. The risk

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[8] For reasons of simplicity, in this Communication the term "clearing and settlement" is used generically to encompass the full range of activities that may be involved in the finalisation of a transaction.

management practices and overall oversight of these systems are important to ensure that the financial system is efficient, liquid, orderly and robust.

## III THE CURRENT SITUATION

### *Interest in pan-EU financial activity has increased*

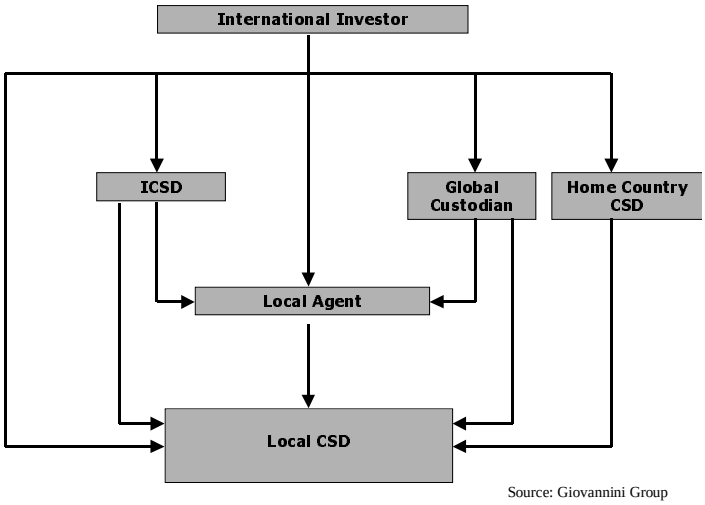
Market practitioners are calling for improvements in efficiency and reductions in the cost of finalising cross-border transactions. They express a variety of concerns: large banks and investment firms, active in a number of markets, want to be able to centralise their securities' holdings in a single system in order to make most efficient use of collateral and to minimise costs. Institutional investors want to see a reduction in the cost of investing in a diverse portfolio of stocks across the EU. Issuers want access to deep and liquid markets, where they can readily raise capital. Retail investors want access to the widest range of stocks possible at a reasonable cost and without additional complexity. In order for these conditions to be met, the full range of pre- and post-trading systems across Europe must form an effective, integrated network.

Traditionally, in domestic markets, all exchange transactions in securities were finalised using the system(s) located in the same country as the exchange. A number of factors are causing this former one-to-one relationship to break down. Participants on the exchanges are no longer limited to domestic players. Securities are now traded on more than one exchange or on other, non-domestic platforms which have an international membership and are, very often, incorporated in countries other than the securities traded. Hence the traditional model whereby the location of settlement is determined by the location of trading may no longer be appropriate for all market participants.

### *Current EU cross-border clearing and settlement arrangements are inefficient*

Current arrangements for the finalisation of securities transactions in the EU are generally efficient at a national level but are too complex and costly for a single financial market across the Union. By way of illustration, the diagram below shows the multiplicity of channels that are used to access settlement systems in other Member States.

**Channels for Cross-Border Settlement**




Source: Giovannini Group

Much of the *complexity* can been ascribed to fragmentation, with the degree of fragmentation, and correspondingly of risk and cost, varying according to the type of security, of transaction and the different jurisdictions involved. There are numerous systems, with differing specifications and characteristics. This increases the complexity of the technology, connections, knowledge and training required to undertake transactions across borders in the EU. Different market and system rules, different membership requirements, different legal jurisdictions must all be understood and complied with in order to ensure the safety and finality of transactions.

The *costs* of undertaking securities transactions in the EU are difficult to quantify. They vary according the security involved, the type of transaction, the nature of the counterparty, the size of the transaction, the jurisdictions and the systems involved. Recent studies confirm that the post-trade processing costs of a cross-border (inter-system) securities transaction in the EU are multiples higher than for a corresponding transaction within a national market. Comparisons are sometimes made to the cost of post-trade processing in the US, where the national market also exhibits lower costs than those involved in cross-border transactions in the EU. These higher costs in the EU comprise both direct costs resulting from membership of systems and transaction fees, and other, less observable costs, which can both be traced to the existence of barriers that arise from the fragmented infrastructure of EU financial markets. The Giovannini Report identified a list of such barriers.

