

DRAFT

**RESPONSE OF EUROCLEAR UK & IRELAND LIMITED
to the
FINANCIAL STABILITY AND DEPOSITOR PROTECTION:
FURTHER CONSULTATION DOCUMENT (JULY 2008)**

3 September 2008



Introduction and Summary

This document sets out the views of Euroclear UK and Ireland ("EUI") on the financial stability and depositor protection: further consultation document published in July 2008 as well as the document also published in July 2008 entitled financial stability and depositor protection: special resolution regime.

EUI¹, a member of the Euroclear Group of companies, is the operator of the real-time securities settlement system for dematerialised UK, Irish and international equities, public sector securities and money market instruments ("CREST"). On any one day, securities with an aggregate value in excess of £1.2 trillion (or equivalent) are transferred through CREST; and payments in an aggregate value in excess of £800 billion (or equivalent) pass through the CREST "embedded payment systems" for sterling, euro and US dollars.

EUI itself is an Operator of a "relevant system" which is approved by the FSA under the USRs; and it is recognised as a clearing house for the purposes of section 288 of the 2000 Act. EUI is also the operator of a system which has been "designated" by the FSA (after consultation with the Bank) for the purposes of the SFRs. EUI enjoys a similar regulatory status in Ireland in relation to its provision of the securities settlement system for Irish dematerialised shares and other securities.

The July Consultation Document sets out the joint proposals of the FSA, the Bank and HM Treasury on a number of issues that impact upon EUI and its systems. EUI's position at the heart of the securities settlement infrastructure for UK, Irish and international securities means that it shares and fully supports one of the key objectives of the Authorities, as set out in their January Consultation Document; namely, to "strengthen the stability and resilience of the financial system – in the UK and internationally". EUI is also uniquely placed to comment on the joint proposals from the perspective of its day-to-day practical experience in operating a system that is integral to the stability and efficiency of, and wider public confidence in, the UK (and other major) financial markets.

We welcome, therefore, this opportunity to comment on the July Consultation Document. EUI agrees that it is essential, in the light of sustained (and continuing) disruption in global financial markets, to re-assess whether the regulatory and statutory framework that supports market infrastructure systems such as CREST remains robust and resilient. And we accept that the Bank of England must have an oversight regime for all payment systems. However, we have a number of concerns and questions about the proposed statutory framework for so-called "embedded-payment" systems.

We understand that the process of actually implementing the changes proposed in the Consultation is well advanced, although the consultation is still open until 15 September, and that a draft MoU between the FSA and the Bank is already being drafted, aiming (inter alia) at reducing the risk of duplicate regulation on embedded payment systems. We welcome the production of such an MoU and would suggest that its contents (where appropriate) should be discussed with the embedded payment systems to ensure that the regime being implemented does indeed reduce the burden of potential duplicate regulation

¹ Abbreviated terms used in this response document are defined in the Glossary set out in Annex 1.

and enforcement action. We also believe that such a MoU should be published to ensure full transparency of the approach of regulators and overseers to their regulated entities.

The main points of our response are summarised below:

(i) **The authorities need to recognise the differentiation between “clean” payment systems and “embedded-payment” systems and the perception that the existing regulatory regime combined with an informal oversight regime by the Bank for such embedded payment systems has proved highly effective.** It should be recognised that the market and regulatory issues that affect “embedded payment systems” (such as the payment systems in CREST) are different from those that affect “clean” payment systems. EUI favours its continuing supervision by a single regulator which we see as being consistent with section 3.39 of the Consultation Paper where it states that “the responses to the consultation overwhelmingly advocated a *single* regulator model, with the Bank of England retaining this role ...”. EUI believes that the present arrangements for its systems (formal supervision by the FSA combined with informal oversight by the Bank) have proved to be robust and effective. EUI sees no reason for any material changes in those arrangements. Our more detailed points in this area are set out in Chapter 1(a) and (b) of this response document.

(ii) **The potential for the new regime to encumber EUI (and other embedded payment systems) with a duplicate regulatory regime leading to increased regulatory costs for the regulated entity.** Our concerns here relate not just to the potential for duplicate information requests but also the potential for a duplicate, and indeed non-harmonised, enforcement regime. Our more detailed points in this area are set out in Chapter 1(c) of this response document. We have also set out in Chapter 1(d) those matters which should be addressed in the proposed MoU to be put in place between the Bank and the FSA. These matters include the coordination between the regulators, control of costs associated to information requests and a dispute resolution mechanism.

(iii) **The need to minimise potential conflicts of interest in any regulatory regime.** The Bank is a major participant in CREST and utilises CREST facilities for its own market operations. EUI would be concerned, in addition to the points outlined in (1) above, that potentially, if the Bank were to be given formal statutory powers over EUI’s embedded payment systems, the boundaries between the Bank’s oversight and market operations might become blurred – both in reality and, equally crucially, *as a matter of market perception*. Effective “Chinese Walls” should therefore be in place. This is another factor that has influenced EUI’s conclusion that ideally the FSA alone should retain sole responsibility for the *formal* regulation of its systems (including the CREST embedded payment systems). Our more detailed points in this area are set out in Chapter 1(e) of this response document.

(iv) **Systems that are “designated” for the purposes of the SFRs should not be required to re-apply for recognition as a payment system by HM Treasury.** Our more detailed points in this area are set out in Chapter 1(g) of this response document.

(v) EUI, in the same way as other RCHs, enjoys statutory immunity from liability in damages in relation to the performance of its regulatory functions as an RCH (under section 291 of the 2000 Act). However, it enjoys no corresponding immunity in relation to the performance of its regulatory functions as an Operator of a “relevant system” under

the USRs. This is a regulatory lacuna that needs to be addressed. Our more detailed points in this area are set out in Chapter 2(a) of this response document.

(vi) As HM Treasury is aware, EUI has in the past expressed concerns that the statutory protections afforded to “system-charges” and “collateral security charges” (which are taken by CREST settlement banks in support of their provision of credit and liquidity for EUI’s embedded payment systems) have not kept pace with other wider European developments. Accordingly, EUI welcomes the Government’s indication that it intends to introduce a new power to enable it to make secondary legislation in relation to financial collateral arrangements which strengthen the protections available to them. Our more detailed points in this area are set out in Chapter 2(b) of this response document and in Annex 3.

