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Re: Comments on the Draft ESCB-CESR Standards for Securities Clearing and Settlement Systems in the European Union of May 2004

Dear Gentlemen:

The Securities Industry Association ("SIA")¹, through its Cross-Border Sub-Committee², welcomes the ESCB-CESR Working Group's call for comments on the second draft of the Standards for Securities Clearing and Settlement Systems in the European Union published in May 2004. We continue to support the Working Group's goal of enhancing the safety, soundness and efficiency of clearing and settlement in the European securities markets.

We appreciate changes in the standards which reflect comments made in the SIA's response to the first consultation in the fourth quarter of 2003³ regarding the need to distinguish CCPs and CSDs, which are market infrastructures, from custodian banks which act as intermediaries. We welcome the removal of intermediaries from the scope of standards 13, 14 and 17 on governance, access and transparency.

¹ The Securities Industry Association brings together the shared interests of more than 600 securities firms to meet common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and international markets and in all phases of corporate and public finance. Further information about the SIA membership, committees and initiatives are available on its website, www.sia.com.

² The Cross-Border Subcommittee is comprised of a subsection of representatives from SIA's Operations Committee. The Cross-Border Subcommittee is primarily a U.S.-based group of global and regional securities firms and banks. Several of our members join us regularly from Europe, and we also have U.S.-based representatives of non-U.S. entities. Our perspective, therefore, tends to be on the growth of global cross-border securities transactions.

³ Letter dated December 10, 2003.

However, we continue to be concerned about two major aspects of the standards:

Collateralization by “systemically important” custodians

The revised standards delegate to national regulators and overseers the determination of whether or not a custodian operates a systemically important system, and Standard 9 states that collateralisation of these custodians’ credit exposures, including intraday credit, should be envisaged.

We have two main concerns with this approach. First, the standards do not explain what are the risks that “custodians create for the financial system,” nor why bank regulations are insufficient. This could easily lead to unnecessarily burdening banks with collateralization requirements that will ultimately increase the cost of investment in the European markets to investors, without commensurate benefits. Second, national regulators are free to use their own interpretation and assessment criteria, which will lead to uneven designation (as “systemically important”) initially across Member States, and ultimately broad designation at a pan-European level, as attempts to achieve consistent regulation could potentially lead to the adoption of the lowest common thresholds for the designation of systemic importance. Again, this will add unnecessary costs to investment in Europe.

Separation of operational risk from credit risk

The first draft of the standards made reference to the United States regulators in their Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System published in April 2003. In particular, the standards of August 2003 adopted a five percent volume benchmark used by the Interagency Paper as the standards’ threshold in the determination of systemic importance. Even though the current draft of the standards makes no reference to a five percent volume benchmark, systemic importance continued as a regulatory concept to be applied to custodians.

We feel it is necessary to reiterate the necessity to clearly separate systemic importance into operational risk and credit risk elements, as these require different risk management approaches. As such, we offer a brief overview of U.S. regulators’ approach to risks inherent in firms processing a large volume of securities transactions, and in particular highlight the recommendations of an interagency report published in January 2004 which contains further progress in the approach to separating and managing operational and credit risk.

The Interagency Paper of April 2003 concluded that, “...The resilience of the U.S. financial system in the event of a wide-scale disruption rests on the rapid recovery and resumption of the clearing and settlement activities that support critical financial markets. Some organizations, namely core clearing and settlement organizations⁴ and firms that play a significant role in critical financial markets⁵, present a type of systemic risk to the U.S. financial system should they be unable to recover or, in some instances, resume

⁴ Core clearing and settlement organizations consist of two groups: market utilities (government or industry-owned organisations whose primary purpose is to clear and settle transactions for critical markets); private-sector firms whose aggregate market share is significant enough to present systemic risk in the event of their sudden failure to carry on these activities because there are no viable immediate substitutes.

⁵ Firms that play significant roles in critical financial markets are those that participate (i. e. trade) with sufficient market share in one or more critical financial markets such that their failure to settle their own or their customers’ material pending transactions by the end of the business day could present systemic risk. A firm is considered significant if it settles at least five percent of the value of transactions in that critical market.

clearing and settlement activities that support these markets.” The focus of the Interagency Paper was exclusively on continuity of business arrangements in the event of wide-scale disruptions such as a breakdown in transportation, telecommunications, power or other critical services.

In January 2004, the Federal Reserve, Comptroller of the Currency, and the Securities and Exchange Commission published a report of the private-sector Working Group on Government Securities Clearance and Settlement and endorsed its recommendations. These included a differentiation between operational disruptions which strike suddenly, and non-operational vulnerabilities, which usually have a lead-up period during which regulators, supervisors and market participants could take action – such as the involuntary exit of the business by a commercial provider forced by a loss of market confidence in the face of financial or legal problems.

For operational disruptions, the report recommends that regulators monitor and test implementation of sound practices and implementation guidelines, that the private sector develops a secure and resilient telecommunications infrastructure, and that market participants and regulators study further the threat of cyber-terrorism. For non-operational disruptions, the report recommends the sale of an exiting bank’s business to another well-qualified bank, and a further study of the concept of “NewBank”, a shelf corporate structure set up in advance that would assume operations using the exiting bank’s existing operational capabilities.

In marked contrast to reactions of the banking community in Europe to the ESCB-CESR Standards, U.S. banking institutions were broadly supportive of the Interagency White Paper recommendations. The reasons for this are clear. In their approach, U.S. regulators did not attempt to impose additional regulations on firms considered to play significant roles in critical markets. Rather, they tried to ensure the promulgation of best practices, used market-led initiatives to ensure a robust communications infrastructure, and fostered competition as a means to reduce concentration of risks. We believe a combination of these approaches in Europe would not only fulfill the objective of risk reduction, but also benefit market participants by avoiding the cost of excessive regulation, preserving choice, and encouraging innovation. Additional regulation of service providers without demonstrating that such regulations are justified (or even beneficial) will add cost without any appreciable reduction in risk.

In conclusion, members of SIA would be most happy to facilitate the ESCB-CESR Working Group’s further understanding of the U.S. approach to the implications of volume concentration and the methods to mitigate systemic risk. In the spirit of the EU-U.S. dialogue on financial services, we would welcome an opportunity to further the common objective of building a safe, sound and efficient securities clearing and settlement infrastructure in Europe. Comments regarding this letter may be directed to Richard Bommer at SIA, email- rbommer@sia.com.

Sincerely,

Mary Dupay
Chairperson
Cross-Border Subcommittee of the
Operations Committee