13 May 2015

Building a Capital Markets Union ("CMU")
Euroclear SA/NV Response

This response covers the views of all CSDs within the Euroclear Group to the European Commission's CMU Green paper published in February 2015.

Euroclear is also a Board Member of ECSDA and chairs both its Public Policy Working Group and its Settlement Practice Working Group. As a consequence, Euroclear has been extremely closely involved in the production of ECSDA's consultation response, with which we are in agreement. Our response should be read as a complement to that of ECSDA.

Euroclear SA/NV's public ID number in the EU Transparency Register is 88290282308-75.

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PART I Introductory Comments from a post-trade perspective

Euroclear is the world's largest post-trade provider of securities settlement services in fixed income, ETFs, equities, and funds. We serve a global client base out of our Head Office in Brussels and from our domestic European CSDs. We support fully the move towards a single integrated CMU which would result in the more efficient allocation of capital, reduced reliance on bank financing, as well as improving both EU growth and competitiveness globally.

The securities settlement space in the EU has been the subject of significant and unique change over the last three years. Significant, because CSDs will now all be subject to the detailed CSD Regulation, which entered into force in September 2014 and for which we await the final detailed Level 2 measures from the EBA and ESMA. But the change is also unique, because securities settlement systems in the Eurozone (and beyond) will shortly begin the migration to Target2-Securities (the single platform to which virtually all Eurozone CSDs will outsource their settlement systems between 2015 and 2017). The technical development of Target2-Securities has been accompanied by a comprehensive effort to harmonise market practices across those markets which are migrating to T2S. The combination of the CSD Regulation ("CSDR") (and global principles for Financial Markets Infrastructures agreed by CPMI-IOSCO) and the introduction of Target2-Securities together represent the most important building blocks for a capital markets union for post trade services.

Our comments in this paper have been developed according to the following three core principles.

(i) CMU initiatives should be targeted, evidence-based, and feasible and they should be implemented in a reasonably short timeframe.

We do not believe that (in the post trade space, at least) significant new initiatives are needed given that the single rule book for CSDs is still being completed and is unlikely to be implemented fully until 2018 by when the CSDR and Target2-Securities should both be fully implemented (see above). The Commission should only pursue initiatives which demonstrably deliver a difference to completing the single market. The Commission should consider a new "CMU test" that, as part of future impact assessments, assesses how existing and future legislation contributes to the CMU's objectives.

Widespread reform (as has been attempted at least twice before in the last 10 years with the Securities Law Legislation) should be avoided. Legislative initiatives could take many years to be agreed and implemented by the industry, which is why reforms should be precise and feasible to ensure that a material beneficial impact on jobs and growth can be delivered quickly.

(ii) The Commission should require a high burden of proof to justify the creation of significant and new reform

The reform process initiated by the last Commission has still not been fully implemented. Important and significant pieces of legislation are still being finalised (MiFID2, CSDR, R&R for FMIs) and many key elements of existing legislation have still not been fully implemented (such as the Liquidity Coverage ratio and the Leverage ratio in the CRR).

(iii) The Commission should examine the cumulative effect of existing legislation and its effects on the successful development of CMU

The recent body of financial services legislation was developed largely in response to the financial crisis and quite correctly focused on reducing risk and increasing stability across EU financial markets. However, many of the challenges to the delivery of a successful CMU may lie in this package of legislative measures. For example, the increasing use of segregation which can greatly affect settlement efficiency cross-border or the provision of triparty repo services. In addition, the wide-ranging (and untested) Settlement Discipline Regime under the CSDR may actually reduce the attractiveness of EU capital markets for investments from outside the EU and other provisions could hinder capital market movements between EU and third countries through CSDs. In addition, proposals still under consideration (such as FTT) appear to run counter to the ambitions of CMU.

In some cases, the objectives that the legislators were pursuing could be achieved through different means which could reduce the impact on the competitiveness of EU markets. As an example, the objective of better protection of ownership rights over securities could be ensured through better reporting mechanisms and/or appropriate insolvency frameworks, rather than segregation and a possible future securities legislation.

Part II Answers to Questions in the CMU Green Paper

Question 1 Beyond the five priority areas identified for short term action, what other areas should be prioritised?

The five priority areas identified by the European Commission for short term action are, in our view, an appropriate response to the challenges of stimulating long term growth and more efficient capital markets.