(vii) Finally, we set out in Chapter 2(c) a number of issues on which EUI seeks assurances from the Authorities that arise out of the proposed special resolution regime and related matters.

Any questions on this response should be addressed to Anouk Gauthier +44 (0)20 7849 0014 or Paul Symons (+44 (0)20 7849 0034).

1 Oversight of payment systems: embedded payment systems

(a) Distinguishing between Clean and Embedded payment systems

The main stimulus for the Authorities' proposals in relation to the new framework for the oversight of payment systems is that the current lack of formal powers in the Bank means that, where it has limited operational involvement in a system, it has to rely upon "transparency, expertise" (January Consultation Document, paragraph 3.31) and "moral suasion" (July Consultation Document, paragraph 3.37) to ensure the robustness and resilience of payment systems which are of systemic or of system-wide importance.

EUI accepts that "clean" payment systems (such as CHAPS and BACS) are presently subject to no formal, statutory oversight by the Bank or, indeed, any other regulatory authority. It seems reasonable, therefore, to conclude that the proposed framework (or elements of it) might be appropriate for such systems in order to meet the Authorities' key objectives. However, this is simply not the case for embedded payment systems.

It is important to recognise that there is a fundamental distinction between clean payment systems and embedded payment systems that operate as part of a securities settlement system. Where payment facilities operate in CREST, they operate primarily as a component of CREST's DvP functionality. DvP is a key requirement of any modern, dynamic system enabling investors to transfer title to securities against simultaneous final payment. In our view, the characteristic feature of a securities settlement system is not the payment services it provides – rather, it is the *securities*-related services that are provided. This rather fundamental point supports a materially different practical and regulatory perspective on the operation of embedded payment systems. They operate as facilities which, although of the utmost importance, are *supplemental or incidental* to the holding and transfer of securities through the system.

This is reflected, for example, in the following points.

(i) The USRs contain the primary statutory framework for CREST's operation as a "relevant system" for uncertificated (dematerialised) securities. The USRs regulate payment-related issues in the CREST relevant system under the general umbrella of matters which are "supplementary or incidental" to the functions that "enable title to units of a security to be evidenced and transferred without a written instrument" - see USRs, regulation 2(1).

(ii) The SFRs allow the "designation" of a system in order to protect finality of settlement and the system's integrity from the invalidating effects of the applicable insolvency law. Under the SFRs, there are two designating authorities – the FSA and the Bank. The FSA designates securities-related systems; and the Bank designates payment systems. Crucially, where a system is one through which both securities transfer orders and payment transfer orders are effected (such as CREST), it is the FSA (in consultation with the Bank) that is the relevant designating authority: SFRs, regulation 7(2) (and see definition of "designating authority" in regulation 2(1)). The FSA is, therefore, the designating authority for the CREST UK system under the SFRs.

(iii) Following on from (ii) above, EUI's systems have been designated by the FSA in the UK (in relation to their operation for securities constituted under UK laws) and in

Ireland (in relation to their operation for securities constituted under Irish law). This is because EUI and the relevant designating authorities have concluded that, for the purposes of Article 2(a) of the Settlement Finality Directive, the law that “governs” a securities settlement system equates to the law which governs the validity and effect of *securities* transfer orders, being the law under which the relevant securities are constituted (and not, for example, the law that governs the relevant payment arrangements). This is the law that essentially characterises the primary function of a securities settlement system.

The practical result of these observations is that historically, and we believe correctly, EUI’s embedded payment systems have not been viewed in isolation from the securities settlement arrangements that they are designed to support. It is important that these are not viewed in isolation in order for EUI to continue to offer full DvP settlement as it currently does. It has been recognised that it is the FSA (as the regulator of the securities-related activities that are the true characteristic of EUI’s systems) that should have sole formal responsibility for the supervision of EUI and its systems. The main regulatory focus, therefore, on CREST has been (and should remain) its role as a provider of a system for the holding and transfer of title to securities; and which permits investors to settle trades in securities on a DvP basis. In performing these functions, EUI (unlike the operators of clean payment systems) is already subject to robust formal regulatory supervision by the FSA in its capacity as an Operator of a relevant system approved under the USRs and as an RCH under the 2000 Act. In these respective capacities, EUI must (amongst other things) satisfy a number of regulatory requirements impacting upon its payment arrangements – and which we set out in Annex 2 to this response document.

(b) The effectiveness of the current informal regulatory regime

In respect of all of the regulatory obligations summarised in Annex 2, EUI is subject to powers of withdrawal or revocation of its approval or recognition, as well as of direction. These powers are exercisable by the FSA. It is correct, of course, that EUI is also subject to informal oversight by the Bank as overseer of systemically-important payment systems. EUI considers that the combination of the formal statutory supervision of it and its systems (including the payment facilities that operate as part of CREST) by the FSA, and the informal oversight by the Bank, have proved in practice to be highly effective. This is evidenced by the following examples.

(i) In its *“Payment Systems Oversight Report 2007” (February 2008)* the Bank concluded that CREST’s sterling and euro payment systems fully observed six of the nine Core Principles applicable to them. The Bank considered that the payment systems broadly observed CP VII (the system should ensure a high degree of security and operational reliability and should have contingency arrangements in place for timely completion of daily processing); and partly observed CP IX (the system should have objective and publicly disclosed criteria for participation, which permit fair and open access) and CP X (the system’s governance arrangements should be effective, accountable and transparent).

(ii) EUI’s response to the Bank’s conclusions that it only broadly and partly observed Core Principles VII, IX and X has been swift and positive (as is recognised by the Bank in its Oversight Report):

- (a) EUI continues to monitor, review and follow up the operational incidents that caused the Bank's concerns in relation to CP VII; EUI has issued a further programme of software releases to strengthen operational stability and improved the robustness of testing and effectiveness of incident reporting;
- (b) EUI has developed and published, together with the CREST settlement banks and in consultation with the Bank, a new CREST Rule 16 which ensures that all criteria imposed by the existing CREST settlement banks before they will accept credit or other exposures to an applicant bank are publicly disclosed (which it is anticipated has considerably strengthened EUI's observance of CP IX); and
- (c) in addition to the existing desirable features of EUI's governance arrangements (including the involvement of independent Board directors within the Euroclear corporate structure and the work of the UK Market Advisory Committee set-up to ensure a high-degree of user-governance in the various national markets where Euroclear provides settlement services), EUI has set-up a new Settlement Bank Committee as a dedicated forum for discussion of issues relating to the interbank payment arrangements.

