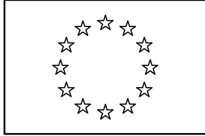

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.4.2004
COM(2004) 312 final

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

Clearing and Settlement in the European Union – The way forward

TABLE OF CONTENTS

Introduction

Current Situation

1. **The Clearing and Settlement arrangements**
2. **The barriers identified by the Giovannini reports**
3. **Absence of a common regulatory/supervisory framework**
4. **Absence of a level playing field**

The Commission's Objectives

The Commission's Practical Initiatives

1. The setting up of the "Clearing and Settlement Advisory and Monitoring Group"
2. A framework Directive for efficient and safe, pan-European Clearing and Settlement.

2.1 Rights of access and Choice

2.2 Common regulatory/supervisory framework

2.3 Governance

3. Addressing legal and tax law discrepancies

3.1 The Legal Certainty Project

3.2 Taxation issues

4. **Competitive issues and competition policy**

Conclusions

INTRODUCTION

The creation of an integrated and efficient European capital market is one of the most important and ambitious economic projects currently under way in the European Union. Since 1999, when the Financial Services Action Plan was launched, considerable progress has been made towards this goal, both in terms of legislative measures and market integration.

A crucial element of this framework will be the safety and efficiency of the arrangements required to finalise securities transactions ("Clearing and Settlement"). These arrangements, largely invisible to the retail investor, lie at the core of all securities markets and are indispensable for their proper functioning.

Although the concepts underlying these processes and mechanisms are quite straightforward, the mechanisms themselves are very complex to put in place and to operate, especially in a cross-border context. Purely domestic clearing and settlement activities in the EU are relatively cost effective and safe. But cross-border arrangements are complex and fragmented, resulting in much higher costs, risks and inefficiencies. Without efficient clearing and settlement arrangements, the ability and willingness of participants to trade in EU securities will be sub-optimal; the liquidity of financial markets will be affected and the cost of capital will be higher than it need be.

Against this background market forces are driving the demand for far greater pan-European efficiency. The introduction of the euro and improvements in information technology have contributed to the increase of the number and the relative importance of cross-border transactions. As a result, the strains on and the expectations from cross-border clearing and settlement arrangements have increased considerably. Clearing and settlement service providers are seeking to enhance performance, reduce costs and establish a pan-European presence, on their own or through mergers and alliances, which is beginning to lead to significant restructuring. At the same time, regulators, supervisors and overseers are taking steps in order to increase the clarity and homogeneity of standards applicable to securities clearing and settlement systems, to update their supervisory methods in order to meet the challenges posed by market developments, and to enhance safety.

In this Communication, the Commission outlines the actions it intends to undertake in order to improve Clearing and Settlement arrangements. The Commission's approach is based on the following considerations:

– the objective to be pursued is the achievement of an efficient, integrated and safe market for securities clearing and settlement;

– the integration of securities clearing and settlement systems will require the combined intervention of market forces and public authorities. In this context, the Commission will seek to promote co-ordination between private sector bodies, regulators and legislators so as to achieve the desired outcome as efficiently as possible;

– in an integrated barrier-free environment, infrastructure providers and users of the relevant services should have access to and choice of their preferred, properly authorised and supervised clearing and settlement system, operating in full conformity with the EU's competition rules. In order to arrive at such a liberalised environment and to ensure the mutual recognition of systems, regulatory intervention at an EU level, through the adoption of a framework Directive, will be necessary;

– in exercising its powers, the Commission will respect the subsidiarity and proportionality principles enshrined in the EU Treaty as well as the diversity of approaches in the different Member States as regards market structures.

– the legal underpinnings of clearing and settlement in the EU should be clear, reliable and coherent.

– further consolidation in clearing and settlement in the EU should mainly be market-driven, to the extent that legitimate public policy concerns are met.

The Commission invites comments on all aspects of this Communication from the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions, national regulatory and supervisory authorities, other EU level and national organisations and federations, market practitioners, institutional investors, infrastructure providers and all other interested parties by the 30th of July 2004.

It will then finalise its decisions during 2005 as to the course of action it will adopt and the exact contents of any measures that may prove necessary.

CURRENT SITUATION

1. The *Clearing and Settlement* arrangements

In this Communication the term *"Clearing and Settlement"* is intended to describe the full set of arrangements required to finalise a securities or derivatives transaction[1]. These arrangements encompass a broad collection of institutions, instruments, rules, procedures, standards and technical means.

The performance of clearing and settlement functions has been entrusted mainly to institutions such as Central Securities Depositories and Central Counterparties. The former mainly perform functions relating to *settlement* and *custody*, while the latter typically perform functions relating to *clearing*. Central Securities Depositories and Central Counterparties do not usually deal with retail investors. Access to these institutions is offered by other entities – namely, Custodians and Clearing Members – which act as Intermediaries for clearing and settlement activities. However, certain Intermediaries may not wish to access directly these institutions; they use other Intermediaries instead. As a result, a multi-tier intermediary structure is possible.

In a nutshell, the full set of institutional arrangements required to finalise a securities transaction can be defined as a Securities *Clearing and Settlement* System. Within this broad framework, we can further distinguish among Securities Settlement Systems, Central Counterparties, Custodians and Clearing members. Securities Settlement Systems can be considered to include all institutions performing the Pre-settlement, Settlement and Custody functions; Central Counterparties can be defined as institutions performing the *Clearing* function. In this Communication the *Clearing* function is defined as the activities that have as effect to guarantee from the potential losses arising in the event of default of a counterparty to a trade ("replacement cost risk"). Custodians provide Intermediary services in the *Settlement* activity, while Clearing Members provide Intermediary services in the *Clearing* activity.

---

[1] Unless otherwise specified, the term "transaction(s)" will be deemed to include both securities and derivatives transactions.

Traditionally, *clearing* has mainly referred to the process of calculating the mutual obligations for the exchange of securities and money, on a gross or net basis, prior to settlement. This process may also include netting with novation which has as an effect to guarantee counterparties from replacement cost risk. As the risk profile for these activities is different, in this Communication, the former activities (i.e. the mere process of calculating the mutual obligations) are considered as part of Pre-settlement, while the latter activities (i.e. those that have as effect to guarantee counterparties from replacement cost risk) are defined as *Clearing*. *Settlement*, on the other hand, is considered as including the final transfer of securities from the seller to the buyer and of funds from the buyer to the seller.

Cross-border transactions can be settled through the following channels:

1) direct remote access to the foreign Securities Settlement System;

2) use of a custodian having direct or indirect access – typically through a local participant – to the foreign Securities Settlement System;

3) use, as an Intermediary, of a Central Securities Depository or an International Central Securities Depository[2] that has direct or indirect access to the foreign Securities Settlement System.

In a cross-border context, Securities Settlement Systems may offer direct services to remote participants in relation to securities for which they represent the final point of settlement (option 1 above). As already mentioned, custodians typically act as Intermediaries for settlement activities. They act in this capacity with respect to cross-border settlement as well (option 2 above). Securities Settlement Systems may also act in an Intermediary capacity, i.e. as Investor–Securities Settlement Systems, in relation to securities kept in final custody in another Securities Settlement System, named Issuer–Securities Settlement System (option 3 above).

In the provision of cross-border settlement services, therefore, Securities Settlement Systems, acting in their Intermediary capacity, and the custodians are, at least potentially, in competition with each other. The possibility for the Issuer–Securities Settlement System to offer direct remote access means that it can also, at least potentially, compete with the Investor–Securities Settlement Systems and the custodians in the provision of cross-border settlement services[3].

Current arrangements for the finalisation of transactions in the EU are generally considered efficient at a national level, but very inefficient at a cross-border level. Securities Clearing and Settlement Systems in the EU have historically developed on a purely domestic basis, as cross-border trading activity has, in the past, been very limited. Given the large economies of scale and scope that characterise Securities Settlement Systems and Central Counterparties, domestic systems have experienced a process of consolidation leading to the creation of

---

[2] International Central Securities Depositories are Securities Settlement Systems for Eurobonds. The only two examples of International Central Securities Depositories are Euroclear Bank and Clearstream Banking Luxembourg.

[3] The same is also true for clearing through a Central Counterparty. Cross-border clearing can be performed either on a remote access basis or through the services of a general clearing member or through the services of a different Central Counterparty. In the latter case, the foreign Central Counterparty will treat the "Investor-CCP" as a participant requesting margins commensurate to the latter's positions.

domestic monopolies or quasi-monopolies operating under uniform technical, regulatory and legal frameworks.

The inefficiencies of cross-border arrangements in the EU are due to a lack of global technical standards, the existence of differing business practices and inconsistent fiscal, legal and regulatory underpinnings. As a result, cross-border *Clearing and Settlement* in the EU is much more costly and complex than at purely domestic level and, potentially, less safe. This fragmented market structure is no longer acceptable at a time when investment strategies are increasingly based on pan-European, sector-based considerations and a single EU financial market is being created.