The remaining barriers to efficient post trade processes are the public sector barriers, such as tax and legal restrictions, identified as long ago as 2001 and 2003 in the two so-called "Giovannini" reports. Since the adoption of the final CESAME report in 2008[1], very slow progress has been made in removing the public sector barriers; tax barriers are only subject to non-binding recommendations, and the legal barriers still persist in the absence of a further harmonisation of securities laws across the EU. Any attempt to improve access to post trade financial market infrastructures must therefore, focus on those public sector barriers (and we cover these points in this response).

The priority of the current Commission should be to ensure that recently adopted EU laws are consistently implemented, and that ongoing legislative proposals are geared towards supporting well-functioning and internationally attractive financial markets. For instance, the Commission should (in the context of CMU) examine the likely unintended consequences of certain provisions in the CSD Regulation ("CSDR") which might render EU capital markets less attractive for small and medium sized enterprises (such as the Settlement Discipline Regime in Article 7 of the CSDR).

Q22 What measures can be taken to facilitate the access of EU firms to investors and capital markets in third countries?

We agree that there is wide scope for attracting additional debt and equity investment from third countries. To ensure that the EU can benefit from the increasing amount of international capital looking for investment opportunities, there should be good access between the EU's wholesale markets and other global markets.

In this context, we note that Euroclear Bank (an international CSD based in the EU) serves as a single access point to an international client base, facilitating global investment into securities issued by EU firms. For example, US or Chinese investors can access an EU based financial market infrastructure, Euroclear Bank, to invest in euro sovereign debt securities or in EU-issued equities and debt.

As a corollary, we also facilitate our clients accessing third country settlement systems (and therefore third country securities) through their direct connections to Euroclear Bank in Brussels. This benefits not just our EU clients seeking to invest in securities issued in third countries, but also deepens the liquidity of those capital markets by attracting foreign investment. This model of overseas links (regulated under the CSDR) operates effectively only if the third country system to which Euroclear is linked facilities the use of omnibus accounts for

[1] http://ec.europa.eu/internal_market/financial-markets/docs/cesame/cesame_report_en.pdf

cross border activity (see also answer to Q27 below). Although the decision whether to make these accounts available is always in the hands of domestic authorities in those third countries, we believe that the EU Commission and other authorities could to do more to promote the benefits of omnibus accounts globally, with supra-national bodies like IOSCO and the Financial Stability Board.

Finally, European legislation (including Level 2 rules) should encourage foreign investors to invest in the EU; the costs of compliance for market infrastructure should not be disproportionate to those in, for example, the US or Asia.

Q23: Are there mechanisms to improve the functioning and efficiency of markets not covered in this paper, particularly in the areas of equity and bond market functioning and liquidity?

We believe that it is too early to assess whether further initiatives are needed in this area, simply because key legislative texts such as MIFIR, and CSDR, have still not been fully implemented. We strongly encourage the Commission to assess the effects of these Regulations (particularly the new pre and post transparency regimes in MIFID and the Settlement Discipline and Buy-In regime in CSDR, both of which could have significant effects on market liquidity), before proposing new changes to the functioning of equity and bond markets.

We also draw the Commission's attention to our answers to Questions 22 and 27 in which we explain the constraints on efficiency which can be caused by the increasing demand from regulators for greater segregation of securities across the holding chain. We believe an analysis of the benefits and costs of segregation should be a key part of the Commission's CMU analysis.

Q24: In your view are there areas where the single rulebook remains insufficiently developed?

As we mention in response to Question 23 above, we believe it is too early to assess whether the single rulebook is sufficiently developed when so many pieces of the rule book remain still to be implemented.

Q25: Do you think that the powers of the ESAs to ensure consistent supervision are sufficient? What additional measures relating to EU level supervision would materially contribute to developing a capital markets union?

In line with the subsidiarity principle, we believe that CSDs which are active primarily at domestic level should continue to be supervised by national competent authorities, and that the involvement of authorities from other Member States in the supervision of a CSD is only warranted in case the CSD activities are of substantial importance to these ("host") Member States.

The recently established, and highly complex, supervisory arrangements for CSDs under the CSDR should be kept under review to assess whether they are working effectively.

Q26: Taking into account past experience, are there targeted changes to securities ownership rules that could contribute to more integrated capital markets within the EU?

A number of issues that had been considered as part of a European Securities Law Legislation proposal have now been dealt with as part of the Securities Financing Transactions Regulation, the Shareholders Rights Directive and the CSDR. As a result, what remains to be addressed through any potential European Securities Law Legislation proposal are the substantive rules for intermediated securities and a general conflict of laws rule for securities.

Considerable work has been undertaken over many years to consider how substantive securities laws can be harmonised internationally (the Geneva Securities Convention of 2009) and across the EU (the Securities Law Directive) so as to reduce the legal risks and costs associated with cross-border holdings of securities. However, it has proven difficult in the past for Member States to agree politically to this harmonisation of securities laws. This is because harmonising securities laws can be expected to have an impact on legal concepts deeply embedded with national laws.