***Current EU legislation***

The instruments that make up the EU regulatory framework for clearing and settlement do not combine to provide a comprehensive framework covering the full range of activities and functions involved in the finalisation of transactions. Nor do they cover all the types of institution that are involved in such activities. In fact, recently institutions have begun to break away from their traditional, clearly defined roles resulting in a blurring of the borderline between activities performed by different entities. This in turn has led to calls for a 'functional approach' to regulation, under which the regulatory regime for each activity would be governed by reference to the inherent risks of that activity, not by reference to the type of institution undertaking the activity. Thus, entities providing the same functions/services would be subject to the same rights and obligations. The current EU legislative instruments are the Settlement Finality Directive (SFD), solvency ratio provisions of the Banking Co-ordination Directive, the Capital Adequacy Directive (CAD) and, partially, the Investment Services Directive (ISD). A fuller description of the current legal framework is attached at Annex I.

***Risks related to the activities of clearing and settlement***

The risks arising from different types of post-trade activity must be adequately managed and monitored. In a cross-border context, not only the technical capacity and risk management of the systems themselves are critical, but also the technical links between those systems, and the legal relationships between them.[9]Risks relate both to whether the failure of a single participant would have knock-on effects on other members, or on the system itself, as well as the potential impact of a failure in the system on the stability of the wider financial system.

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[9] Annex 4 of the Recommendations of CPSS-IOSCO Joint Task Force contains a description of how the settlement of cross-border trades can give rise to particular risks: Custody and legal risks may be increased by the involvement of multiple agents and multiple jurisdictions; the nature of risk involved in a particular transfer is also affected when settlement occurs outside the CSD of issue, or when cross-system settlement occurs.

The interests of public policy bodies therefore cover macro financial stability issues, market regulatory issues and prudential supervision of both the central counterparty, clearing and settlement entities themselves, and their members. In a fully integrated network of post-trading services across the EU, the prudential and operational risks would be highly complex and require careful management in order to safeguard the overall integrity of the clearing and settlement infrastructure and by extension the financial system as a whole.

## IV EU OBJECTIVES

There are two main policy objectives in order to achieve an integrated EU post-trading environment. First, to remove barriers to the finalisation of individual cross-border transactions, and thereby increase the efficiency of cross-border clearing and settlement in the EU.

Second, to remove any distortions and constraints in the EU post-trading environment so that different players can compete. Those providing the same functions should be subject to equivalent rules and obligations and have equivalent rights. Trading and post-trading infrastructure should not restrict or distort activity nor should there be additional constraints on the performance of cross-border (as opposed to domestic) activity.

The policy objectives described above are designed to create the conditions for a market-driven process of restructuring the post-trading industry. Underlying these objectives are a number of principles: the extension of consumer choice; the fostering of competition; and the maintenance of financial stability and investor protection.

## V HOW TO ACHIEVE THE OBJECTIVES

These objectives can be achieved by a combination of actions, which are described below.

### 1 Remove Barriers to the Finalisation of Individual Cross-Border Transactions

The first objective involves removing those obstacles that impose costs and risks on those undertaking cross-border transactions. The Giovannini Report divided barriers into technical or market practice barriers, barriers relating to tax procedures and legal barriers.

#### *Technical & Market Practice Barriers*

Some of these barriers relate solely to technical requirements, others to market practice. This latter group are more complex, being sometimes embodied in law, sometimes the result of stock exchange rules and sometimes simply convention in that Member State.

Annex II lists the market practice and technical barriers identified in the Giovannini Report and presents a possible set of actions designed to address this category of barrier. The technological and systems aspects fall primarily to the private sector. It should be for the market to decide what combination of systems, technology and/or links will best meet its needs. Actions such as the implementation of communication standards and systems harmonisation would all contribute towards inter-operability, i.e. to allow systems to inter-connect, compete or integrate.