The European Parliament's Resolution of January 2003[4] underlined that the existing clearing and settlement arrangements do not enable cross-border transactions to be processed efficiently and, in consequence, it is impossible to exploit to the full an internal market in financial services. The Parliament noted that the existing state of the market makes it essential for a proposal for a directive to be drawn up. The Parliament suggested that the exercise of risk by CSDs should be limited to operational risk and that provision of value added services by CSDs should be subject to functional separation. It also called upon the Commission to study thoroughly the US example of a unified clearing, settlement and custody framework. The Commission invites any comments which interested parties might wish to make in the light of the EP's request for this issue to be given further study.

2. The barriers identified by the Giovannini reports

The nature of the problems in this area has been the focus of much attention recently. Among other reports on this subject, the two reports of the ***Giovannini Group*** identified 15 barriers, divided into technical or market practice barriers, barriers related to tax procedures and legal barriers ("the Giovannini Barriers")[5], as the main causes of fragmentation and inefficiencies. The reports concluded that until these barriers are eliminated, the EU clearing and settlement environment will remain a juxtaposition of domestic, non-integrated markets.[6]

While all the Giovannini Barriers constitute an impediment to the integration of EU securities clearing and settlement systems, they have different effects on the way cross-border clearing and settlement is achieved. The reports acknowledge that one of the most important barriers to integration relates to the restrictions on the location of clearing and settlement. Such restrictions do not allow market participants free access to, and choice of, clearing and settlement locations and so they remove an essential condition for increased competition and efficiency in the provision of cross-border services.

---

[4] European Parliament resolution on the communication from the Commission to the Council and the European Parliament entitled "Clearing and settlement in the European Union: main policy issues and future challenges".

[5] See annex 1 for the list of barriers identified in the Giovannini reports. The full text of the two Giovannini reports are available on the Commission's website and are therefore not discussed in detail in this Communication.

[6] The relevance of the barriers identified by the Giovannini Group, along with the absence of a common regulatory/supervisory framework for and of a level playing field in Securities Clearing and Settlement Systems (see below), were considered in the first Commission Communication on *Clearing and Settlement*, "Clearing and settlement in the European Union – Main policy issues and future challenges", COM(2002)257, 28.5.2002, available at http://europa.eu.int/comm/internal_market/en/finances/mobil/clearing/index.htm.

However, even if the obstacles as to the location of clearing and settlement were lifted, other barriers identified by the Giovannini group would still restrict the effective exercise of the relevant rights of access and choice. For instance, some of these barriers make it more attractive or even impose the use of local participants to access foreign Securities Settlement Systems. This is the case for all actions the performance of which requires specialised knowledge or local expertise (e.g. national differences as regards the treatment of interests in securities held with an intermediary, corporate actions, securities issuance practices, etc) or when local participation is actually imposed (e.g., by Member States' rules that give withholding tax responsibilities exclusively to local intermediaries). These barriers effectively prevent the use by foreign investors or intermediaries, of cross-border settlement channels other than through local participation.

Another category of barriers constitute an effective impediment to the use of Securities Settlement Systems as intermediaries in cross-border settlement. An example of this type of barriers would be the collection of transaction taxes only via a functionality integrated into the local Securities Settlement System; using a different system could mean paying higher transaction taxes. As a consequence, market participants may, because of cost concerns, not use their preferred settlement location.

Other barriers are a source of additional costs and/or risks when compared to domestic *Clearing and Settlement* (e.g. differences in information technology and interfaces, etc). Eliminating such barriers will reduce the overall cost and risk differences between cross-border and domestic clearing and settlement.

3. Absence of a common regulatory/supervisory framework

Another important element characterising the European Securities Clearing and Settlement Systems is the absence of an agreed common regulatory/supervisory framework. Public authorities have responsibilities concerning the safety of Securities and Clearing Settlement Systems, both from the point of view of investor protection and systemic stability. When systems operate cross-border, national authorities need also to be satisfied that all linked foreign systems are properly regulated and supervised.

In the absence of a common regulatory framework, regulators may deny access to, or oppose the use of, foreign systems in order to maintain the smooth operation of markets and to guarantee financial stability.

In response to these concerns, the European System of Central Banks (ESCB) and the Committee of European Securities Regulators (CESR) have launched a joint working group, the ***ESCB/CESR Working Group,*** to develop common standards for entities providing clearing and settlement services in the EU. Their work is based on an adaptation of the CPSS-IOSCO[7] Recommendations[8] to the European context. ESCB and CESR published for consultation their draft standards in July 2003[9]. The standards will not be mandatory; they will not therefore supercede any national legal provision that may affect their practical implementation by the competent national authorities.

---

7 Committee on Payment and Settlement Systems of the G10 central banks and International Organisation of Securities Commissions.

8 Recommendations for Securities Settlement Systems, Report of the CPSS-IOSCO Task Force on Securities Settlement Systems, November 2001.

9 "Consultative Report: Standards for Security Clearing and Settlement Systems in the European Union", July 2003.

4. <u>Absence of a level playing field</u>

The absence of an appropriate legislative framework in the EU on Securities and Clearing Settlement Systems along with the fact that certain institutions providing clearing and settlement services are licensed as banks/investment firms raises two major level playing field issues.

While banks and investment firms can offer custody and settlement services on a cross-border basis based on their ISD passport, no corresponding right is provided for providers of clearing and settlement services which are not banks or investment firms.

In the same vein, differences exist as to the capital adequacy requirements applying to providers of clearing and settlement services. In particular, differences exist between entities licensed as banks, on one hand, and those that are not, on the other. Moreover, because of the lack of harmonisation in this field, differences also exist among those entities providing clearing and settlement services that are not licensed as banks.

In addition, while there may be entities licensed as banks that can offer intermediary and banking services as well as core infrastructure custody and settlement services, the same set of rights may not be available to custodians in some Member States.

THE COMMISSION OBJECTIVES

The Commission's overarching objective is the creation of EU Securities Clearing and Settlement Systems that are efficient and safe and which ensure a level playing field among the different providers of Clearing and Settlement services. In order to achieve this objective, the Commission considers that the following measures and policies need to be pursued:

(a) the **liberalisation and integration** of existing Securities Clearing and Settlement Systems through the introduction of comprehensive access rights at all levels and the removal of existing barriers to cross-border clearing and settlement;

(b) the continued application of **competition policy** to address restrictive market practices and to monitor further industry consolidation;

(c) the adoption of a **common regulatory and supervisory framework** that ensures financial stability and investor protection, leading to the mutual recognition of systems;

(d) the implementation of appropriate **governance arrangements**.

Liberalised and integrated securities clearing and settlement systems in the EU will require that all different options for cross-border clearing and settlement are available to markets, Clearing and Settlement service providers and investors. It is only when they enjoy full choice on how to clear and settle cross-border transactions that competition will be fully at work and able to generate positive effects in terms of price reduction and economic efficiency.

For such choice to be fully available, systems must be able to have access to each other. The Commission considers therefore that a fundamental step in achieving a liberalised and integrated market for clearing and settlement in the EU is to grant comprehensive rights of choice and access to all providers of Clearing and Settlement services, including Central Counterparties and Securities Settlement Systems. This is not the case today, nor will it be

with the adoption of the new ISD, due to remaining national and commercial restrictions to the clearing and settlement location.

The introduction of comprehensive rights of access and choice will, however, not be effective or sufficient without the removal of all the remaining barriers identified in the Giovannini reports. The removal of the technical or market practice barriers, the barriers related to tax procedures and the legal barriers is a necessary element for achieving the integration of clearing and settlement in the EU. For this reason, the Commission endorses the general approach taken in the two Giovannini reports. The Commission is also in favour of the specific suggestion of the Giovannini group that the removal of barriers should be effected through the combined efforts of the private and public sectors and according to an appropriate sequence.

Another important barrier to cross-border clearing and settlement that needs to be addressed by public authorities relates to the settlement of the cash leg of securities transactions. Currently, remote participants in the Euro-system national central banks do not have access to the intra-day credit facilities provided by those central banks to domestic participants. This does not constitute a problem to securities settlement during TARGET[10] operating hours, as TARGET participants can easily move funds from one account to another. However, it becomes a problem outside TARGET operating hours, particularly in those cases in which Securities Settlement Systems operate overnight settlement processes.

The Commission considers that, generally speaking, the cross-border settlement of the cash leg of securities transactions should be made as easy as is compatible with the objectives of the Euro-system and the other EU central banks, e.g. by making it possible for banks to centralise liquidity in one central bank account and then transfer the funds during securities settlement systems operating hours or, alternatively to use one single account, as will be possible with the envisaged enhanced release of TARGET (TARGET 2[11]), to support their settlement activity in the EU[12].