First, some of our clients and other stakeholders see benefit in reform. Where securities are held through multiple intermediaries, establishing the ownership rights and/or entitlements the holders of securities acquire may require an analysis of multiple laws. This is entirely natural in an environment where securities laws are domestic. We note that while domestic laws generally have a clear and explicit framework for the holding and transfer of domestic securities, this is not always the case for foreign securities.

Secondly, the EU does not have a single conflict of law rule for the holding and transfer of book entry securities (ie a rule to determine which law will govern securities entitlement and proprietary matters). Existing EU rules are spread over several legal instruments (such as, the Settlement Finality Directive "SFD", the Financial Collateral Directive "FCD", and the Winding-Up Directive) with a particular focus on collateral transactions.

As a CSD with links to 46 countries world-wide and as a taker of global collateral, effective conflict of law rules are important for Euroclear and its clients and consequently we would prefer a global approach to this issue as attempted by the Hague Convention in 2002[2]. For lack of a global solution, we would support a further review of such conflict of law rules in the EU, but note that the attempts so far, in the context of the Securities Law Directive and the CSD regulation, have been unsuccessful.

In addition, we note that the implementation of the SFD and the FCD has (inevitably) been subject to different transpositions in different member states. This has led to a number of discussions about how to ensure the consistency of interpretation, and implementation, of the SFD when a CSD has migrated to T2S. A review of the

[2] Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary, dated 13 December, 2002.

implementation differences in these directives, with the aim of eliminating implementation discretion, would be helpful in ensuring consistency of implementation and would further strengthen the robustness of post-trade processing in the EU.

Finally, the Commission should also consider more consistent rules on the segregation of client securities accounts. The current fragmented approach includes different rules on account segregation spread over many pieces of legislation (EMIR, MiFID, and CSDR inter alia) and there does not seem to be a clear vision in terms of the right "level" in the chain at which segregation is needed to ensure adequate investor protection. A more consistent and truly harmonised approach on this issue would benefit investor and issuer transparency, while clarifying the rules to which intermediaries and infrastructures are subject in relation to account and asset segregation.

Q27: What measures could be taken to improve the cross-border flow of collateral? Should work be undertaken to improve the legal enforceability of collateral and close-out netting arrangements cross-border

Collateral underpins a wide range of financial market transactions and in recent years its importance has only increased. As a result, efficient cross-border flows of collateral are essential to support integrated wholesale financial markets within Europe. Infrastructures, such as CSDs, are at the centre of delivering efficient and low cost, global collateral solutions to market players. Euroclear mobilises round €1,000bn of collateral for its clients each working day and a multiple of that amount for the market's bilateral securities financing transactions which are settled through its settlement systems.

Collateral efficiency is impeded currently by three main legal issues:

- *Segregation requirements*: Custody segregation requirements have been introduced in the EU and globally with a view to enhancing certainty for 'who owns what' collateral and re-enforcing investor protection. However, segregation is an operationally cumbersome way of meeting this objective and it introduces other types of risk. In general, there should be a consistent/common approach for segregation requirements with fair/competitive provision of services and choices for end-users. Where collateral is subject to processing from a 'pool' of assets, the implementation of collateral segregation requirements, especially when involving fully segregated account structures (with asset and account segregated along the collateral chain even up to the Issuer CSD level) will be difficult to implement and will reduce the efficiency of collateral processing[3].
- *(Future) Settlement discipline (buy-in) requirements*: Settlement discipline provisions and buy-in procedures in case of settlement fails in the CSDR could impact the availability of collateral and collateral movements (see also industry impact studies e.g. by ECSDA and ERC).
- *The cumulative effects of other regulation*: There needs to be much greater analysis of the impact on collateral requirements of regulations on capital and liquidity (CRD IV, MMFR), clearing of transactions (EMIR,

[3] Assets that are held in a pooled/omnibus account can be handled and transferred efficiently; segregation requirements could introduce market settlement delays (with increased counterparty exposure) and could slow the collateral substitution, optimisation and movement process.

MIFIR), margins/haircuts (EMIR, CRD IV, CSDR) and mandatory straight-through-processing/STP requirements (MiFID II/MiFIR).

Some of the key challenges to the efficient movement cross border however, are operational, not legal; and have been identified in the European Central Bank's three reports on collateral and repo markets published on 7 July 2014[4], to which we contributed.