Inter-operability involves a three step process:

– Establishing definitions of the various functions involved in finalising transactions.

– Establishing common processes and methods for each stage of the transaction chain – membership criteria, settlement periods and timetables, netting procedures and risk management.

– Adopting harmonised communication links and standards for messages.

The technical capability already exists to deliver inter-operability of systems, but there has been little progress in this direction in the EU. There are a number of explanations for this: First, continued uncertainty over the final outcome of the integration process has resulted in reluctance to invest in change. Second, some cite the continued presence of tax and legal barriers as an inhibiting factor. However, the lack of progress may also be put down to perverse incentives among infrastructure owners, management and users. These arise either because the parties involved derive profit in some way from the current fragmented environment, or because those who would bear the costs of technical developments are not the ones who stand to gain the most from them.

National and EU-level public authorities should seek to find ways to overcome this market failure and undertake complementary actions. Some possible courses of action are detailed in Annex II. For example, national authorities can remove restrictions embodied in their law and simplify procedures for issuance and for corporate actions. The work by the ECB/CESR Joint Working Group to develop common principles and standards will also help to reduce divergence in market practice.

Restrictions on settlement location that result in the need to access multiple systems were cited as the second most important barrier by respondents to the Giovannini questionnaire. The Commission has included a provision in its proposals for a revision of the Investment Services Directive[10] that would enable market participants to choose their location of settlement. The envisaged right would allow institutions to decide where to settle transactions and hold securities on the basis of their own business needs. They could therefore choose to centralise holdings in a single system or combination of systems, making the selection on the basis of cost, efficiency, access to funding, level of service or other considerations important to them. This would reduce complexity and allow for more efficient management of collateral. The Commission should also work to ensure that the legal framework for securities transactions is supportive of cross-border activity.

*Is the combination of actions outlined in Annex II the best approach to the removal of this category of barrier? Which actions should be priorities?*

***Tax Barriers***

Differences in the procedures used in national markets for the collection and refund of taxes impact directly on cross-border financial activity. The Giovannini Report singles out two specific tax barriers that relate more directly to clearing and settlement. Both of these concern the ability of institutions to provide tax services regardless of their country of establishment. Some, but not all national authorities have already removed restrictions on the categories of institution that are able to provide services in their country.

[10] A revision to the ISD is envisaged for the end of 2002. A further consultation on this proposal was launched in March).

Some tax barriers raise broader, more fundamental issues for the operation of European financial markets. The complexity and variety of procedures for the processing of, particularly, withholding and capital gains taxes result in higher costs and the need to use the services of intermediaries with local knowledge. The recent proposal from the Commission for a savings tax directive,[11] builds on the principle of information exchange between member states. The savings tax directive will establish minimum requirements for identification by the paying agent of the beneficial owners and their residence. This is likely to have a positive impact on the administrative burden for the institutions involved.

More broadly, different categories of trade, such as secured loans, swaps and repos, receive different tax treatment across borders. These inconsistencies throw up technical barriers, but are not in fact related to clearing and settlement systems, except where they are used as the means to implement procedures.

Further study by the Commission is required in this area, in order that technical differences in the procedures for handling taxes related to securities markets do not continue to hamper the ability of market participants execute their optimal trading and investment decisions. Work has begun: for example, in a Communication to the Council and the European Parliament[12] the Commission identifies specific tax obstacles to cross-border economic activities in the internal market and proposes a series of targeted remedial measures. Among the many issues identified in this paper was the potential source of obstacles and distortions existing in the area of double taxation conventions.

***Legal Barriers***

The legal basis for clearing and settlement systems, participation in those systems, holdings and transfers of securities in the systems should be sound and transparent, both in the normal course and in the event of insolvency or default. This is particularly important in the EU, where it is increasingly possible for the securities, the counterparties to a transaction, the trading platform and the systems used for finalisation of the transaction to be in different jurisdictions. The barriers identified in the Giovannini Report arise from the application of conflict of law rules, different legal regimes governing securities and their transfer and the treatment of bilateral netting.