Although the liberalisation and integration of markets are essential elements of the whole process, they will not be sufficient to ensure efficient securities clearing and settlement systems in Europe. The competent authorities would also need to ensure the full respect of ***competition law*** by Clearing and Settlement service providers. Integration of existing Securities and Clearing Settlement Systems has the potential to increase efficiency; this potential should not be hindered by the adoption by Securities Clearing and Settlement Systems of anti-competitive practices, such as unfair denial of access or the imposition of excessive and/or discriminatory prices.

In addition to the actions mentioned above, the Commission considers that a ***common regulatory and supervisory framework*** needs to be introduced in the EU. Such a framework will enhance the safety of Securities and Clearing Settlement Systems and permit their mutual recognition. In fact, the safe functioning of all post-trade arrangements is vital to the safety of the financial markets and the stability of the financial system as a whole. Participants in

---

[10] TARGET is the European network of Real Time Gross Settlement payment systems.

[11] ECB, "TARGET 2: Principles and Structure", 16 December 2002. TARGET 2 offers the possibility to consolidate the technical platforms of the national systems "to those central banks which… decide to give up their individual platforms". Such consolidation will no doubt facilitate cross-border settlement.

[12] The CESR/ESCB consultative report addresses a similar recommendation to central banks inviting them "to enhance the mechanism for the provision of central bank money by, e.g., extending the operating hours of the cash transfer system and by facilitating access to central bank cash accounts."

Securities Clearing and Settlement Systems are confronted with a variety of risks[13]. If one participant's failure to settle renders other participants unable to meet their obligations, a Securities Clearing and Settlement System could become a major source of financial instability.

As Securities Clearing and Settlement Systems hold the assets that are used to secure payments in large-value payment systems and as collateral in monetary policy operations, their safety and efficiency is also of the utmost importance for the efficiency of payment systems and monetary policy.

It is also necessary that securities transactions are finalised speedily and efficiently in accordance with the terms of the trade. If investors perceive a Securities Clearing and Settlement Systems as unsafe, they will not be willing to enter into financial transactions that are cleared and settled in that Securities Clearing and Settlement Systems. In such a case, there will be a direct impact on financial market liquidity and indirectly on the cost of capital.

For these reasons, under the present regulatory framework regulators can deny access to, or oppose the use of, foreign systems if they are not confident that the smooth operation of the markets for which they are responsible can be maintained and the overall financial stability guaranteed.

The Commission considers that this concern should be addressed and that the liberalisation and integration of Securities Clearing and Settlement Systems should be coupled with a common regulatory and supervisory framework system, which will increase the safety of the overall clearing and settlement environment in the EU while also leading to the mutual recognition of systems.

The adoption of measures intended to liberalise access and to establish a common regulatory/supervisory framework will also create a level playing field by eliminating the existing disparities as regards access rights and capital requirements between clearing and settlement service providers that are licensed as banks and those that are not. In fact, the same activities should be subject to the same treatment (the "functional approach") regardless of the institutions that perform them. This approach implies the adoption of common definitions for the activities involved in the *Clearing and Settlement* process. It does not however imply the segregation of functions at this stage. Nonetheless, parties are invited to comment on such an approach in the light of arrangements which exist in some European domestic markets and which differentiate between infrastructure and banking functions.

Some of the public authorities' concerns regarding the safety of Securities Settlement Systems and Central Counterparties and their possible adoption of anti-competitive practices can be also addressed ex-ante through reliance on effective ***governance arrangements***. Such mechanisms must be considered as complementary to the policies mentioned above, namely competition policy and effective regulation and supervision.

The Commission's policy regarding clearing and settlement will therefore focuses on (a) the **liberalisation and integration** of existing Securities Clearing and Settlement Systems, (b) the application of **competition policy,** (c) the adoption of a **common regulatory and**

[13] Such risks include liquidity risk, credit risk, custody risk, operational risk and legal risk. See the CPSS-IOSCO Recommendations for a thorough discussion of these issues.

supervisory framework including the question of definitions, and (d) the adoption of appropriate **governance arrangements**.

* * *

Once all required measures have been adopted, consolidation among Securities Settlement Systems and Central Counterparties is expected to accelerate. The Commission agrees with the conclusions of both the Lamfalussy and Giovannini reports that the process of consolidation needs to be market-led.

The Commission considers that, as long as the appropriate regulatory/supervisory and competition policy safeguards are established, it should be neutral as regards such structural issues as (a) the degree and form of consolidation (either horizontal or vertical), and (b) the opportunity for Securities Settlement Systems and Central Counterparties to offer Intermediary and/or Banking services. Provided these safeguards are established, the Commission will refrain from proposing or imposing any specific market and/or institutional structure; it will also refrain from proposing or imposing any segregation of the Intermediary and Banking activities eventually offered by Securities Settlement Systems or Central Counterparties. Market forces will determine the "final" structure of the *Clearing and Settlement* industry. Markets, not the regulators, are best placed to decide on the structure of the industry and on the combination of consolidation and integration that best meets their needs.

The general aim of the authorities should be to facilitate this process, encouraging market forces whilst ensuring that public policy objectives are addressed. Such public policy objectives will have to be addressed through the envisaged common regulatory and supervisory framework, through the full respect and implementation of existing national and community competition law provisions and finally through the implementation of appropriate governance arrangements.

THE COMMISSION'S PRACTICAL INITIATIVES

Achieving the objective set out above – that is, the creation of efficient and safe EU Securities Clearing and Settlement Systems which ensure a level playing field among the different providers of Clearing and Settlement services – will be a lengthy and complex process and require the combined efforts of market infrastructures, market participants, regulators and legislators. The Commission considers that it will need to play a major role in providing the necessary political impetus, in co-ordinating actions and in proposing specific legislative measures in order to establish the necessary legislative framework.

On the basis of the above, the Commission intends to:

(a) ***Set up an Advisory and Monitoring group:*** The Commission intends to set up an advisory and monitoring group in order to tackle all Giovannini Barriers for which the private sector has sole or joint responsibility, and to promote the overall integration and liberalisation project.

(b) ***Propose a Directive on Clearing and Settlement:*** The Commission considers it necessary to complement the market-led removal of the relevant Giovannini barriers with a secure legal framework ensuring the freedom to provide securities clearing and settlement services throughout the EU on the basis of common requirements. Such a framework will ensure that restrictions and barriers as regards the location of

clearing and settlement are lifted. It will also ensure the mutual recognition of the various national systems based on the home country principle. The Directive should be a framework Directive, in that it should only set out general principles in conformity with the Lamfalussy process.

(c) ***Address legal and tax issues:*** The Commission intends to set up expert groups to consider the legal and tax-related barriers to integration, to evaluate the situation and, if needed, suggest methods of harmonisation of national law and/or procedures.

(d) ***Ensure the effective implementation of competition law:*** The Commission and national competition authorities will address anti-competitive market practices, such as unfair denial of access and the imposition of excessive and/or discriminatory pricing, and at the same time monitor existing monopoly positions and further industry consolidation intervening when necessary.

The setting up of the Advisory and Monitoring group and the expert groups on legal and tax issues is to be considered as a priority action.

1. The setting up of the "Clearing and Settlement Advisory and Monitoring Group"

Among the measures and policies to be pursued in order to achieve the Commission’s objectives, the integration of existing Securities Clearing and Settlement Systems is the one that requires more coordination between private and public sector bodies. In order to overcome barriers to integration, action by such bodies will be called for and the relevant synergies will need to be established.

The launching of these private and public sector-led actions will have important repercussions on the way clearing and settlement functions are performed throughout the EU. Processes, policies and attitudes will have to change as a result. The Commission is also aware that market participants' interests may not coincide, depending on their functions and the services they provide. For some of them, participation in an open and integrated market will require substantial investments while for others the risk of losing particular areas of business to competition will be important. This may cause delays and frictions in the adoption and acceptance of measures tackling the different barriers.

For these reasons, all bodies concerned by this process must be convinced of the need for particular action. Strong political leadership is required. In addition, monitoring of the results of the whole process is needed to ensure that the efforts will be sustained and that the general purpose and direction of the process will not be diverted.

In order to obtain the required results, the Commission favours the setting up of an informal advisory and monitoring group. This proposal echoes recommendations made by the Giovannini group of experts, which considered that the establishment of a co-ordination and monitoring mechanism would be advisable for the success of the whole operation.

In particular, it is envisaged that this group will, together with the Commission:

(a) ***promote*** the overall project and ***provide*** the public with all necessary explanations and reports of the state of reform, ensuring transparency at all times;

(b) ***operate as a forum*** for both public and private sector bodies with a view to ensuring their confidence that progress is being made;

(c) ***liaise*** with the groups of experts that will tackle the legal barriers and the barriers related to tax procedures (see section 3).

(d) ***informally assist*** the Commission;

(e) ***interface*** between the private and public sector bodies involved in the process with the aim of:

- defining interdependencies among the different barriers;
- coordinating detailed action plans and ensuring the consistency of the overall implementation process;
- monitoring progress and sequencing of actions;

(f) ***liaise*** with the Group of 30 and other international bodies to ensure the consistency of initiatives in the EU with those developed at international level.