Q28: What are the main obstacles to integrated capital markets arising from company law, including corporate governance? Are there targeted measures which could contribute to overcoming them?

Maintaining and improving standards of corporate governance across the European Union plays a key role in contributing to growth, stability, and long-term investment. The Commission can play an important role in establishing common standards upon which Member States can build, and in encouraging high standards of corporate governance by spreading best practice across Member States. However, across the EU there are a very wide range of company law and corporate governance systems, and differences in market structures and shareholder base.

Lack of transparency can prevent issuers from easily obtaining information on the identity of their shareholders and could create dis-incentives for the cross-border issuance and trading of financial instruments. Existing processes for shareholder identification generally work well at a domestic level, but are not always efficient when it comes to identifying non-domestic shareholders, primarily because the flow of information is less automated and involves longer chains of intermediaries.

The review of the Shareholder Rights Directive ("SRD") has the potential to address some of the obstacles to cross-border shareholder identification and the cross-border exercise of shareholder rights. We believe that the impact of the revised SRD on shareholder transparency should be closely monitored in order to assess whether further improvements, through legislation or through industry initiatives, are needed.

Q29: What specific aspects of insolvency laws would need to be harmonised in order to support the emergence of a pan-European capital market?

As a post-trade service provider we do not see a need to harmonise insolvency law in order to support the emergence of a pan-European capital market.

A related issue has been discussed in the context of how to handle cases of insolvency of a CSD's participant - or a central bank's payment system's participant – when the CSD has outsourced its settlement platform to Target2-Securities ("T2S"). A key question is how to treat pending transfer orders (i.e. pending settlement

[4] http://www.ecb.europa.eu/pub/pubbydate/2014/html/index.en.html

instructions) in a cross-border transaction. This is an important question relevant for cross-border securities transactions among T2S markets but across all EU markets in general.

A dedicated T2S task force analysed the matter in 2014. Following a mapping exercise it became apparent that, in insolvency cases affecting CSD participants, there is considerable heterogeneity in the current rules and procedures across the 21 European markets using T2S. In some jurisdictions, transfer orders are put on hold or cancelled. In others, the accounts held by the declared insolvent participant with the CSD are blocked. This heterogeneity could generate uncertainty in cross-border contexts (and ultimately discourage cross-border activity).

The T2S task force considered some proposals for further action: among others (i) harmonisation of the information sharing process between CSDs and NCBs in T2S and (ii) some general principles on the identification and management of pending transfer orders across T2S markets. The T2S community of stakeholders will work further on these non-legal and rather technical and procedural issues.

In addition, the task force identified some further points requiring a wider harmonisation of insolvency procedures in Member States. In most cases this may be due to divergence of national laws in implementing the Settlement Finality Directive (see our answer Question 26 above) suggesting that a detailed Commission review and further harmonisation of Member States' transposition of the Settlement Finality Directive is needed.

Q30: What barriers are there around taxation that should be looked at as a matter of priority to contribute to more integrated capital markets within the EU and a more robust funding structure at company level and through which instruments?

It is clear that direct tax is a Member State competence and decided by unanimity. However, the improvements that are need to support CMU must include harmonisation of procedures and processes (NOT rates).

Without a harmonised, streamlined relief at source system, investors and intermediaries will continue to face the costly administrative burdens of diverging domestic procedures, excess tax will often be withheld and markets will be less attractive to investors. As the tax burden on an investment return can be significant, investors may choose to invest locally in order to avoid dealing with complex and costly procedures. "Residence" countries will see their investor base eroded and will continue to face costs in the form of processing certificates of residence, under-reporting of income, and/or over reporting of foreign tax credits. "Source" member states who continue to operate tax reclaim systems will continue to bear the costs associated with such a system, such as the stamping and certification of tax reclaim forms and processing refund payments.

In this context we welcomed the recent recommendations issued by the Tax Barriers' Business Advisory Group (T-BAG) in the area of withholding tax. However, a survey that was run in the T2S community in the course of 2014 across 21 Member States clearly showed that not one of the T2S markets was planning to fully comply with the T-BAG recommendations. In addition, we note that both the Commission and the OECD, together with EU Member States, have been looking into tax relief procedures and have explored options to harmonise, remove

barriers and create a level playing field since as early as 2001. However, it seems that Member States have in the past expressed reluctance to take this work forward.

Action must be taken here, if the full benefits of a CMU are to be realised. We would suggest, in common with the response of the T2S Advisory Group, that the Commission should first ensure that the T-BAG recommendations are in full alignment with other recent international initiatives on withholding tax procedures (e.g. OECD) and only then consider initiating the relevant legislation.