*Conflicts of law*

There is no single legal regime governing securities transactions within the EU. Cross-border business often raises uncertainties over the applicable law for transactions which are cleared or settled in different jurisdictions. Existing legislation at EU level has been designed to provide greater legal certainty as regards the determination of the applicable law from the different jurisdictions involved.

The Settlement Finality Directive (SFD) and the proposed Collateral Directive (CD) both contain provisions that represent an evolution from the principle that the applicable law should be that of the jurisdiction where a security (or entitlement in respect of a security) is located. Instead, the security is to be treated[13] as being located at the relevant register, account or system where it has been recorded. This principle is known as PRIMA (Place of the Relevant Intermediary Approach). But the SFD and CD rules apply only in limited

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11 Proposal for a Council Directive on taxation of savings income in the form of interest payments

12 Towards an internal market without corporate tax obstacles 23 October 2001 (COM (2001) 582 final).

13 SFD Article 9(2) and CD draft Article 10

circumstances: the SFD only to securities offered as collateral to central banks and to payment and settlement systems, and the CD only to securities offered as collateral. The principle of PRIMA also underlies the proposed Hague Convention on Indirectly Held Securities which is planned to be finalised during 2002. The Convention deals with the law applicable to proprietary rights in indirectly held securities and would unify the approach used in all jurisdictions adopting the convention. The Commission supports the intention behind the development of the Convention and is currently examining the compatibility of the Convention as drafted with Community legislation. It would bring law into line with existing market realities in Europe, whereby the location of the account on which book entry securities are held is generally regarded as being the location of the security.

*Diversity of legal regimes governing securities and their transfer*

Given the substantial divergence in the legal treatment of securities across the EU,[14] it has been suggested that the optimal solution would not stop at achieving certainty as regards determining which law is applicable, but would also require achieving a uniform legal treatment of securities across the EU. This implies creating a special legal regime for securities – a "uniform securities code". Such a regime would be far from easy to design, especially for equities, because of the many links with national property, company, succession and insolvency law in Member States. The Commission therefore believes that it is not a solution that could be agreed upon in the short term.

*Are further measures, beyond the adoption of the Hague Convention, required to achieve effective resolution of conflicts of law in the EU?*

*Would adoption of these measures be sufficient to resolve the main legal uncertainties for securities transactions in the EU?*

*If not, is a 'securities code', establishing a uniform legal treatment of securities across the EU, either necessary or desirable?*

## 2 Remove distortions and constraints in EU Post-trading Environment

The second objective is also essential for the creation of an environment which is supportive of greater cross-border activity. Such activity should be free from constraint, without jeopardising market integrity or financial stability. This requires the removal of distortions or inequalities in the treatment of the same activities. Next, all markets, infrastructure providers and market participants should be able to access all necessary systems, regardless of their location. Fully integrated markets require that rights of access to systems be comprehensive, transparent and non-discriminatory and, above all, effective. The parallel application of competition policy can be used to reinforce these measures.

### *Level playing field between institutions involved in clearing and settlement*

The current regulatory arrangements in the EU reflect a traditional institutional approach to regulation and result in an uneven treatment of clearing and settlement activity. Outside the provisions of the SFD, only those clearing and settlement entities that are licensed as banks or investment firms are covered by EU legislation. In the context of ensuring competition

[14] And the open-ended nature of the type of instruments that may be described as securities.

between entities providing the same services across Europe, it is important to establish a level playing field.