In addition to the matters outlined in paragraph (ii) of this Chapter 1(b), EUI has responded promptly and positively to resolve a number of concerns expressed by the Bank in relation to EUI's US dollar payment system.

The constructive and helpful dialogue that EUI has with the Bank, as informal overseer of its payment systems, is driven by a number of factors:

- (i) EUI is acutely aware that the maintenance of its reputation as a provider of a world-class securities settlement system means that it must achieve, and be seen to achieve, compliance with the Core Principles and other principles that (consistent with best practice) should be observed in the operation of a systemically-important payment system;
- (ii) unlike clean payment systems, and as we have outlined above, EUI is already subject to close formal supervision by the FSA in relation to the operation of its systems (including its payment-related functions); and
- (iii) in its operation of the sterling and euro embedded payment systems, EUI has put in place a robust contractual framework with the Bank and the CBFSAI respectively to govern the collaborative arrangements between it and the relevant central bank for the operation of the real-time gross payment functions that are provided as part of the "Sterling DvP Service" and the "Euro DvP Service".

(c) Potential duplication of Regulation

In relation to EUI, the proposed framework would produce a "two regulator model" – EUI would be formally answerable to, and subject to supervision by, both the FSA and the Bank *in relation to the same payment functionality*.

While we welcome the assurances that the Bank and the FSA have given to us informally that the Bill will only codify the Bank's existing informal oversight regime, there is still a

possibility that this could still lead, not only to unnecessary costs and diversion of management resources to deal with the demands of two regulators, but could also potentially result in the failure of a single, uniform regulatory response to the wider system issues that affect or arise out of the CREST payment arrangements. For example, and in extremis, termination or other limitation by the Bank of EUI's permission to operate as a payment system would clearly prevent or impede its ability to operate a securities settlement system that provides DvP settlement.

We require clarity as to the precise requirements that these two regimes will impose on EUI and assurances that the regulatory burden on EUI will not increase as a result of the Bill. We very much welcome the assurances made privately by the Bank and the FSA that the regime should lead to no changes in the practical effects of the oversight process. However, we need to be certain, not just that information requests are coordinated between the FSA and the Bank, but that the enforcement regimes under the FSMA and the Act are consistent and utilised in a harmonised way; EUI would not wish to incur different penalties from different regulators for the same incident. Attached to this note as Annex 4 is a table which contrasts the varying and inconsistent enforcement powers available to HMT/FSA as an "operator of a relevant system", with those available to the FSA under the REC and the 2001 Regulations and with the new powers available to the Bank in the current July Consultation Document.

(d) The MoU

We believe that an MoU (which we understand is already under consideration between the Bank and the FSA) would be a mechanism to ensure that the formal and parallel regimes under the proposed Bill and the FSMA were delivered in a consistent manner. In particular, we believe that the MoU should cover issues such as:

- (i) a recognition that the oversight of embedded payment systems creates different regulatory issues to those arising for clean payment systems;
- (ii) the Bank and the FSA should ensure that any information that they request from an embedded payment system is proportionate to the need for that information and that due checks are made to ensure that the information requested is not already available within the FSA or the Bank;
- (iii) the Bank or the FSA should not exercise its statutory information gathering powers against an embedded payment system unless it has first consulted with the other;
- (iv) the Bank should ordinarily seek to perform its oversight functions of an embedded payment system through the same 'informal' practices (consultation/requests/'moral suasion') that it currently uses. The Bank should only exercise its 'formal' powers over an embedded payment system if it determines that its use of the 'informal' tools available to it have not achieved the desired result;
- (v) the Bank must have the opportunity to raise issues concerning the oversight of an embedded payment system with the FSA, and the FSA will inform the Bank of its regulatory activities in relation to recognised bodies as impacting upon their embedded payment systems;

- (vi) a recognition that the regulated entity may seek to cover the costs of production of information requests. For example if a commercial product (such as stock loan data) is available, it is paid for fairly and appropriately;
- (vii) The Bank and the FSA should ensure that any enforcement action is taken in a fully coordinated manner and that duplicate and/or inconsistent enforcement action is never undertaken for the same incident. For example, the Bank may not exercise any of its statutory powers to impose penalties on an embedded payment system; or to disqualify a person from managing an embedded payment system; or to require an embedded payment system to cease certain activities; or to close that system; or to inspect premises; or any other power that might adversely affect the operation of an embedded payment system as part of a recognised body without the prior agreement of the FSA. Similarly, the FSA should seek agreement with the Bank before taking any enforcement actions;
- (viii) each of the Bank and the FSA shall otherwise assist each other in enabling or facilitating the effective exercise of their respective powers against a recognised body and its embedded payment system;
- (ix) in developing the principles to which the managers of embedded payment systems are to have regard (paragraph 3.54 et seq. of the July Consultation Document), the Bank shall consult with the FSA and confirm that the FSA is satisfied that those principles do not prevent or impede the FSA's supervision of the recognised body;
- (x) the Bank and the FSA must review, taking input from the embedded payment systems, at least annually the respective oversight/regulatory requirements that they have imposed on recognised bodies to ensure that they identify and remove any duplicate or overlapping requirements. The conclusions of that review should be made public at least to the recognised bodies;
- (xi) the Bank and the FSA must review the MoU every three years to ensure that it is achieving its objectives, with an interim review if there are significant policy changes or new legislation which requires elements of the MoU to be updated. The conclusions should also be made public; and
- (xii) the FSA and the Bank should also consider a dispute resolution mechanism which could include a timetable for agreeing any issue and an escalation procedure to a referee (such as HMT) if the disagreement persists.

(e) Oversight of payment systems: demarcation of oversight and operational functions

Regulation is most effectively delivered when the regulator is independent of its regulated institutions; indeed this is why many central banks have now completely separated supervisory responsibilities from their core purpose of maintaining financial stability.