This *"Clearing and Settlement Advisory and Monitoring Group"* should be composed of high level representatives of various private and public bodies involved in this project, including the ESCB and CESR.

The Group will be chaired by the Commission. It is expected that the Group will meet at least twice a year and that it will also appoint specialised subgroups responsible for particular aspects of the process.

2. A Framework Directive for efficient and safe pan-European *Clearing and Settlement*

The removal of technical and market practice barriers for which the private sector has been attributed some responsibility is a necessary but not sufficient condition for achieving a liberalised, integrated and competitive post-trading market in the EU. The Commission considers that meeting this objective will require the adoption of a framework Directive which will address the following issues:

- comprehensive rights of access and choice;
- common regulatory framework;
- appropriate governance arrangements.

2.1 Rights of access and choice

The achievement of an integrated Securities Clearing and Settlement System will largely depend on Clearing and Settlement service providers' enjoying effective freedom of access to, and choice of, their preferred clearing and settlement location on non-discriminatory terms. It is clear from the responses the Commission received to its first Communication that certain access and choice restrictions still remain today. In many cases, these stem from national law provisions or their interpretation. Examples of these are laws that require that stock exchange transactions be settled in an affiliated system and laws that give special privileges to local banks for the settlement and servicing of securities portfolio. The most efficient way to remove these or similar direct or indirect restrictions, incorporated in a multitude of national legal instruments, is likely to be the adoption of a framework Directive, introducing

comprehensive rights of access and choice and the conditions for their exercise. The alternative, namely to rely on voluntary action by the national legislators or regulators, would be much less certain and might not guarantee EU-wide liberalisation for a long period of time.

Although the EU has begun to tackle this issue through Community legislation, more will need to be done in order to create a truly liberalised and integrated cross-border post-trading environment. The current Investment Services Directive (ISD)[14] provides that authorised firms, namely investment firms and banks, have the right of direct or indirect access to clearing and settlement facilities provided for to members of regulated markets throughout the EU. Under that rule, authorised firms with remote access to regulated markets must also be allowed access to the clearing and settlement systems of that market under conditions that are non-discriminatory when compared to the access conditions granted to local participants.

The new ISD[15] extends this right, in the sense that authorised firms may now directly access clearing and settlement systems in another Member State even when they are not members of a regulated market or a Multilateral Trading Facility in that Member State. The new ISD also grants elements of choice to both markets and authorised firms in routing trades for clearing or settlement. Thus the proposal grants to:

a) ***authorised firms***: the right to access Central Counterparties and Securities Settlement Systems located in other Member States;

b) ***authorised firms***: the right to choose the settlement location of their transactions, provided that:

   – the necessary links are in place for their system of choice to be used;

   – there is agreement by the regulated market authority that the system of choice allows for the smooth and orderly functioning of financial markets.

c) ***regulated markets***: the right to make use of the services of Central Counterparties established in another Member State for some or all transactions; however, the competent authority of that regulated market has a right of opposition when the use of a foreign Central Counterparty demonstrably endangers the orderly functioning of the regulated market[16].

The **access rights** granted under the new ISD are not comprehensive and, therefore, they do not allow for the integration of systems at all levels. They only apply to authorised firms; Central Counterparties and Securities Settlement Systems do not have a corresponding right

---

14 Directive 93/22 of 10 May 1993, OJCE1993 L141/27

15 Directive of the European Parliament and of the Council on markets in financial instruments, markets, amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC of 7 April 2004. The Directive provides in its Article 34 that *"Member States shall require that investment firms from other Member States have the right of access to central counterparty, clearing and settlement systems in their territory for the purposes of finalising or arranging the finalisation of transactions in financial instruments. Member States shall require that access of those investment firms to such facilities be subject to the same non-discriminatory, transparent and objective criteria as apply to local participants. Member States shall not restrict the use of those facilities to the clearing and settlement of transactions in financial instruments undertaken on a regulated market or MTF in their territory*

16 The new ISD proposal clearly recognises public authorities' concerns relating to the use of foreign systems when they do not operate on the basis of a common regulatory framework.

to become members of other systems. This limits authorised firms' ability to exercise their corresponding right to choose the settlement location.

The **right to choose the settlement location**, granted under the new ISD, is intended to eliminate the need for authorised firms to maintain multiple memberships in Securities Settlement Systems. Such a right will enable them to decide where to settle transactions and hold securities on the basis of their own business needs. They may therefore choose to centralise holdings in a single system or combination of systems, selecting freely on the basis of cost, efficiency, access to funding, level of service or other considerations important to them. This reduces complexity and allows for much more efficient management of collateral.

However, authorised firms will not be able to exercise their right of choice unless the preferred settlement location has access to the "Issuer-Securities Settlement System". Therefore, Securities Settlement Systems should have the right of access to Securities Settlement Systems located in other Member States. Moreover, the right to choose as provided for in the new ISD does not include *Clearing*. The Commission considers that authorised firms should be given the option of choosing not only the settlement location, but also the clearing location. By choosing the settlement location, market participants would be able to settle cross-border through the Securities Settlement System of their choice. In the same way, by choosing the clearing location, market participants would be able to clear cross-border in the Central Counterparty of their choice. For **the right to choose the clearing location** to be effective, Central Counterparties must have the right to access to Central Counterparties located in other Member States.

Central Counterparties typically interpose themselves between the counterparties to trades, acting as the buyer to every seller and the seller to every buyer ("novation"); in order to be able to settle the novated transactions, Central Counterparties must also have direct or indirect access to the Securities Settlement Systems where transactions are ultimately settled and securities held. Consequently, Central Counterparties must also have the right of access to Securities Settlement Systems located in other Member States.

Providing access rights to Central Counterparties and Securities Settlement Systems not only makes authorised firms' rights of choice effective, it also ensures a level playing field among clearing and settlement service providers.

The **right to make use of the services of Central Counterparties** established in another Member State, granted to regulated markets under the new ISD, aims at increasing competition in the provision of clearing services in the EU.

The right of choice granted to regulated markets is not comprehensive in that regulated markets should also have the right to choose the services of a Securities Settlement Systems located in other Member States, along with the right to choose the services of a foreign Central Counterparties. Moreover, the same rights should be extended to Multilateral Trading Facilities[17].

The Commission considers therefore that the framework Directive on *Clearing and Settlement*, combined with the new ISD Directive, should "together" provide for the following set of rights of access and choice:

---

[17] The political agreement reached by the Council on October 7th 2003 on the draft new ISD overcomes both limitations by granting to both regulated markets and Multilateral Trading Facilities the right to choose the services of foreign Central Counterparties and Securities Settlement Systems.

- *investment firms and banks*: the right to access Securities Clearing and Settlement Systems located in other Member States;

- *Central Counterparties*: the right of access to Central Counterparties and Securities Settlement Systems located in other Member States;

- *Securities Settlement Systems*: the right of access to Securities Settlement Systems located in other Member States;

- *Regulated markets and Multilateral Trading Facilities*: the right to enter into appropriate arrangements with Central Counterparties and Securities Settlement Systems located in other Member States.

In all these cases, access should be governed by transparent and non-discriminatory rules, based on objective criteria. In order to avoid discrimination, where standard service levels or pricing apply, any variation from these should also be justified on objective grounds. It is also important to note that the existence of comprehensive rights of access in favour of Securities Settlement Systems and Central Counterparties does not imply that these entities should be obliged to request and maintain access to other systems. However, if a link between two Securities Settlement Systems exists and is operational, it should not be possible for them to deny the use of the link for the purpose of settling transactions in those securities for which either of the two Securities Settlement Systems represents the final point of settlement.

2.2. Common regulatory/supervisory framework

National restrictions on access and choice may reflect historical conditions, but they may also reflect the legitimate interest of national regulators/supervisors and overseers to safeguard the safety of systems and overall financial stability. As stated above, CESR and the ESCB are in the process of developing standards aimed at defining a common regulatory/supervisory/oversight framework that will provide a basis for addressing such concerns in the EU. It is expected that regulators, supervisors and overseers ("national authorities") will integrate these standards into their respective assessment frameworks and in this way assess compliance with them. These standards will not be mandatory and will not supersede any conflicting national legal provisions.

As cross-border mergers and links between Securities Clearing and Settlement Systems develop, there will also be an increased demand for cooperation among national authorities to achieve effective cross-border regulation and supervision. In this context, it is important to have clarity over the applicable regime, i.e. which authority is competent for the regulation and supervision of a particular set of cross-border clearing and settlement activities. In the absence of a common framework, current cross-border co-operation between national authorities with an interest in a system or its participants is agreed directly between these authorities as and when market developments make such cooperation necessary. Again, the CESR-ESCB draft standards provide for an appropriate scheme for the division of responsibilities among the national authorities concerned. However, the relevant standard will not supersede public authorities' responsibilities under national laws.