One of the issues that has arisen as part of the process of revision of the ISD, is the treatment of bank-licensed custodians and Central Securities Depositories (CSDs) not licensed as banks. Custody is a non-core service under the ISD, such that investment firms (and banks) with a passport to provide core services can also provide custody on a cross-border basis. Custody services have been widely interpreted to include settlement of securities across accounts at the custodian. This therefore amounts to a passport for bank/investment firm licensed custodians to provide settlement across the EU. No corresponding right exists for those CSDs that are neither banks nor investment firms. However, as custodians expand the range of their activities, the boundary between the services provided by custodians and those of settlement systems is becoming less clear, such that the members of the systems could be seen as competitors to the systems themselves for certain services, for example asset servicing. The consultation on the ISD has highlighted this regulatory imbalance and has led to calls for a clear legal framework covering the activities of clearing and settlement.[15]

Another area where the treatment of banks/investment firms differs to that of non-bank custodians and infrastructure providers is capital adequacy. At present, two institutions undertaking the same business could be subject to different regulation, and hence have different obligations and rights either domestically or across the EU. To achieve a level playing field would require that the same activities be subject to the same treatment. However, no common definitions of post-trading activities exist at EU level to assist in the determination of own capital requirements or of capital treatment for exposures to particular entities. The 1996 paper of the Basel Committee dealing with treatment of multilateral netting under the Accord provides some "minimum standards" for clearing houses. However, there are no equivalent standards in European legislation containing a common view on the precise activities conducted and the attendant risks.

*Does the creation of a level playing field require that common functional definitions of clearing and settlement activities be developed at EU level?*

*Which post-trade activities should such definitions encompass?*

The SFD protects transfer of collateral security provided in connection with a system, which includes transfers to central counterparties or clearing houses. However, it is sometimes argued that the implementation of the Directive has not resulted in the desired uniform treatment across Europe of the definition of finality or of the full range of risks involved in operation of or participation in systems. The Commission is required to present a report on the application of this directive to the European Parliament and the Council. A study has been launched for this purpose and its results will be available in 2003.

[15] Many respondents to the Giovannini Group questionnaire and ISD consultation argued that common EU principles are needed for the authorisation, supervision and capital adequacy of clearing houses. Common principles were seen as ensuring a level playing field for clearing houses and as minimising the risk of regulatory arbitrage among market participants.

***Rights of Access and Choice to clearing and settlement processes***

*Existing legislation*

The ISD currently allows that remote members of regulated markets be allowed access to the clearing and settlement systems of that market. Central counterparty clearing house and settlement systems therefore can and do accept members located in other Member States. Membership criteria form the first line of risk management for a system, so institutions wishing to become direct members must be technically, financially and legally capable of fulfilling their obligations. However, the membership criteria applied by the system must be reasonable, objective and transparent and that such criteria be uniformly applied. More specifically, there should be no discrimination, including with regard to the functionality offered, on grounds of type or location of the entity applying for membership.

*Orientations for ISD revision*

The March 2002 proposals relating to clearing and settlement in the consultation on a revised ISD would grant elements of choice to both markets and investment firms in the routing of trades for clearing or settlement. Market participants could make use of central counterparty clearing facilities in other Member States for off-market transactions and have the right to choose the location of the settlement of their transactions, provided that the necessary links are in place for their system of choice to be used. Regulated markets could have the right to make use of the services of central counterparties established in another member state for some or all transactions, subject to approval of the competent authority responsible for oversight of the market.

*Limitations on the current proposals*

Neither the existing ISD, nor the plans for its revision contain truly comprehensive rights of access and choice. They address some of the restrictions facing participants on location of settlement, but do not offer a corresponding right for central counterparties and central securities depositories to become members of other clearing and settlement systems. EU legislation could be used to create rights of access and choice for and between all types of entity involved in the clearing and settlement process. Consideration would need to be given to whether there are efficiency or risk management arguments that point to the maintenance of 'default' routing of transactions to central counterparties.

*Should EU legislation be used to provide comprehensive rights of access and choice across and between all levels of the trading and settlement chain?*

These rights of access and choice will not result in increased integration or competition if they cannot be exercised effectively. In addition to the technical, operational and legal issues described above, there are also concerns about the actions of national regulators, who would have the right to object on grounds of adverse implications for the smooth operation of the market. In the absence of agreed standards for the authorisation, oversight and supervision of these systems, national authorities may have concerns about use of systems in other jurisdictions for the finalisation of transactions on their markets, or involving their institutions and investors. Common, objective criteria for regulators to assess the risks posed by different systems and links are required in order to avoid arbitrary restriction of access and choice.

