A Vision for Integrated Post-Trade Services in Europe

ESSF White Paper
August 2009

1. Executive Summary

Europe needs a single, integrated, low risk and low cost post-trading system for the benefit of its users and to be globally competitive. This objective has been shared by the securities industry and public authorities since the beginning of this decade.

Estimated aggregate excess costs of post-trading of between EUR 2 and 5 billion p.a.¹ emphasise the importance of achieving efficient post-trading in Europe. Moreover, replacing a highly fragmented structure with a single, integrated post-trading system will significantly improve the liquidity and resilience of European securities markets.

The ongoing cooperation between public authorities – in particular the European Commission and European Central Bank – and the private sector has produced encouraging results. However, significant obstacles remain, including material differences in the operational, legal, fiscal and regulatory environments that apply to post-trading.

Representing the major users of the international securities markets, this White Paper sets out the ESSF’s vision for the future post-trading landscape in Europe and its characteristics. It outlines the building blocks required to make the vision become reality, assesses the current extent to which those blocks have been constructed and applied, and defines the outstanding action needed.

In our view the remaining obstacles must be removed as a matter of urgency. To this end we advocate precisely targeted action of the public sector in the areas of securities law, fiscal procedures and risk regulation, supervision and oversight and by the private sector in the domain of operational processes. Notwithstanding clear responsibilities and accountabilities, we deem the continued successful cooperation of public and private stakeholders indispensable.

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¹ Commission draft working document on post-trading activities of 23 May 2006 and annexes. Private sector studies have shown similar results.
2. Introduction

Europe needs a clear vision for its post-trading landscape and a coherent strategy for delivering this goal. Representing the main users of European post-trading services and leveraging our proven ability to deliver real risk and cost reduction to that industry, the European Securities Services Forum (ESSF)\(^2\) sets out in this paper its vision for delivering, a single, integrated, low risk and low cost post-trading system in Europe.

We believe this vision is entirely consistent with the European Commission’s objective of creating an integrated securities market and in particular, 'smooth, safe and sound post-trading arrangements in the EU' (EC Communication on Clearing and Settlement Communication COM(2004)312). Indeed, we fully acknowledge and strongly support the steps taken by the Commission and other public authorities such as the European Central Bank to address the barriers that stand in the way of integrated and efficient European post-trading, including: the analysis of the Giovannini Group, the work of the CESAME / CESAME2 Groups, the Legal Certainty Group, the Fiscal Compliance Group, the Code of Conduct on Clearing and Settlement and the Target2-Securities project.

These initiatives have resulted in valuable progress towards a single market for post-trading services. For example, the efforts to dismantle the Giovannini Barriers show encouraging results (particularly in respect of those Barriers for which the private sector is responsible) and the price transparency and service unbundling sections of the Code of Conduct have largely been implemented, leading to an increase in competition and reduction in fees.

Nevertheless, significant obstacles remain to the ‘domestication’ of cross-border clearing and settlement in Europe, including material differences in the processing, legal, fiscal and regulatory regimes that apply to post-trade services.

These remaining obstacles must be removed as a matter of urgency. The events of the last two years have underscored the importance of developing a more resilient financial system to minimise systemic risk. Although the clearing and settlement components of the financial system have proved generally robust, we believe that a move from the current fragmented structure towards a more effective single European market in post-trading services, with the elimination of all material restrictions and barriers, will make a significant contribution to a safer financial system. Building on the achievements to date, we believe that removing the remaining restrictions and barriers will not only favour further increases in competition and efficiency but also improve the liquidity of European financial markets and thereby enhance the shock-absorption capacity of the system, and contribute to financial stability.

To fully dismantle the defined (and additional) barriers, we take the view that the current successful targeted cooperation between public authorities – in particular the European Commission and the European Central Bank – and the private sector should be continued.

\(^2\) The ESSF is the European post-trading centre of competence of the Securities Industry and Financial Markets Association (SIFMA). Its members are the major users of international securities markets. Representing its members as towards market infrastructure organisations and public authorities, the ESSF acts as an agent for change providing and supporting solutions in the securities clearing, settlement and custody space to reduce risks and costs to market participants.
This is not meant to change responsibilities and accountabilities but rather to fruitfully combine authority and capabilities toward a common objective.

In Section 3 of this paper, we set out the ESSF’s vision for post-trading in Europe. Section 4 outlines the building blocks needed to make that vision become reality and Section 5 identifies the action steps (and parties responsible for taking them) required to construct the building blocks. In Section 6, we make concluding remarks on the need for concerted action by all stakeholders and our ability and willingness to play a leading role in this process.
3. Vision for the future post-trading landscape in Europe

Our vision is for a small number of post-trade infrastructure service providers to compete in a harmonised and therefore low-risk operational, legal and regulatory environment to offer innovative and low cost services to all users on a non-discriminatory basis.