These inherent shortcomings of the standards demonstrate that although standard setting may provide some level of common framework for securities clearing and settlement, they may not replace a proper legislative framework. The Commission considers therefore that, as is the case with the introduction of comprehensive rights of access and choice, reliance on voluntary action by the national legislators or regulators to provide a common regulatory/supervisory

framework, will provide less legal certainty and may not guarantee a level regulatory playing field for a long period of time.

These shortcomings will be avoided through the adoption of a Directive which will establish a common set of high-level principles for the authorisation, regulation and supervision of Securities Clearing and Settlement Systems. However, the specific rules to be applied by Securities Clearing and Settlement Systems should be flexible and should closely reflect market and supervisory practices. For this reason, the Commission considers that the high-level principles should be further concretised by specific measures to be adopted under the four-level approach embodied in the Lamfalussy procedure. The CESR/ESCB standards might then form the basis of any level 2 implementing measures to be developed in accordance with the enabling provisions of the framework Directive.

It is envisaged that the Directive should provide for:

- A functional approach;
- Initial and on-going prudential and investor protection requirements; and
- Supervisory co-operation.

Functional approach: In line with the work undertaken recently by the CPSS-IOSCO and the ESCB/CESR working groups, the Commission considers that the Directive should be based on the functional approach. This will ensure consistency of action and avoidance of regulatory conflicts.

In this context, the Directive should introduce common functional definitions of *Clearing and Settlement* activities. Such definitions might cover, but not necessarily mirror, a broad range of post-trading activities, such as trade *matching and confirmation*, *clearing*, *settlement, custody* and the *notary* function. In any case, they should be based on appropriate segments of the value chain, not on the "Intermediary" or "Infrastructure" status of the service provider, even though such dichotomy may still be relevant for the sake of deriving the level of risk associated to the different functions. Parties are invited to comment on the relevance of such a dichotomy in this context. The Commission considers that the degree of detail in the definition of functions will depend on how the different activities relate to the prudential and investor protection requirements that will be considered appropriate, in particular with respect to the various categories of risk – credit risk, operational risk, custody risk, etc – that such requirements are intended to tackle. It should also be considered whether definitions and the scope of application of the Directive should be extended as to cover further post-trading activities, such as *collateral management* or *asset servicing*.

The Commission is conscious of the fact that current market practice has sometimes resulted in the use of the same term to denote different and/or complementary functions. The Directive should tackle this issue by adopting definitions which unambiguously relate to functions, even though they might not necessarily encompass the totality of current uses of a term. In the present Communication, the Commission has purposely used two broad categories of functions only, that is *Clearing* and *Settlement*. *Clearing* is defined as the activities, e.g. novation, that have as effect to guarantee counterparties from the replacement cost risk, while *Settlement* is defined broadly to include Pre-settlement, Settlement and Custody. These definitions will have to be made more narrow and precise in the envisaged Directive, taking into account their relation with the appropriate prudential and investor protection requirements.

Initial and on-going prudential and investor protection requirements: The aim of the new legislative framework embodied in the envisaged Directive on *Clearing and Settlement* is to enable Securities Clearing and Settlement Systems to provide services freely in other Member States. At the same time these entities represent an important source of counterparty and systemic risk to other market participants. For these reasons, the Commission considers it necessary, if mutual recognition within the framework of the internal financial market is to be achieved, to establish common initial and on-going prudential and investor protection requirements, plus further requirements relating to governance (see section 2.3).

Therefore, the Directive should establish appropriate initial and on-going **capital adequacy requirements** applicable to Securities Clearing and Settlement Systems in the EU. Capital requirements for *Clearing and Settlement* activities need to be clearly linked to functions, as appropriately defined, and to the level of risk associated to those functions ("functional approach"). The Commission considers that such capital requirements should take into account those at present applicable to banks, notably with respect to credit risk. However, to the extent that the current and foreseeable capital adequacy framework applicable to banks is not considered appropriate to cover risks specific to *Clearing and Settlement*, the capital adequacy framework for Securities Clearing and Settlement Systems should be adapted accordingly. Further prudential requirements are at this stage not excluded.

The Directive should also establish **high level principles on risk management**, such as Delivery Versus Payment, along with some further principles on **investor protection**, such as those aimed at preserving the integrity of the issue and at protecting customers' securities. In particular, it is fundamental that the reliability of book-entry holdings through all layers of the intermediary chain is ensured. Proper accounting practices and reconciliation procedures of book-entry holdings throughout the chain of intermediaries are necessary companions of any effort to clarify the legal effects of indirectly held securities (on the efforts to harmonise these legal effects please see section 3.1 below). The Commission considers that such high-level principles on risk management and investor protection should further be concretised by specific measures, such as those being developed by CESR/ESCB.

Supervisory co-operation: The introduction of comprehensive access rights, the removal of existing barriers to cross-border clearing and settlement and the introduction of a common regulatory framework are likely to bring about a greater degree of integration and consolidation in the *Clearing and Settlement* industry. For this reason, the regulatory framework needs to incorporate a model for supervisory co-operation, to avoid Securities Clearing and Settlement Systems operating cross-border being subject to the supervision of multiple supervisors, which would increase the cost of regulation and its complexity.

The supervisory model applied in the EU harmonised sectors of banking, investment services, etc, is based on the principle of **home country control**. This principle, enshrined in several EU Directives, provides that the supervision of an entity for the activities carried out in its home country or abroad through a branch or by way of provision of services, is the responsibility of the home country authorities. It also provides that foreign subsidiaries of these entities are supervised by the authorities of the Member State where the subsidiary is established. The host country authorities, on the other hand, retain responsibility for certain issues, such as the supervision of the liquidity of branches, monetary policy implementation measures etc. This supervisory model also provides a framework for the regular exchange of information and cooperation between supervisors.

The Commission considers that a similar model, adapted as necessary to address the specificities of the clearing and settlement sector, should be introduced to coordinate the supervisory responsibilities of national authorities.

This supervisory co-operation framework will also have to take into account, and adapt to, the fact that certain entities may already be subject to an existing supervisory regime (such as the banking regime). The Directive should avoid the duplication of supervisory requirements.

On the basis of these provisions, Securities Settlement Systems, Central Counterparties, Custodians and Clearing Members would acquire an EU passport that, in turn, would allow them to operate cross-border. Currently only custodians have such a passport, based on the ISD provisions. The clearing and settlement passport will ensure a level playing field among all providers of clearing and settlement services.

2.3. Governance

Securities Settlement Systems and Central Counterparties enjoy a very high degree of market power. They also have the potential to become a source of instability for the financial system as a whole. To the extent that the process of integration brings about a higher degree of consolidation in the EU, the potential for any individual Securities Settlement System and Central Counterparty to become a source of financial instability is greatly increased. Governance arrangements can be used to reduce these concerns.

The Commission considers it extremely important that Securities Settlement Systems and Central Counterparties implement appropriate governance arrangements. Accordingly, it believes that some high level principles should be included in the framework Directive.

Governance arrangements encompass the relationship between owners, board of directors, management and other interested parties, including users and authorities representing the public interest. The various categories of stakeholders have different interests. Owners of Securities Settlement Systems and Central Counterparties are legitimately interested to maximise profits. Users are interested in receiving the services that meet their needs at reasonable prices. Public authorities are interested that Securities Settlement Systems and Central Counterparties: (i) do not engage in anti-competitive practices; and (ii) have in place adequate safeguards against risk. Such interests may conflict with each other. For example, profit maximisation must not come at the expense of increasing risk, which could be the case if a Securities Settlement System or Central Counterparty did not make the necessary level of investments, both in terms of information system and personnel.

Key components of governance include: (i) the ownership and group structure; (ii) the composition of the board of directors; (iii) the reporting lines between management and the board of directors; and (iv) the management incentives and the process that makes it accountable for its performance, e.g. audit committees[18].

One major distinction is between two stylised governance structures: (i) user-owned/user-governed entities; and (ii) for-profit entities. In the first case, users own the company; what is relevant, however, is the fact that ownership shares are allocated according to usage. Moreover, the same ownership shares should be reflected in the composition of the board. In this way, the company would not just be user-owned, but also user-governed. Because usage

[18] See the CPSS-IOSCO Recommendations and the CESR/ESCB standards.

by users can vary overtime, a mechanism is needed in order to reconcile ownership shares with usage. In the second case, shareholding is not connected with usage. Between these two stylised forms of governance, there is ground for intermediate solutions.

The Commission considers that an appropriate governance structure is particularly important in order to address potential problems in this area. However, it does not intend to enter into the debate about what form of governance structure - user-owned/user-governed entities or for-profit entities – is preferable. The important thing is that whichever model is chosen, the requirements set forth are fully respected.