But, the reality is that the Bank is an important user of EUI's systems and services and has responsibilities for financial stability in the UK. In addition, the Bank is also the provider of the "settlement asset" for the sterling embedded payment system. Its operational

participation in CREST means that it is vital that the operational area of the Bank is, *and is seen to be*, completely segregated from that which deals with the oversight of embedded payment systems.

Similarly, we would be grateful for confirmation from the Authorities that the principles contemplated by paragraphs 3.54-3.56 of the July Consultation Document will be developed solely in the performance by the Bank of its regulatory functions as overseer of payment systems – and not in support of its market operations. The limitation of this power should be clearly expressed and supported by the new legislation.

(f) Should the proposed powers be extended to cover other entities?

Unlike many payment systems, EUI (as operator) does not provide the settlement asset for the payment system and does not incur any credit or liquidity exposures under the system. The settlement asset is provided either by the Bank or the CBFSAI (for sterling and euro) or the CREST settlement banks (for US dollars). Equally, it is the central banks and the CREST settlement banks that assume and manage the liquidity and credit risks that arise out of the operation of the CREST embedded payment systems. In consequence, there are a number of significant matters relating to the operation of these systems that are not properly within the control of EUI – and in relation to them it relies upon the co-operation of the relevant central bank and the settlement bank community. An example of this is the development of CREST Rule 16 (which we referred to above). This rule sets out, amongst other things, the criteria that *the CREST settlement banks* impose before they consent to EUI's admission of a new applicant bank to the relevant embedded payment system. This is appropriate because the relevant criteria relate to matters that allow the CREST settlement banks to manage the credit, operational and legal risks that *they* will assume by consenting to the admission of the new settlement bank. If a particular issue were to arise in similar circumstances, the Authorities might feel that it would be a more appropriate and effective response to exercise the relevant power directly against the participant or participants concerned, rather than EUI as operator.

(g) No further reapplication for recognition

We also consider that systems that are "designated" for the purposes of the SFRs should not be required to re-apply for recognition as a payment system by HM Treasury. The fact is that the CREST UK system (including the supporting payment arrangements) has been designated by the FSA (after consultation with the Bank); and this was done after due regard to its systemic importance (see e.g. regulation 4(2) and the requirements of the Schedule to the SFRs). The special status accorded to "designated" systems for such regulatory purposes is recognised, for example, in Article 28(2) of the Payment Services Directive – which disapplies the PSD rules relating to access in respect of designated systems. In EUI's view, it would be an unnecessary duplication of regulatory process and costs to require designated systems to be separately "recognised" by HM Treasury.

2 Additional Issues

(a) EUI as Operator of a “relevant system” and statutory immunity

Statutory immunity is provided to recognised bodies (including EUI when acting in its capacity as an RCH) from liability in damages when performing their regulatory functions, unless they can be shown to have acted in bad faith – see section 291 of the 2000 Act. The July Consultation Document proposes the granting of statutory immunity to the Bank in relation to the performance of its regulatory functions under the new legislation.

As outlined in the third paragraph of the introduction and in the last paragraph of Chapter 1(a) (and Annex 2), EUI is similarly charged with the performance of regulatory functions as Operator of a “relevant system” under the USRs. However, in performing these regulatory functions, EUI does not presently enjoy the same immunity that it has when performing its functions as an RCH. This is a regulatory lacuna which has systemic stability consequences and should be answered by new powers taken in the proposed bill (or otherwise by a suitable amendment to the USRs).

In short, EUI is concerned that, in the absence of appropriate statutory protection when acting as Operator, it continues to be exposed to costly and disruptive litigation in respect of the functions performed by it. The threat of such litigation, even if ultimately unsuccessful, may adversely affect its performance of those functions. It may, for example, in certain circumstances undermine EUI’s willingness or ability to take swift and effective action to protect the integrity of its systems. This is potentially detrimental to the interests of the financial markets served by EUI.

The grant of statutory immunity to a recognised body (and the prospective grant to the Bank) in the performance of its “regulatory functions” is a clear indication that, as a matter of public policy, Parliament (and the Government) has concluded that the effective performance of regulatory functions by an infrastructure body is fundamental to the maintenance of stability and confidence in the UK’s financial system. EUI seeks the logical extension of that policy approach to the performance of its regulatory functions as an Operator of a “relevant system” under the USRs – and no more.

(b) Financial collateral arrangements

We note from paragraphs 4.44 to 4.46 of the Consultation Paper that the Government intends to consult on any future regulations made using the powers which strengthen the protections available to financial collateral arrangements. As the Government is aware, EUI strongly supports any legislative development that provides appropriate protection to “system-charges” (under the Financial Market and Insolvency Regulations 1996) and “collateral security charges” (under the SFRs). These are charges taken by CREST settlement banks to manage the intra-day exposures they incur by reason of their extension of credit to CREST members within EUI’s embedded payment systems.

We have previously provided to HM Treasury our “gap” analysis of where we believe the protections presently afforded to system-charges and collateral security charges fall short of protections now available to other types of financial collateral arrangement (both in the UK and elsewhere in the EEA). We have taken this opportunity to set out our analysis in Annex 3 to this response document. We would welcome an early opportunity to discuss this analysis and the Government’s proposals in this area.

(c) Special resolution regime and failing banks

We have considered the Authorities' proposals for reducing the impact of a failing bank – both as set out in Chapter 4 of the July Consultation Document and in the SRR Consultation Document. Our observations on these proposals are as follows.

We note from paragraph 4.43 of the July Consultation Document that the FSA intends to work further with banks to ensure that indirect members of payment systems have contingency plans in place in the event that their sponsor bank fails. We would welcome, as part of that process, discussion with the FSA and the other Authorities on how the European Commission's proposals to amend the Settlement Finality Directive to extend its protections to "indirect participants" of a securities settlement system might be made to work effectively in the UK and CREST context.

We have the following observations in relation to the proposed special resolution regime (SRR).