In our vision, the future post-trading system in Europe would have the following characteristics:

**The regulatory, legal, fiscal and operational environments for post-trading are harmonised across Europe:** The resilience, safety and soundness of providers of post-trading services is regulated, supervised and overseen on a robust and consistent basis across Europe. The substantive and conflict-of-law rules applying to securities holdings and dispositions are harmonised and homogenous procedures govern the collection of taxes in the context of post-trade processing. All material operational processes for post-trade services are standardised and highly automated.

**The risks of post-trading are low while efficiency is high:** Harmonised regulation, supervision and oversight on the basis of robust minimum standards ensures the safety and stability of post-trading service providers and thus that of the system they comprise. Homogenous legal and processing environments are reflected in low levels of legal and operational risk for post-trading services. Taken together, the harmonisation of rules, regulations and processes is conducive to the consolidation of - and/or interoperability between - service providers which is in turn reflected in further risk reduction (through e.g. the area-wide availability of CCP services) as well as more competition and innovation and lower costs.

**Post-trading is non-discriminatory:** Every market participant has the ability to clear, settle and hold any security with any provider of the relevant service irrespective of location. And the costs of doing so on a domestic or cross-border basis have converged to a point where they are the same.

Together these characteristics reflect a truly single market in post-trade services.
4. Building Blocks – the requirements to make the vision become reality and our high level assessment of the current state

4.1. Building Blocks

We believe that all the following building blocks must be constructed, implemented and applied for our vision to become reality.

4.1.1. Harmonised and standardised operational processes for

- **Clearing:**
  - Comprehensive, interoperable pan-European CCP services are available for all exchange traded products in all European markets.

- **Settlement:**
  - Settlement processes are aligned to T2S.
  - A uniform settlement cycle is enabled by same-day affirmation and implemented matching standards.

- **Asset-Servicing:**
  - Market standards for corporate actions processing are implemented.
  - Harmonised, non-discriminatory and more efficient registration processes are available.
  - Market-wide operational standards for general meetings are implemented giving all holders as of record date (harmonised across Europe) the effective ability to vote at meetings.
  - Asset-servicing is non-discriminatory (e.g. all investors enjoy equal practical ability to participate in corporate actions irrespective of nationality).

- **Communication:**
  - High straight-through processing is achieved through a common communication protocol based on ISO 15022 / 20022 standards.
4.1.2. **Harmonised legal environment**, in particular in the following areas

- Legal effects of book entries (securities law reform) consistent with the Unidroit Convention;
- Holding patterns, account structure with area-wide acceptance and application of nominee concept and omnibus accounts;
- Internationally compatible conflict of laws regime;
- Targeted company law reform providing for uniform shareholder definition and registration as well as non-discriminatory corporate actions.

4.1.3. **Harmonised and efficient securities related fiscal procedures**:

- Withholding tax at source relief procedures being the rule;
- Highly efficient withholding tax refund procedures, where relief at source procedures are not available;
- Absence of tax collection (transaction taxes, capital gains taxes) that is linked to settlement process.

4.1.4. **Consistent and coordinated risk regulation, supervision and oversight**:

- Providers of post-trading services are subject to common definitions, authorisation and operational rules and requirements at the European level.

4.2 **High level assessment of current state**

Regarding the harmonisation and standardisation of operational processes fundamental achievements to date have been:

- the availability of CCP services for exchange traded products in major European markets
- the agreement on the T2S User Requirement Document
- the broad agreement on the necessity to harmonise settlement cycles in Europe
- the market standards for matching agreed by CSDs and users, currently in the implementation phase
- the agreement and endorsement of market standards for corporate actions processing
- the agreement on a common communication protocol based on ISO 15022/20022.

However, standard setting work has to be finalised, gaps have to be closed, interoperability has to be expanded and agreed standards need to be implemented.
Moreover, in many cases the support of public authorities will be required to eliminate national specificities, such as the registration process for equities in Spain.

Key ground work has been successfully performed by the Legal Certainty Group and the Fiscal Compliance Group in respect of harmonising the legal environment and fiscal procedures. We deem the recommendations of both expert groups an excellent basis for respective targeted legislative action.

We believe that encouraging first steps have been undertaken by CESR and CEBS and ESCB toward consistent and coordinated risk regulation, supervision and oversight, on which we would expect the authorities to continue building.
5. Required Action

Building on the steps taken so far by both the public and private sector, we believe that targeted action is required in the following areas and by the following stakeholders to construct the building blocks necessary to deliver a single market in post-trading services.