* * *

Governance arrangements should be clearly specified and transparent. This implies that, *inter alia,* owners of Securities Settlement Systems and Central Counterparties should disclose, subject to a given threshold, their ownerships shares; moreover, directors and management salaries and any incentive schemes, should be made public, or at least disclosed to their users. In this way, it would be possible to know to whom profits are distributed, how much directors and management are remunerated and what their incentives are. Transparency of governance arrangements also implies that objectives and major decisions are disclosed to owners, users and public authorities.

Moreover, Securities Settlement Systems and Central Counterparties should have one or more independent committees, such as an audit committee, composed of a majority of independent directors. The audit committee's responsibilities will be to make sure that public authorities' concerns and users' interests are properly addressed on the following issues: (a) internal organisation and the overall adequacy of human and technological resources; (b) accounting; (c) information system reliability; and (d) risk-management policies. Some of the tasks attributed to the audit committee can be handed over to external companies, due to their highly technical nature. Such a committee should also identify and manage potential conflicts of interests between owners and users and between owners and/or users, on one side, and the public authorities, on the other. Independency of directors is usually assessed with respect to management and controlling shareholders. Because of the inherent public authorities interests over the well functioning of Securities Settlement Systems and Central Counterparties, an appropriate number of directors should also be independent with respect to users and non-controlling shareholders.

The question of the governance arrangements which should apply to Intermediaries in particular in relation to their securities services activities also needs to be addressed. The Commission considers that the regime applicable to them should be consistent with the governance arrangements envisaged for qualified shareholders and management of Securities Settlement Systems and Central Counterparties, which are important to ensure transparency, fitness and propriety and the containment of risks.

* * *

These measures are broadly in line with the policy orientations set forth in the Commission Communication on Company Law and Corporate Governance[19]. However, the Commission considers that, because of the public authorities interests that Securities Settlement Systems and Central Counterparties do not engage in anti-competitive practices, further governance

---

[19] COM(2003) 284(final) of 21.5.2003

measures could be appropriate, having regard to the current and foreseeable development of the industry. Increased integration will mean that different categories of institutions will likely be in competition in the provision of cross-border *Clearing and Settlement* services. For instance, Central Securities Depositories, International Central Securities Depositories and custodians will likely be in competition in the provision of cross-border *Settlement* services. For this reason, it is envisaged that Central Counterparties and Securities Settlement Systems keep segregated accounts of, and provide for the unbundling of, the services they offer in their Intermediary capacity. The same provisions should apply to any non-core activity, such as Banking, eventually performed by Securities Settlement Systems and/or Central Counterparties. Although these further measures may be considered more intrusive than other disclosure requirements - for instance, accounting separation may imply discretionary choices on how to attribute costs – they increase the degree of transparency of Central Counterparties and Securities Settlement Systems. In this respect, the present Communication follows the approach proposed in the Communication on Company Law and Corporate Governance, according to which "preference should be given whenever possible to **disclosure requirements**, because they are less intrusive in corporate life and because they can prove to be a highly effective market-led way of rapidly achieving results" (p. 11).

Accounting separation: In order to achieve accounting separation, a separation of costs and revenues is needed. The requirement that specific services be priced separately, as further discussed below, would allow separation of revenues. As Securities Settlement Systems and Central Counterparties are characterised by large economies of scope with respect to the performance of core activities, on one hand, and the non-core activities, on the other, separation of costs will involve discretionary choices.

For instance, by allocating a very low percentage of costs to the non-core activities, any Securities Settlement System or Central Counterparty would be able to show that it is making a profit on such activities, which would be a sign that no cross-subsidisation is taking place. Such evidence would be misleading: if the "right" percentage of fixed costs was allocated to the non-core activities, they would be found to be less profitable or, in the extreme case, to effectively run a loss. Cost allocation is therefore an issue to be dealt with very carefully if the desired results are to be achieved. To this end, the envisaged Directive could refer to internationally accepted standards on cost allocation, which may provide a solid starting point for these entities to meet their obligations. In any event, as discussed above, the Communication foresees that accounting issues, including cost allocation, will have to be responsibility of an **Audit Committee** to be composed by a majority of independent directors.

Unbundling: It is also envisaged that non-core services, such as those offered in Intermediary capacity and the Banking activities, be priced and, on demand, supplied separately. Such requirement might adequately address concerns that Central Counterparties and Securities Settlement Systems are tempted to force their users upon buying any "monopoly" service they might offer, on condition that they also buy other, unwanted, services from the same provider. Such practice will raise competition law concerns and will inhibit users' ability to move their activities to the most efficient supplier, thus potentially reducing efficiency.

The supply of Banking services (including receiving of deposits and provision of credit) poses specific problems. Generally speaking, Securities Settlement Systems' participants may need credit to overcome temporary shortages in their cash position when settling securities transactions. They would need credit in the same asset type (central bank money or commercial bank money) used for the settlement of the cash leg of securities transactions. Securities Settlement Systems settling in their own (commercial bank) money will also provide credit to their participants.

There are several ways to deal with the issue of supply of Banking services by Securities Settlement Systems under monopoly conditions. One is to make settlement in central bank money compulsory. The second is to oblige Securities Settlement Systems to offer the option to settle in central bank money. A further alternative would be to oblige Securities Settlement Systems settling in commercial bank money to allow other banks to provide for the settlement of the cash leg of securities transactions. In each of these alternatives, Securities Settlement Systems' participants would not be obliged to use the banking services offered by the Issuer-Securities Settlement System.

The Commission considers that Securities Settlement Systems settling in commercial bank money should at least provide a choice for their participants to settle in central bank money as well. This is the approach adopted in the ESCB/CESR draft standards on clearing and settlement.

* * *

Finally, in order to achieve a level playing field in this respect, management and qualified shareholders of Securities Clearing and Settlement Systems should meet the fitness and propriety requirements and the suitability requirements respectively applicable to the management and the qualified shareholders of banks or investment firms.

For all the reasons mentioned in the preceding sections, the Commission considers that the adoption of a framework Directive will be necessary to introduce (a) comprehensive **rights of access and choice**, (b) a **common regulatory framework**, and (c) appropriate **governance arrangements**.

The *envisaged* directive is only a first step. It should ensure an appropriate balance between ex ante legislation and ex post intervention of the competition authorities to enforce competition rules. The Commission will continue to monitor closely and, where necessary, adapt its approach to developments. In case of further market developments it may be necessary to review the approach set out, including via further measures to ensure that the legal framework in place ensures a level playing field for the different operators and adequately addresses the potential problems which may arise.

3. Addressing legal and tax law discrepancies

3.1 The Legal Certainty project

The safety of any securities clearing and settlement system ultimately depends on the soundness of the legal system on which it is built. General laws, such as property, securities and insolvency laws, as well as more specific rules, including systems' operating rules, all influence the way securities clearing and settlement systems work and their overall efficiency. In order for Securities Clearing and Settlement Systems to fulfil their function adequately, the legal framework should be clear, reliable, coherent and predictable in its interpretation and implementation. In this way, legal risks to participants and to the system as a whole are greatly reduced.

Cross-border clearing and settlement involves multiple legal jurisdictions, representing differing legal traditions and approaches. While each of these jurisdictions may adequately address issues arising in a domestic context, when providing cross-border clearing and settlement services there is a need to identify clearly the national law applicable to the contractual and proprietary aspects of the whole operation (the conflict of laws issue).

Additionally, even if the identification of the applicable substantive national laws is properly addressed through the harmonisation of national conflict of law provisions, discrepancies in the national substantive laws of the various jurisdictions concerned may still adversely affect the whole process. These particularly complex legal issues add considerably to the costs and uncertainties of cross-border clearing and settlement.

The two Giovannini reports provided a clear description of the problems raised by legal issues in this context. They identified as important barriers to further integration, the uneven application of national conflicts of law rules, the national difference in the legal treatment of bilateral netting and the absence of an EU-wide framework for the treatment of interests in securities. The reports also found as an important barrier existing national law differences as to the moment a purchaser is considered to be the owner of a security for the purposes of corporate actions.

The current EU legal framework already addresses some of these issues. Thus, differences in the legal treatment of netting and conflicts of law issues have been addressed, to a large extent, by the Directives on Settlement Finality[20] and on Financial Collateral Arrangements[21]. These two Directives also contain special provisions as to the application of insolvency laws to Securities Clearing and Settlement Systems and financial collateral arrangements, which aim at increasing the safety of systems and the security of financial collateral arrangements.

The Settlement Finality Directive minimises the disruption caused to a settlement system by insolvency proceedings and ensures that transfer orders and netting are legally enforceable and binding on third parties. Consequently, the unwinding of netting will not be possible where transfer orders have been entered into the system. Moreover, settled transactions may not be reversed on the basis of the so-called "zero-hour rule", sometimes incorporated in insolvency laws. The Directive also provides that transfer orders be irrevocable after a moment specified by the system. Finally, collateral provided to central banks or in connection with participation in a system is insulated from the effects of insolvency law.