*What factors should market regulators be concerned with in deciding whether to grant use of a system in another member state?*

***Development of common regulatory view***

At present there is no agreed common regulatory status for central counterparties, settlement systems and custodians in the EU. If inter-connectivity and consolidation of systems are to develop in Europe, then it is important to consider now the issues arising for public authorities, in order that national differences in regulatory practice do not act as a drag on market development.

Currently, cross-border co-operation and communication between authorities with an interest in a system or its participants is arranged directly between those authorities as and when mergers and joint ventures arise. As cross-border mergers and links develop, so there will be an increase in the burdens on regulators to achieve effective supervision of these functions. It becomes ever more important to have clarity over the applicable supervisory regime (i.e. which authority, among the different ones that might be involved in cross-border clearing and settlement, is competent in the supervision of that cross-border business).

The process underway through the ECB/CESR Joint Working Group to develop a common view on a broad range of aspects in relation to these systems can only serve to improve understanding of the current landscape and achieve greater convergence on the issues of particular regulatory concern in relation to different systems and activities. The Group has also undertaken a consultation exercise, and will draw on the responses in the development of any European adaptation of the CPSS/IOSCO Recommendations.

However, it is possible that common industry and/or regulatory standards may not be sufficient to provide a fair and stable framework for cross-border use of clearing and settlement systems. They may leave room for continued constraint on the exercise of rights of access and choice. In this case, some high-level principles could be enshrined in a legal framework at EU level. These could be enshrined in a form of framework directive covering aspects such as the authorisation, supervision, risk management techniques, default arrangements, or capital treatment of such institutions.

*Is there a need for framework legislation governing these functions at EU level?*

*If so, what particular aspects should be included in any such legislation?*

***Competition policy***

The major force for facilitation of competition between undertakings providing clearing and settlement services will initially come from measures to ensure open access and interoperability of networks. However, the parallel application of the competition rules is also necessary.

Articles 81, 82 and 86 of the Treaty (the EU competition rules) apply to undertakings in all sectors of the economy, including clearing and settlement.

Article 81 prohibits agreements between undertakings that can have an appreciable effect on trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition. With the exception of certain "hardcore restrictions" such as price fixing, market sharing and output limitation, agreements can only infringe

Article 81 where they are entered into by undertakings with sufficient market power as to cause negative market effects. Article 82 is a provision that places particular obligations on undertakings holding a dominant position on the market. Efficient businesses are run with a view to establishing strong market positions, to a point which may result in significant market power. Holding a dominant position is not wrong in itself, if it is the result of the firm's own effectiveness. But if the firm exploits its dominant position to stifle competition, there is an anti-competitive situation which may constitute an abuse with the meaning of Article 82 of the Treaty.

Article 86 gives the Commission the responsibility to check that Member States (as well as those undertakings concerned) comply with the Community competition rules, when they grant exclusive or special rights to undertakings,

The Commission services are in the process of conducting an in-depth ex officio inquiry of the clearing and settlement sector. The addressees of this inquiry are market participants including banks, trading platforms, and clearing and settlement systems. The purpose of the inquiry is to ensure that Community competition policy is being properly respected in this important sector.

The Commission has already identified a number of possible competition concerns in the field of clearing and settlement

– First, some market participants have indicated that certain settlement systems may be engaging in discriminatory pricing and the application of dissimilar conditions to equivalent transactions.

– Secondly, exclusive arrangements may exist between exchanges and clearing and settlement systems which restrict competition in clearing and settlement services.

– Thirdly, some market participants have pointed out the possible risk of excessive prices being charged for clearing and settlement services where (i) the clearing and/or settlement system is controlled by a trading platform and (ii) trades on that platform have to be cleared and/or settled in that system (so-called “vertical silos”).

The ex officio procedure will examine whether any of these possible concerns are justified, and if so whether they can be addressed under the EU competition rules.