It is critical that these work-streams are exclusively focused on the building block in question to avoid the risk of compromising the timely completion and effectiveness of the block. Applying this principle to the need for new legislation or regulation, we believe that while there may be a need for targeted legislative and/or regulatory action in the specific areas set out in this paper, more broad-ranging legislation or regulation for post-trading is likely to be ineffective and counterproductive as it would necessarily impact areas where the market is best placed to complete progress towards a single market in post-trading while failing to address in sufficient detail the narrow areas where legislation may be necessary.

The CESAME / CESAME2 Group has proved to be a highly useful instrument to monitor and coordinate the work aimed at dismantling the Giovannini Barriers. We strongly support the CESAME2 Group to further intensify this work.

5.1. Law Reform

We highly welcome the project initiated by Commissioner McCreevy to dismantle the legal Giovannini Barriers, as we inter alia outlined in the position paper of the ESSF Legal Committee of 24 November 2008 and in our 11 June 2009 response to the Commission consultation on Legislation on Legal Certainty of Securities Holding and Dispositions. We reiterate our view expressed in this context that:

- the law reform in regard of the legal effects of book entries should concur to the highest possible extent with the Unidroit convention;
- the harmonisation of both substantive law and conflict-of-laws at European and international levels is essential for an optimal functioning of post-trading;
- the recognition and application of different holding patterns (nominee concept, omnibus accounts) are an indispensable element to achieve the objective of increased efficiency and cost effectiveness; and
- legislative measures that have objectives other than the removal of the Giovannini legal barriers, such as shareholder transparency and visibility, should not be part of this harmonised legal framework for intermediated securities.

Moreover, we believe that targeted company law reform is required to provide for a uniform shareholder definition, recognition and registration as a shareholder and non-discriminatory corporate actions.

We believe that the Commission is best placed to lead the law reform process and encourage it to continue to be guided by market practitioners as to the issues in need of attention and proposals for doing so.
5.2. Fiscal Procedures

To eliminate fiscal barriers we strongly support the Recommendations of the Fiscal Compliance Group and advocate respective legislative action. Furthermore, in our view tax collection (transaction taxes, capital gains taxes) linked to settlement processes should be abolished by means of legislative action.

Notwithstanding national sensitivities with respect to fiscal matters, we strongly believe that the Commission is best placed to lead the removal of fiscal barriers.

5.3. Risk regulation, Supervision and Oversight

We welcome CESR’s 19 February 2009 Preliminary Advice to the European Commission on (inter alia) possible solutions to addressing differences between Member States on the regulatory arrangements for post-trading infrastructures. As short-term measures, we welcome the CESR recommendations that: (i) EU institutions should give the ESCB/CESR Recommendations their ‘strong political endorsement’ to encourage their implementation; and that (ii) In cases where access and interoperability links have been requested, then the regulators concerned are committed to facilitate such links by agreeing exchange-of-information and other cooperation arrangements. In the medium to longer term, we encourage CESR (and the ESCB) to build on these measures by e.g. working with market participants to identify areas of insufficient detail or clarity in the ESCB/CESR Recommendations and on this basis develop and implement a more comprehensive regulatory best practice framework to further address national differences.

We believe that the members of the ESCB and CESR are best placed to lead the harmonisation of the regulatory, supervisory and oversight environment and encourage all authorities to continue to be guided by market practitioners as to the issues in need of attention and proposals for doing so.

5.4. Operational Processes

We take the view that the progress to date of the industry working groups tasked with the harmonisation and standardisation of operational processes, including settlement cycles and market standards for corporate actions processing, demonstrates unequivocally that market participants are best placed to develop standards, analyse the gaps between these and local practices and on this basis execute national implementation plans. In certain areas, such action may benefit from targeted regulatory support, although such support as is envisaged by the European Central Bank in the context of T2S should precede any regulatory action.

We believe that market practitioners are best placed to lead the harmonisation and standardisation of operational processes and in this context identify to the competent authorities the areas in need of legislative or regulatory support.
6. Conclusion

We share with the European public authorities the goal of a single, integrated, low risk and low cost post-trading system for Europe. Indeed, we fully support the steps already taken towards that objective. However, significant obstacles remain, including material differences in the operational, legal, fiscal and regulatory environments that apply to post-trading. The financial crisis and in particular the need for a resilient and stable financial system and thus a true single market in post-trading underscores the urgency to remove the outstanding barriers. Given their direct exposure to and close interest in addressing the risks and inefficiencies of the current fragmented system, we believe that the users of post-trading services are best placed to play a leading role in the formulation and delivery of a vision for Europe’s post-trading landscape. However, users cannot do this alone: the timely delivery of a single market in clearing, settlement and custody will require the concerted efforts of all private and public stakeholders.