The Directive also addresses the issue of conflicts of law in relation to such provision of collateral in cases where the rights of the collateral taker are recorded on a register, account or a CSD. The Directive adopts the place of the relevant intermediary approach (PRIMA), namely that the determination of the rights of the collateral holders shall be governed by the law of the Member State where the register, account or CSD is located.

The Financial Collateral Directive, which is in the process of implementation by Member States, has a much broader scope of application since it covers (almost) all financial collateral transactions performed by systems and "financial intermediaries"[22]. It reduces formal requirements for financial collateral agreements and protects their validity and irrevocability against certain insolvency provisions, such as "zero-hour" rules. It recognises close-out netting even when its enforcement is triggered by the commencement or the continuation of winding-up procedures or reorganisation measures. The Directive adopts the same PRIMA approach to address conflicts of law issues in relation to the legal nature and proprietary effects of *book entry securities collateral*[23], the requirements for perfection and validity

[20] Directive 98/26 of 19 May 1998, OJ 1998 L166/45

[21] Directive 02/47 of 6 June 2002, OJ 2002 L168/43

[22] Financial collateral transactions carried out with natural persons are not covered by the Directive.

[23] Collateral which consists of financial instruments, title to which is evidenced by entries in a register or account.

against third parties, the conflict of competing titles and interests in such collateral and the requirements for its realisation.

The conflict of laws issues arising in the context of book-entry securities have been subsequently re-addressed by the newly adopted Hague "Convention on the law applicable to certain rights related to securities held with an intermediary".

Under the Convention, the law applicable to certain rights related to securities held with an intermediary will be the law agreed by the account holder and the relevant intermediary, provided the law in question meets a so-called "reality test" intended to ensure that the intermediary's securities business has some connection to that jurisdiction, though not necessarily in relation to the account in question.

The implementation of the Hague Convention in the EU will enable participants to determine in advance of any action, with certainty and with only reasonable effort what national substantive law governs their rights to indirectly-held securities. In the context of its responsibilities, the Commission will make the necessary arrangements for the signature and subsequent accession to the Convention by the European Union and its ratification by the Member States. The Commission will also take the necessary steps to bring the Settlement Finality and the Financial Collateral Directive in line with the conflicts of law provisions of the Hague Convention.

In spite of the improvements that these measures will bring in terms of legal clarity and to the overall soundness and efficiency of cross-border clearing and settlement in the EU, they have not addressed a number of other important legal barriers.

The most prominent of these is the ***absence of an EU-wide framework for the treatment of interests in securities held with an intermediary***. This absence has been identified by the Giovannini Group as the most important source of legal risk in cross-border transactions.

Securities are increasingly held and transferred on the basis of book entries. For instance, dematerialised securities are exclusively represented by a book entry in an account held by an intermediary. When securities are held as book entries in intermediaries' accounts, it is first of all necessary to have clarity as to the legal nature of the rights that investors have with respect to such book entries. In fact, legal interpretations of these rights vary considerably from one Member State to another.

Equally important are the legal framework of transfers of rights in respect of indirectly-held securities. While in practice dispositions of such rights are effected by mere book entries, it is claimed that not all national jurisdictions have appropriately adapted their legal system for such dispositions. It is also important to ensure clarity as to the determination of the exact time at which indirectly-held rights are transferred.

Other issues that need be addressed are the determination of priorities between competing interests as recorded in the relevant accounts and how to avoid creditors attaching or claiming an investor's right at a level in the chain of holdings higher than where such right is actually recorded or constituted ("upper-tier attachment"). As securities are usually pooled in omnibus accounts, an upper-tier attachment would have the effect to freeze all securities recorded in the account where the attachment is made, not just those of the investor concerned.

The absence of a coherent approach across the EU on these issues seriously affects cross-border clearing and settlement efficiency and safety. The Commission considers that this issue

should be tackled as a matter of priority, although it may take sometime to bring forward concrete proposals.

Another issue that needs to be addressed concerns differences in national legal provisions affecting ***corporate action processing***, such as discrepancies in Member States' laws as to the determination of the exact moment when a purchaser is considered to be the owner of a security, e.g., for the payment of dividends. National laws may provide that such moment is the trade date, the intended settlement date or the actual settlement date. As noted in the two Giovannini reports, such discrepancies may inhibit the centralisation of securities settlement and, for this reason, constitute a barrier to further integration. As a consequence, there might be a need for harmonisation of the relevant rules.

Finally, the Commission wants to consider in more detail the issue of ***securities location***. It has been suggested that restrictions relating to the issuer's ability to choose the location of its securities act as a further barrier to Securities Settlement Systems consolidation. The basis for these restrictions can be found either in national law linking listing in a particular market with the use of the local CSD or in company law. The Commission intends to consider this issue further, taking into account the differences between the various types of securities, as well as the company law implications of such requirements.

In view of the importance of these issues, the Commission, supported by the recommendation of the Giovannini group of experts, considers that a specific exercise should be launched to address these issues. The Commission proposes to set up a group, composed of experts from academia, public authorities and practising lawyers. It will be tasked with undertaking further analysis of these issues, proposing solutions and, eventually, helping to draft specific legislative proposals. The composition of the Group will need to reflect the legal traditions of current and future Member States. However, a core secretariat will provide the necessary impetus for the project. The group will also liaise with other bodies, such as UNIDROIT[24], that might have undertaken similar work at the wider global level.

In view of the complexity of the subject and its intricate connexion with national property and company law, the Commission expects this project to be long-term. Its exact scope will be defined at the time the Group is created; however, it should address issues such as:

- the nature of the investor's rights in relation to securities held in an account with an intermediary;
- the transfer of these rights;
- the finality of book-entry transfers;
- the treatment of upper-tier attachment;
- investor protection from insolvency of the intermediary;
- the acquisition of these rights in good faith by third parties;

[24] UNIDROIT (the "International Institute for the Unification of Private Law") is an independent intergovernmental organisation whose purpose is to study needs and methods for modernising, harmonising and co-ordinating private and in particular commercial law as between States and groups of States.

- differences in the rules relating to the transfers of ownership for the purposes of corporate actions, to the extent that these differences are incorporated in national laws;

- the choice of securities location.

For each of these issues, differences in national laws should be evaluated and, if needed, a proposal for harmonisation should be made.

3.2 Taxation issues

Member States have entered into bilateral agreements, under which both the state where income is sourced and the state where the recipient is resident for tax purposes claim the right to impose tax on income generated by an investment. Relief from potential double taxation is granted in one of two ways. Either one state exempts the income from tax altogether (unusual and mainly confined to so-called "direct investors:" those with a minimum shareholding of perhaps 10%); or the state of residence gives credit for any tax deducted in the source state. These are generally known respectively as the "exemption" and "credit" methods.

However, the normal tax rate in the source state may be broadly comparable with the rate charged by the state of residence. Using the credit method would result in very little tax being paid in the state of residence because the source country's tax would fully (or almost fully) cover any tax liability. Yet it is in the state of residence where the owner is more likely to benefit from services that are paid from taxation. Thus, the agreements usually provide for a reduction in the normal rate of withholding tax in the source state, so as to leave some tax payable in the state of residence.

The Giovannini reports identified and invited public authorities to tackle a number of practical problems that arise from the procedures whereby only certain intermediaries are permitted to apply a reduction of the normal rate of withholding tax. In particular, some Member States only permit institutions established within their territory to operate withholding tax procedures. Other Member States allow foreign intermediaries to apply reduced rates of withholding tax but only on condition that they appoint a local fiscal representative. The Giovannini reports suggest that such a situation effectively prevents the possibility for an intermediary to operate on a cross-border basis or to use the Intermediary services of a Securities Settlement System, thus greatly limiting competition in the provision of cross-border Settlement services. Therefore, market participants are prevented from choosing the most efficient way to operate cross-border, which in turn increases the inefficiency of the whole process.

Moreover, differences exist in the procedures used in the various Member States to collect, or grant relief from, withholding tax. Even if total or partial relief is granted, eligible investors may be required first to suffer the tax and subsequently reclaim it. Procedures applicable to repayment of withholding tax can be very complex and may also differ considerably across Member States. Such complexities and differences significantly increase the cost of cross-border Settlement.

The relevance of these barriers to efficient cross-border Settlement was also argued during the consultation to the first Commission Communication on *Clearing and Settlement*. Indeed, some respondents considered that, while substantive tax harmonisation is not currently necessary, harmonisation of the different procedures involved in tax processing should be pursued, while at the same time ensuring equal treatment for domestic and foreign investors.

The Commission notes that there is an increasing tendency to move away from withholding taxes towards a greater reliance on information exchange. This enables tax authorities to have the proper information available to them in order to charge the right amount of tax on the right person. Information exchange on as wide a basis as possible underpins Council Directive 2003/48/EC dealing with taxation of income in the form of interest received across national frontiers[25]. Moreover, there is now a Directive for Mutual Assistance on Recovery[26], under which the competent authorities of one Member State can assist those of another with the collection of both direct and indirect taxes due in the first-mentioned state from a debtor located in the second. In addition, the original Directive on Mutual Assistance[27] is currently undergoing modernisation with a view to strengthening it. Therefore, Member States will have better possibilities for controlling taxpayers who are located outside their territorial jurisdiction.