## VI THE NEXT STEPS

This Communication draws together a number of the highly-interconnected issues and the various strands of work currently underway in Europe on this subject. It sets out the current thinking of the Commission in this area and seeks views on the best steps forward.

Reaction is sought by 31 August 2002, both to the paper as a whole, and to the specific questions highlighted in the text. These are reproduced below for ease of reference.

Following reaction to this consultation, the Commission will be better placed to consider what action(s) could be appropriate in this area. Some possible actions could be further legislative measures to improve legal certainty for securities transactions, or a proposal for a framework directive defining the functions and conditions of business of clearing and settlement entities.

At the same time, a number of other initiatives will produce input into the debate:

– The Giovannini Group will publish its second report, providing their own view on where the priorities for action in this area should lie and examining possible models for the future.

– The Group of Thirty will produce its recommendations to improve the global clearing and settlement landscape.

– The ECB/CESR Joint Working Group will continue their work on harmonisation at the level of supervision and oversight.

All of these elements, alongside the responses to this Communication will inform the Commission in deciding what its next steps should be. Around the end of 2002 the Commission will produce a document outlining the results of this policy review and the consultation process, including setting out any further steps that it intends to take.

Questions to which specific response is sought

*Is the combination of actions outlined in Annex II the best approach to the removal of this category of barrier? Which actions should be priorities?*

*Are further measures, beyond the adoption of the Hague Convention, required to achieve effective resolution of conflicts of law in the EU? Would adoption of these measures be sufficient to resolve the main legal uncertainties for securities transactions in the EU?*

*If not, is a 'securities code', establishing a uniform legal treatment of securities across the EU, either necessary or desirable?*

*Does the creation of a level playing field require that common functional definitions of clearing and settlement activities be developed at EU level? Which post-trade activities should such definitions encompass?*

*Should EU legislation be used to provide comprehensive rights of access and choice across and between all levels of the trading and settlement chain?*

*What factors should market regulators be concerned with in deciding whether to grant use of a system in another member state?*

*Is there a need for framework legislation governing these functions at EU level? If so, what particular aspects should be included in any such legislation?*

## ANNEX I: EU LEGISLATIVE POSITION

The regulatory framework is mainly composed of the Settlement Finality Directive (SFD), solvency ratio provisions of the Banking Co-ordination Directive, the Capital Adequacy Directive (CAD) and, indirectly, the Investment Services Directive (ISD).

*Settlement Finality Directive (98/26/EC).* The purpose of the SFD is to reduce the systemic risk associated with participation in payment and securities settlement systems, and in particular the risk linked to the insolvency of a participant in such a system. As such it contains provisions establishing the finality and non-revocability of transfer orders and payment netting; on the non-retroactivity of insolvency proceedings; on the insolvency law which is applicable to claims and obligations in a payment/securities settlement system; on the insulation from insolvency proceedings of collateral posted in connection with participation in a system and on the law applicable to cross-border provision of collateral.

*Banking Co-ordination Directive/ Capital Adequacy Directive (93/6/EEC, 98/31/EC, 98/33/EC).* There are two aspects of these directives and any future revisions that are relevant to clearing and settlement entities. First, the treatment of exposures to central counterparties, settlement systems and custodians. Second, the capital requirements of the institutions themselves.

Article 2(9) of Directive 93/6/EEC states that "*exposures incurred to recognised clearing houses and exchanges shall be assigned the same weighting as that assigned where the relevant counterparty is a credit institution.*" There is no common EU definition of a 'recognised clearing house'. Directive 98/33/EC gives the competent authorities of Member States the right (until 31 December 2006) to exempt OTC contracts from counterparty risk requirements if a central counterparty clearing house is used and all current and future exposures are fully collateralised on a daily basis. It is not clear whether this latter exemption extends to institutions from a jurisdiction other than the one in which the central counterparty is authorised.