- (a) We would be concerned to ensure that the Authorities were confident that the private sector, bridge bank and partial transfer tools that form part of the SRR could be made to work efficiently and effectively where the failing bank is a CREST settlement bank. A number of points occur to us here.
 - (i) We note that paragraph 3.10 of the SRR Consultation Document contemplates a power to transfer property of a failing bank that would not otherwise be transferable. The bundle of rights and obligations that make-up a bank's status as a "CREST settlement bank" is non-transferable in the sense that, first, those rights and obligations are personal to the bank that is admitted by EUI to participation in CREST with that status; and, second, the other settlement banks have a right of veto over any new settlement bank (subject to satisfaction of the published admission criteria set out in CREST Rule 16). The admission criteria used by EUI and the remaining CREST settlement banks are designed to protect the integrity of the CREST system and to mitigate the inter-settlement bank exposures that arise under the CREST "embedded" payment systems. EUI's admission criteria are largely determined by reference to its regulatory obligations (as an RCH and as an Operator of a "relevant system" approved under the USRs). In principle, the power of transfer contemplated by paragraph 3.10 of the SRR Consultation Document would appear to permit a transfer of the settlement bank status of a failing bank to a private sector purchaser or a bridge bank. If this is correct, EUI and the CREST settlement banks would wish to be satisfied that any decision made by the Bank to effect such a property transfer would not affect the integrity or security of EUI's systems and market confidence in them, or create new and unacceptable inter-settlement bank exposures for the CREST settlement banks. We would expect that appropriate criteria to which the Bank would need to have regard in effecting such a property transfer instrument in relation to a CREST settlement bank would be set out either in the statute or in the statutory code of practice described in paragraphs 2.28 *et seq.* of the SRR Consultation Document. We would welcome discussion with the Authorities on the safeguards for EUI's systems and the other CREST settlement banks that would be appropriate to deal with these concerns.

- (ii) A partial transfer of a CREST settlement bank's business creates particularly difficult issues. For example, it might be decided that the sterling settlement bank business of a failing bank should be transferred to a private sector purchaser or bridge bank; but to leave behind the US dollars and euro settlement bank business in the residual settlement bank. In such a case, where previously there was one settlement bank (providing CREST payment facilities for sterling, euro and US dollars), there are now two settlement banks. The difficulty is that there is one set of contractual arrangements with EUI that governs the totality of the settlement bank payment facilities (and similarly between the settlement bank and its customer – the CREST member). In such a case, do the Authorities envisage that their partial transfer powers will enable them to transfer rights and obligations under a single contract (or set of contracts) *to the extent they relate to the settlement bank's sterling functions*, while leaving the same rights and obligations in the residual settlement bank *to the extent they relate to the settlement bank's euro/US dollar functions*? If so, how is it proposed to allow for this in the relevant statutory powers?
- (iii) The point made in (ii) is put into sharper relief in relation to the charge arrangements that a settlement bank will have by way of security for the payment facilities it makes available to its customer (the CREST member). The residual bank will have taken a (floating) charge under a single charge instrument (qualifying as a "system-charge" and a "collateral security charge") over all of the member's CREST securities (and various other CREST-related assets). It would have taken such a charge from each CREST member for whom it acts as a settlement bank. It is difficult to see how it would be possible to "split" that charge arrangement utilising the SRR tools – so as to retain effective security for the residual bank over the CREST securities in relation to the member's euro/US dollar liabilities to the residual bank, and provide for an effective charge in favour of the private sector purchaser or bridge bank in relation to the member's sterling liabilities transferred to that purchaser/bridge bank. Would a new charge be deemed to be created? If so, on what terms? What about the priority of that charge (in particular, as against the continuing charge vested in the residual bank)? Would the charge need to be separately registered under the requirements of the Companies Act? This would be impractical, of course, bearing in mind that the residual settlement bank will have taken a charge from each CREST member-customer to whom it provides payment facilities.
- (iv) It is also worth noting that, in relation to the CREST euro "embedded" payment system, a key contract is maintained between each euro settlement bank and the CBFSAI. This contract is governed by Irish law. In practice, there must be considerable doubt whether the property transfer powers to be reserved to the Bank under the new legislation would be effective to permit a transfer of that central bank relationship from a failing settlement bank to a private sector purchaser or bridge bank (in the absence of consent from the CBFSAI).
- (v) Paragraph 3.84 of the SRR proposes that the special bank administration procedure would only be applied to the residual company in conjunction with partial transfers to *a bridge bank*, and not in respect of a partial transfer to a private sector buyer. A CREST settlement bank is required to maintain a number of operational interfaces with EUI, including network communications

utilising the services of an accredited network provider. In practice, therefore, it seems likely that in the case of a partial transfer of a settlement bank's business (on the assumption that that is feasible notwithstanding the points made in (ii) and (iii) above), the residual bank would need to continue to provide operational support for the transferee bank. It follows, we believe, that in the case of a partial transfer of the business of a CREST settlement bank, the absence of the availability of the special bank administration procedure for a private sector purchaser will mean in practice that any partial transfer will almost inevitably be effected to a bridge bank. We are not certain whether this practical limitation on the SRR tools options available to the Bank in the event that a settlement bank falls into financial difficulty is desirable or consistent with the statutory objectives of the SRR as outlined in paragraph 2.2 of the SRR Consultation Document.

- (b) We note that it is proposed that termination or suspension rights that are contractually reserved by a counterparty to a failing bank may be disapplied or "turned off" in certain circumstances (see e.g. paragraph 3.130 of the SRR Consultation Document). EUI would wish to be satisfied that these provisions are not intended to prevent its exercise of termination or suspension powers of the participation of a CREST settlement bank (or, indeed, a CREST member which is a bank), which was in financial difficulty, in the interests of systemic integrity or otherwise to prevent disruption to other CREST participants. EUI's need to be able to do this is driven largely by the regulatory requirements to which it is subject in its capacity as an RCH and as an Operator of a relevant system approved under the USRs. EUI recognises of course that, in practice, its exercise of these powers of termination or suspension would (in relation to a bank participant) occur only after close consultation with the FSA and the Bank.
- (c) EUI would expect that any interference with property rights (or a moratorium on enforcement rights) that might occur under the SRR would not affect the rights, powers or priority of CREST settlement banks under system-charges or collateral security charges (paragraphs 3.77 to 3.79, 3.86 and 3.101 to 3.106 of the SRR Consultation Document). Such charges will be constituted as floating charges over the CREST securities (and similar assets) held by the CREST member (failing bank) in EUI's systems. Any potential interference with those rights would be likely materially and adversely to affect the willingness of the CREST settlement banks to extend credit to CREST members for the purposes of payments through EUI's systems; and, in addition, would be likely to be inconsistent with the provisions of European law (for example, the Settlement Finality Directive or the Directive on financial collateral arrangements).
- (d) Any share transfer or property transfer instrument affecting securities held in CREST would need to recognise and appropriately deal with the specific regulatory framework (contained in the USRs) which governs the transfer of securities held in uncertificated form. This might occur under a share transfer instrument where the shares issued by a failing bank are held in uncertificated form in CREST (e.g. Northern Rock plc); or under a property transfer instrument where the failing bank holds uncertificated securities in CREST. A number of issues arise here which we were, together with HM Treasury, required to resolve in the context of the Treasury's exercise of its powers under the Banking (Special Provisions) Act 2008 in relation to Northern Rock. EUI would wish to be satisfied that the powers to be reserved under the SRR would, in particular, enable:

- (i) the relevant transfer instrument to effect the transfer of uncertificated shares in a manner which is consistent with the operating procedures and practices available to EUI (as a "relevant system" under the USRs);
- (ii) the Bank (or other relevant Authority) to consult with EUI as to the most efficient and effective method to effect such a transfer and so as to minimise the disruption to EUI's systems or its other participants (bearing in mind that the transfer is unlikely to be effected by using the "usual" operating procedures available to effect a transfer of uncertificated securities or their conversion into certificated form); and
- (iii) (iii) EUI to receive the protection of an appropriate immunity from liability by reason of its performance of the functions it is required to perform to facilitate the execution of the relevant transfer instrument – for example, an immunity in similar terms to that contained in article 20 of the Northern Rock plc Transfer Order 2008.

EUI would wish to see an obligation on the relevant Authority either in the statute or in the proposed statutory code of practice to have regard to these (and other relevant) matters before any transfer instrument is made in relation to CREST securities issued or held by a failing bank. We would be happy to discuss further with the Authorities the nature and content of the safeguards that would be required here.

ANNEX 1:
GLOSSARY

"Authorities"	HM Treasury, the Bank and the FSA;
"Bank"	the Bank of England;
"Bill"	the proposed new Banking Reform Bill to be adopted as described in the July Consultation Document
"CBFSAI"	the Central Bank & Financial Services Authority of Ireland;
"DvP"	delivery-versus-payment;
"EUI"	Euroclear UK & Ireland Limited;
"FSA"	the Financial Services Authority;
"MTF"	multilateral trading facility;
"PSD"	Payment Services Directive;
"RCH"	recognised clearing house;
"RIE"	recognised investment exchange;
"SFRs"	the Financial Markets and Insolvency (Settlement Finality) Regulations 1999;
"the January Consultation Document"	the <i>"Financial stability and depositor protection: strengthening the framework"</i> (January 2008) Consultation Document;
"the July Consultation Document"	the <i>"Financial stability and depositor protection: further consultation"</i> (July 2008) Consultation Document;
"the SRR Consultation Document"	the <i>"Financial stability and depositor protection: special resolution regime"</i> (July 2008) Consultation Document;
"the 2000 Act"	the Financial Services and Markets Act 2000;
"USRs"	the Uncertificated Securities Regulations 2001 (as amended).

ANNEX 2:
EUI'S EXISTING REGULATORY OBLIGATIONS AFFECTING ITS EMBEDDED
PAYMENT SYSTEMS

Under the USRs and as an RCH, EUI is subject to a number of existing regulatory obligations impacting upon its operation of the CREST embedded payment systems, including:

- EUI must be able and willing to promote and maintain high standards of integrity and fair dealing in the operation of the CREST functions and cooperate, by the sharing of information or otherwise, with HM Treasury, the FSA and any other authority, body or person having responsibility for the supervision or regulation of investment business or other financial services (see USRs, paragraph 3 of Schedule 1; and paragraph 20 of the Schedule to the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001);
- EUI must maintain systems that minimise the possibility of unauthorised access to, or modification of, any program or data held in any computer forming part of the Operator-system (see USRs, paragraph 5(2) of Schedule 1);
- EUI must maintain systems that can send and respond to payment instructions in sufficient volume and speed (see USRs, paragraph 6 of Schedule 1);
- EUI must maintain adequate payments-related records and permit inspection of them by participants and notify settlement banks of their payment obligations (see USRs, paragraphs 10, 11 and 14(c) of Schedule 1);
- CREST must comprise of operational procedures that achieve DvP settlement (see USRs, paragraphs 13 and 21(1)(c) of Schedule 1);
- EUI must have binding rules and practices for the orderly termination of settlement banks whose participation is disruptive to other participants and to require them to provide EUI with such information in their possession that may be required to meet EUI's obligations under the USRs (see USRs, paragraphs 25(d) and 27 of Schedule 1); and
- EUI must ensure that its clearing services involve satisfactory arrangements (including as to payments) for securing the timely discharge of the rights and liabilities of the parties to transactions in respect of which it provides such services (see paragraph 19 of the Schedule to the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001).

ANNEX 3: "GAP" ANALYSIS FOR CREST FINANCIAL COLLATERAL ARRANGEMENTS

Background

CREST is the securities settlement system for dematerialised UK, Irish and international equities, public sector securities and money market instruments. CREST is operated by Euroclear UK & Ireland Limited ("**EUI**"), formerly known as CRESTCo Limited. EUI is itself a recognised clearing house under the Financial Services and Markets Act 2000; an operator of a "relevant system" under the Uncertificated Securities Regulations 2001 (and equivalent regulations in Ireland); and operator of "designated systems" under the Settlement Finality Directive (the "**SFD**").

Transactions settle in CREST on a Delivery-versus-Payment (DVP) basis. Payments with a value of over £800 billion are made each day through the system. Such payments are only possible as a result of the credit and liquidity facilities which are provided to CREST participants by CREST settlement banks (consisting of leading UK, European and US financial institutions). Each CREST settlement bank will incur an exposure to its CREST participant-customer in relation to CREST payments that the bank makes for the account of the participant. The exposure arises because, under the inter-bank payment arrangements that support settlement, a settlement bank incurs an obligation as principal to effect payment at the moment of CREST settlement (for the account of its customer), but it will not seek reimbursement from the CREST participant until the end of the settlement day or at a later time. This obligation of reimbursement is usually secured by a floating charge taken by the CREST settlement bank over the participant-customer's (or its nominee's) CREST securities.