Given this new context, it is an opportune moment to explore the additional possibilities that are now available to see whether changes in some of the existing rules might be introduced in order to simplify matters for business, while still safeguarding the rights of Member States in relation to tax collection.

The Giovannini group also suggested that the integration of the system for collection of transaction taxes, within the functionality of existing Securities Settlement Systems in the EU, constituted a further tax barrier. In such circumstances, the reports suggested that using a different Securities Settlement System could mean paying higher transaction taxes. Should that prove to be the case, other Securities Settlement Systems may be *de facto* prevented from offering Intermediary services in cross-border Settlement, thus reducing the efficiency of the system. The Giovannini group of experts invited public authorities to consider this barrier and to propose appropriate solutions.

The Commission proposes the creation of a group of experts to examine, in more detail, the taxation issues identified by the Giovannini group and by respondents to the first Commission Communication on Clearing and Settlement as constituting barriers to efficient cross-border Settlement. The expert group should further consider and analyse such issues, with a view to reporting on their relevance and on whether alternative ways might be found to secure the tax receipts to which Member States are entitled, while still permitting all financial institutions across the European Union to compete on an equal footing.

The remit of the expert group would also include the undertaking of a study of the different procedures in place across Member States, with a view to seeing whether these might be capable of being more closely aligned, so that the existence of a multiplicity of rules, which, among other things, raise the cost of cross-border Settlement, could be eliminated or substantially reduced.

The Commission will consider the findings of the expert group and will use them as a basis for discussion with the tax authorities of the Member States, in accordance with the

---

[25] Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, OJ 2003 L175/38

[26] Council Directive 2001/44/EC of 15 June 2001 amending Directive 76/308/EEC on mutual assistance for the recovery of claims resulting from operations forming part of the system of financing the European Agricultural Guidance and Guarantee Fund, and of agricultural levies and customs duties and in respect of value added tax and certain excise duties, OJ 2001 L175/17

[27] Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, OJ 1977 L336/15

established policy of prior consultation on tax issues. If subsequent action at a Community level is considered appropriate, the Commission will endeavour to bring forward appropriate proposals.

4. Competition policy

Consistent application of competition policy is part of the Commission overall approach to *Clearing and Settlement*. Measures intended to promote liberalisation and integration of existing systems and competition policy are complementary in achieving efficient Securities Clearing and Settlement Systems in the EU.

In fact, the financial sector, including all post-trading activities, is subject to the same EU competition rules as all other industry sectors. The Commission works closely with the national competition authorities on cases when both domestic and cross-border issues are to be assessed, e.g. in cases of alleged discriminatory access towards domestic and foreign participants. Furthermore, the implementation, in May 2004, of Council Regulation 1/2003[28] will further strengthen the cooperation between national competition authorities and the Commission in the enforcement of competition rules. This will enhance the effective and coherent application of Articles 81 and 82 of the EC Treaty and be beneficial to the promotion of competition in the financial sector.

Together with the extension of the scope of their activities, there have been recent instances of cross-border consolidation of Securities Clearing and Settlement Systems, which have historically consolidated within Member States. This has included for example the merger of national infrastructures (such as Central Securities Depositories) with companies having a genuine cross-border focus (such as International Central Securities Depositories).

Whilst the Commission is neutral on the question of vertical or horizontal consolidation as well as on the issue of multiple or single infrastructure and ownership profiles, as in any industry sector, where consolidation results in a possible creation or reinforcement of a dominant market position, this will be a cause of concern. To date, most mergers in this sector have not met the thresholds of Council Regulation 4064/89[29], the so called “Merger regulation”, and therefore have not been notified to the EU Competition authorities.

The Commission will continue to monitor mergers and acquisitions in this sector carefully In addition, existing as well as emerging entities must comply with the special responsibilities that Article 82 of the Treaty imposes on them, should they occupy dominant positions. Moreover, agreements among clearing and settlement service providers will also be monitored in the light of Article 81 of the Treaty.

As the pace of systems’ consolidation increases, so do the rights and responsibilities of the buyers and providers of services in this sector. Certain specific issues can be mentioned. They should not however be considered as an exhaustive list of competition concerns or an anticipation of situations which may arise in the future.

Supply of services and non-discriminatory access: In the present industry context, particular attention is given to the respect of competition rules where agreements or concerted practices between companies, or the exercise by a company of its dominant position, restrict

---

[28] Council Regulation 1/2003 of 16 December 2002, OJ 2003 L1/1

[29] Council Regulation 4064/89 of 21 December 1989, OJ 1989 L395/1

competition in a specific market. In making its assessment, the Commission will take into consideration the economic context and the effect that any such practices may have either in creating or in hampering efficiencies and competition in the single market.

Pricing: The Commission is not a price regulator. Prices should be determined by the market but this is subject to certain limits. In particular a dominant undertaking has an obligation under Article 82 of the EC Treaty to avoid *"directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions"*[30] and to avoid *"applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage"*[31].

Exclusive arrangements: The term "exclusive arrangements" covers a variety of dissimilar legal situations. It can be understood as including legislative acts and self-regulation, as well as industry agreements. Exclusive arrangements as such are not prohibited by competition rules. However, they may be subject to the application of Articles 81, 82 and 86 of the EC Treaty, particularly in the context of developing cross-border services. Such provisions within the securities clearing and settlement area may include the obligation to clear and settle only in a specific infrastructure, the exclusive use of a tied central counterparty, etc. On the contrary, non-exclusive arrangements to use a specific infrastructure simply reflect the right of a market to choose the service of a Central Counterparty or Securities Settlement System; therefore, they do not pose particular problems. Where companies that might occupy a dominant position, whether by virtue of state measures or consolidation, benefit from such arrangements, particular attention needs to be paid to compliance with Article 82 of the Treaty.

The Commission is actively monitoring market developments in the Clearing and Settlement area. In the meantime, service providers are advised to take a pro-active competition stance in their business development, and to seek ways of avoiding possible competition concerns at an early stage.

CONCLUSIONS

This Communication defines the key policy objectives that the Commission has taken into account in proposing future action at the EU level. It includes an action plan outlining the various initiatives that need be undertaken to achieve an integrated, safe and efficient securities clearing and settlement environment in the EU.

Comments from the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions, national regulatory and supervisory authorities, other EU level and national organisations and federations, market practitioners, institutional investors, infrastructure providers and all interested parties on all aspects of the Communications are invited by the 30th of July 2004. Comments should be sent to DG MARKT G1, European Commission, B-1049 Brussels (e-mail address <Markt-Clearing-Settlement@cec.eu.int>).

The Commission also invites the European Parliament and the Council to endorse the approach outlined in the present Communication.

---

[30] Article 82(a)

[31] Article 82(c).

Annex 1

Giovannini Barriers
Diversity of IT platforms/interfaces
Restrictions on the location of clearing or settlement
National differences in rules governing corporate actions
Differences in the availability/timing of intra-day settlement finality
Impediments to remote access
National differences in settlement periods
National differences in operating hours/settlement deadlines
National differences in securities issuance practice
Restrictions on the location of securities
Restrictions on the activity of primary dealers and market-makers
Withholding tax procedures disadvantaging foreign intermediaries
Tax collection functionality integrated into settlement system
National differences in the legal treatment of securities
National differences in the legal treatment of bilateral netting
Uneven application of conflict of law rules

Annex 2: GLOSSARY

Central Counterparty ("CCP"): An entity performing the *Clearing* function.

Clearing function: The activities that have as effect to guarantee counterparties from the replacement cost risk.

Clearing and Settlement service providers: SSSs, CCPs, Custodians and Clearing Members.

Clearing member: An Intermediary in the provision of *Clearing* services.

Custodian: An Intermediary in the provision of *Settlement* services.

Intermediary capacity: The provision of direct or indirect access to the Issuer-SSS or the CCP with which a market has entered into appropriate Clearing arrangements.

Investor-SSS: An SSS acting in an Intermediary capacity.

Issuer-SSS: The SSS where securities are immobilised or dematerialised.

Markets: Regulated markets and Multilateral Trading Facilities, as defined in the Directive of the European Parliament and of the Council on financial instruments markets.

Replacement cost: the potential losses arising in the event of default of a counterparty to a trade.

Securities Clearing and Settlement System ("SCSS"): The full set of institutional arrangements required to finalise a securities transaction.

Securities Settlement System ("SSS"): All institutions, in particular Central Securities Depositories, performing the Pre-settlement, Settlement and Custody functions, except the Custodians.

TARGET: **T**rans-European **A**utomated **R**eal-Time **G**ross Settlement **E**xpress **T**ransfer System, composed of the national RTGS payment systems of the EU countries that have adopted the Euro plus the ECB payment mechanism.