There are no specific capital requirements imposed on entities providing central counterparty services. However, some European central counterparties are banks, and therefore fall within the scope of the legislation. Central counterparties in Europe employ a number of different models to ensure that they have adequate resources of a liquid, high-quality nature to cover the risks that they incur.

Direct claims on settlement systems tend to arise only where the system itself operates as a bank. Direct claims would be treated as for a claim on any other bank. As far as the capital requirements for the systems themselves are concerned, only those systems that are banks or investment firms would be subject to capital requirements. However, as noted above, non-bank systems do not have exposures to their members and therefore are not subject to counterparty credit risk.

*Investment Services Directive (93/22/EEC)* The ISD gives authorised investment firms (and banks) a passported right of direct or indirect access to clearing and settlement facilities provided for members of regulated markets throughout the EU.

The proposed *Directive on Financial Collateral Arrangements*, COM(2001)168 final, [on which the Council reached an orientation agreement on 13th December 2001,] seeks to resolve the main problems affecting cross-border use of collateral in wholesale financial markets. The Directive creates an effective and simple Community regime for the creation of collateral

arrangements making it possible for market participants to conclude such arrangements in the same manner throughout the EU. As such it provides limited protection of collateral arrangements from some rules of insolvency law. It creates legal certainty with regard to cross-border provision of collateral, in the form of book-entry securities, by extending the principles already applied under the Settlement Finality Directive to determine where such securities are located. Finally, it restricts the imposition of onerous formalities on either the creation or the enforcement of collateral arrangements. The limitation of administrative burdens will also promote the efficiency of cross-border operations of Central Banks and payment and securities settlement systems covered by the Settlement Finality Directive, which does not deal with such matters.

## ANNEX II: POSSIBLE ACTIONS TO ADDRESS MARKET PRACTICE AND TECHNICAL BARRIERS

| Barrier identified in Giovannini Report | Possible action by private sector | Possible response of national authorities | Possible co-ordinated action at EU level |
|---|---|---|---|
| Differences in IT standards and interfaces | Adoption of EU-wide standards for communication between systems and between systems and their members (ISO 15022) | | Inclusion of communication standards as part of any EU recommendations.<br><br>Setting of a deadline for implementation of standards in respect of Eurosystem activity. |
| National restrictions resulting in use of multiple systems | | Measures to remove restrictions embodied in national law<br><br>Co-ordination/ information sharing with other Member States to facilitate cross-border use | Facilitation of rights of access and choice through single market legislation – e.g. ISD.<br><br>Development of common view on oversight of systems to facilitate cross-border use |
| Differences in rules and processes relating to corporate actions | Implementation of standardised communication between CSDs (ISO 15022) | Measures to simplify processes (e.g. need for physical documentation). | |
| Absence of intra-day finality between systems | Ensure intra-day finality in links between systems | | |
| Impediments to remote access | Systems to operate transparent, non-discriminatory access criteria. All members to be afforded same facilities regardless of location. | Remove legal restrictions preventing exercise of rights of remote access | Facilitate access to systems – e.g. through ISD<br><br>Development of common view on principles governing access to systems |
| National differences in settlement periods | Harmonisation | | Support for harmonisation through recommendations/ standards |
| National differences in operating hours/settlement deadlines | Harmonisation of operating hours, harmonisation and transparency of deadlines. | | ECB standards require conformity with TARGET.<br><br>EU standards/<br><br>Recommendations to broaden scope? |

| | | | |
|---|---|---|---|
| Differences in issuance practice | Development of intra-day links, standardisation of communication (ISO 6166) | Examine issuance practice and reduce complexity e.g. in process for allocation of ISINs | Inclusion of communication standards as part of any EU recommendations. |
| Restrictions on location of securities | | Measure to remove restrictions embodied in law tying place of issue/registry to place of settlement | Facilitate choice of location of settlement through ISD<br><br>Develop legal framework to support transfers of securities throughout EU |
| Restrictions on activity of primary dealers and market makers | | Consider the continued need for restrictions in integrated market and remove | Facilitate choice of location of settlement through ISD<br><br>Develop legal framework to support transfers of securities throughout EU |