The importance of the functions performed by CREST settlement banks, and the need to provide appropriate protections for their security against the adverse effects of an intervening insolvency of the participant-customer, were first recognised by the Financial Markets and Insolvency Regulations 1996 (the "**1996 Regulations**"). The 1996 Regulations give certain limited protections to such charges, as "system-charges", by applying Part VII of the Companies Act 1989 to them – the principal effect of which is to disapply the administration moratorium; the administrator's and administrative receiver's powers to dispose of charged property; the receiver's vacation of office and certain related matters in relation to system-charges (subject to certain temporal and other limitations).

Subsequently, the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "**SFRs**"), which implemented the SFD in the UK, provided certain further protections to a settlement bank's charge (qualifying as a "collateral security charge") from the adverse effects of the insolvency of a CREST participant. The principal relevant aims of the SFD are:

- to reduce the risks associated with participation in securities settlement systems, in particular where there is a close link between such systems and payment systems (Recital (2));
- to contribute to the efficient and cost-effective operation of cross-border payment and securities settlement systems in the EU (Recital (3));

- to minimize the disruption to a system caused by insolvency proceedings against a participant (Recital (4));
- to reduce systemic risk by allowing for the enforceability of collateral security (Recital (9)); and
- to insulate collateral security from the effects of insolvency law applicable to the insolvent participant (Recital (18)).

Article 9(1) of the SFD provides that collateral security should not be affected by insolvency proceedings against a participant and that such collateral security may be realised for the satisfaction of a participant's (i.e. in the CREST context, a settlement bank's) rights against it.

The SFRs implement the principal relevant aims of the SFD and Article 9(1) in relation to collateral security charges (in favour of CREST settlement banks) through:

- regulations 14(1)(d), (5) and (6) – which protect a contract for realising collateral security from the general distributional principle of insolvency law and, in particular, give priority to the settlement bank's claim over:
 - the expenses of a winding-up;
 - the expenses and remuneration of an administrator; and
 - preferential debts - in a winding-up,

but note that as it appears that regulations 14(5) and (6) are intended to be read together and that paragraph (6) is only intended to apply in the circumstances mentioned in paragraph (5), a settlement bank's claim will only be paid out of the proceeds of its security in priority to the chargor's preferential claims and administration expenses if the chargor has first gone into administration – which is a highly unsatisfactory result as a settlement bank would almost certainly wish to enforce its security before the commencement of an administration;

- regulation 14(2)(c) – which prevents an insolvency office-holder from exercising his powers under the Insolvency Act 1986 to prevent or interfere with enforcement action under a collateral security charge;
- regulation 16(1) – which disapplies those provisions of the IA 1986 that allow a liquidator to disclaim onerous contracts and a court to rescind contracts in relation to a contract for the purpose of realising collateral security;
- regulation 16(3) – which disapplies section 127 of the IA 1986 (avoidance of property dispositions effected after commencement of winding-up) to the provision of collateral security and any contract for realising collateral security (or any disposition of property in pursuance of such a contract);
- regulation 17(1) – which prevents an order being made under sections 238 (transaction at an undervalue), 239 (preferences) or 423 (transactions defrauding

creditors) IA 1986 in relation to the provision of collateral security and any contract for realising collateral security (or any disposition of property in pursuance of such a contract);

- regulation 19 – which disapplies the moratorium and related provisions under the administration regime in relation to a collateral security charge; and which disapplies section 127 of the IA 1986 in relation to a disposition of property as a result of which the property becomes subject to a collateral security charge.

The Financial Collateral Arrangements (No. 2) Regulations 2003 (the “**FCA Regulations**”), which implement the Financial Collateral Directive (“**FCD**”) in the UK, provide certain additional protections and other benefits to “security financial collateral arrangements”. As HM Treasury is aware, there is considerable doubt in the financial markets as to the application of the FCA Regulations to floating charges - including system-charges and collateral security charges granted in favour of CREST settlement banks. As a result, there is a serious risk that, at least prior to crystallisation, such system-charges and collateral security charges do not benefit from the provisions of the FCA Regulations. Even if this view is subsequently found to be incorrect, the wide-spread legal uncertainty in the market on this point has undermined market confidence in relying on the FCA Regulations in relation to floating charges (including system-charges and collateral security charges).

The consequence is that, whether in fact or as a matter of perception, there is a serious risk that certain protections afforded to qualifying “security financial collateral arrangements” under the FCA Regulations do not extend to system-charges and collateral security charges. This is a counter-intuitive result and potentially undermines the principal aims of the FCD (which itself must be considered in the context of the framework established by the SFD). The irrationality of this result can be underscored when it is borne in mind that the principal aims of the FCD include:

- to build upon the framework established by the SFD so as to limit systemic risk inherent in payment and securities settlement systems and provide common rules in relation to collateral constituted to such systems (Recitals (1) and (3));
- to contribute to the integration and cost-efficiency of the financial market as well as to the financial stability of the financial system in the EU (Recital (3));
- to disapply provisions of insolvency law that inhibit the effective realisation of financial collateral or cast doubt on the validity of current techniques (such as provision of top-up collateral and substitution of collateral) (Recitals (5) and (16));
- to limit the administrative burdens relating to perfection of financial collateral (Recitals (9) and (10)) – but there must be an appropriate balance between market efficiency and the risk of fraud (Recital 10)); and
- to provide for rapid and non-formalistic enforcement procedures in order to safeguard financial stability and limit contagion effects in the case of a default of a party (Recital (17)).

These aims are substantially similar, and must be considered in the context of, the aims of the SFD outlined in paragraph 4 above. It follows, we believe, that where HM Treasury has concluded that:

- whether in its current implementation of the FCD or in its prospective amendments to the FCA Regulations or otherwise to ensure the aims of the FCD are fully implemented in the UK, certain protections should be afforded to “security financial collateral arrangements” or similar financial collateral arrangements; and
- the appropriate balance between market efficiency and risk of fraud would not be upset by extending those separate and additional protections to system-charges (under the 1996 Regulations) and collateral security charges (under the SFRs),

then those protections should be so extended.

We would suggest that, as it is well recognised that market stability and systemic integrity are supported by the provision of system-charges and collateral security charges in favour of CREST settlement banks, there would be minimal fraud risk (in the manner contemplated by Recital (10) of the FCD) by extending the separate and additional protections of the FCD to such charges.

Gap analysis

Against the background provided by Section A of this Annex 2, and utilising the methodology suggested by it, we consider that the following protections currently afforded (or potentially to be afforded) to “security financial collateral arrangements” under the FCA Regulations should be extended to system-charges and collateral security charges:

- the disapplication of section 4 of the Statute of Frauds (no action on a third party’s promise), which may be relevant to “third party” charges granted by e.g. CREST nominees of a settlement bank’s customer – see regulation 4(1) of the FCA Regulations;
- the disapplication of section 395 of the CA 1985 (registration of charges), and corresponding provisions relating to Scottish and Northern Irish charges – see regulations 4(4), 5 and 7 of the FCA Regulations;
- the disapplication of sections 10(1)(b) and 11(3)(c), 11(2), 15(1) and (2) of the IA 1986, which are not disapplied by regulation 19(1) of the SFRs but which may still have effect in relation to a number of categories of public-utility companies and building societies – see regulation 8(3) and (4) of the FCA Regulations;
- the disapplication of the moratorium that arises under a company voluntary arrangement and related provisions – see regulation 8(5) of the FCA Regulations;
- the disapplication of section 127 IA 1986 in relation to the disposition of the shares of an *issuer* subject to a compulsory winding-up (we understand HM Treasury may be minded to extend regulation 10(1) to cover a transfer of shares under an issuer’s winding-up), and corresponding provisions under Northern Irish insolvency laws;

- the disapplication of section 88 IA 1986 in relation to a transfer of shares (in a voluntary winding-up), and corresponding provisions under Northern Irish insolvency laws – see regulations 10(2) and 11(2) of the FCA Regulations;
- the disapplication of section 176A IA 1986 (share of assets for unsecured creditors) – see regulation 10(3) of the FCA Regulations;
- the disapplication of section 245 IA 1986 (avoidance of certain floating charges) and the corresponding provision under Northern Irish insolvency law - see regulations 10(5) and 11(4) of the FCA Regulations;
- the priority given to the collateral-taker's claim over preferential debts and administration expenses – *and irrespective of whether the collateral-giver is in administration or whether it entered into administration before or after the enforcement of the security (see the concerns outlined in paragraph 6(1) above)*; and
- the power to appropriate financial collateral upon enforcement – see regulations 17 and 18 of the FCA Regulations.

It is also the case that the SFRs do not currently provide clear protection in relation to a participant that is subject to a creditors' voluntary winding-up, but which was commenced as a members' voluntary winding-up – i.e. where there has been a conversion under sections 96 and 102 of the IA 1986 as a result of the liquidator's determination that the company is in fact insolvent. The definition of "winding-up" in regulation 2(1) of the SFRs expressly excludes a members' voluntary winding-up; and regulations 20(1)(b) and 22(2)(b) (and paragraph 5(4)(a) of the Schedule) might be taken to suggest that the protections afforded by the SFRs do not extend to a participant that is insolvent under a creditors' voluntary winding-up that commenced as a members' procedure. It would greatly assist market confidence in the SFRs if:

- it was clarified that references to "winding-up" included such a creditors' voluntary winding-up;
- transfer orders that enter the system before or on the day that the voluntary winding up was converted to a creditors' procedure are protected under regulation 20; and
- the relevant notification obligations under regulation 22(2) and paragraph 5 of the Schedule apply, in relation to such a procedure, to the liquidator and at the time the members' voluntary winding-up is converted to a creditors' voluntary winding-up.

ANNEX 4
FINANCIAL STABILITY AND DEPOSITOR PROTECTION
Further Consultation (July 2008)

Overview of Supervisory Powers

Powers available	New Proposals (powers available to BoE)	Powers available to HMT/FSA under USRs in respect of 'operator of relevant system'	Powers available to FSA against RCHs under REC and FSMA
Enforcement powers			
Give directions	✓	✓ (Reg 8(2)(b), Sch 2 para 1(3)(b) specific procedure to be followed (sch3))	✓ (s 296 FSMA/REC4.6)
Disqualify persons	✓	✗ (power to give directions cannot extend to this action)	✗ (power to give directions cannot extend to this action)
Impose penalty	✓	✓ (fines in specific cases – ex Reg 22(4) and 27(9) + fines are capped)	✗ (but not entirely clear)
Public censure	✓	✗	✗
Withdraw approval / closing system	✓	✓ (Reg 7, Sch 2 para1(3)(a) - specific procedure to be followed (Sch 3))	✓ (s 297 FSMA/REC4.7)
Apply to court, injunctions and restitution orders	?	✓ (Reg 8(2)(a), 9)	✓ (section 380, 382 FSMA)
Investigative powers			
Information gathering	✓	✓ (Reg 10 and requirement to co-	✓ (para 20(2) of Sch to REC, REC

		operate under Sch 1, para 3)	2(18) requirement to co-operate for information sharing purposes)
Require an expert report (on the management and operations of the systems)	✓	✗	✗
Appoint an inspector to inspect premises and infrastructure	✓	✗	✗ (only for RIEs under s 296 (2A))
Notification requirements	?	✓ (Reg 10(5))	✓ (REC 3)
Publish codes of conduct/codes of practice and principles	✓	✓ (Reg 11(3), (10))	✓ FSA generally has rule making powers and power to issue guidance (also REC 2.17)
Impose requirements as to content of rules / review a system's rules	✓	✓ (Sch 1 para 25, 26, Sch 2 sch 1(3)(c))	✓ (para 21 and 25 of Sch to REC, REC 2.14, 2.17)
Supervisory relationship with regulator			
	? Range of supervisory tools may be indicative of closer supervision ?		Co-operative and constructive relationship to enable FSA to have a broad picture of REC's activities. Reliance on REC to take all steps to comply with requirements.