

Paris February 28th, 2011,

Ref: CH/mt/2011

Dear sir,

In March 2010 LCH.Clearnet SA carefully answered your first consultation on the intended reform to the Spanish securities clearing, settlement and registry system. We received with a lot of interest your second consultation which visibly follows a thorough work on the matter and addresses much more precise elements.

LCH.Clearnet SA believes this reform is definitely going in the right direction indicated by the current numerous European brainstorming and regulatory initiatives. Therefore, as we did in the past, we are keen on answering your specific questions, whilst we will not go into all the details since the focus is on the main principles underlying this reform. Many of the European discussions are still ongoing and the views we express here are obviously conditional to their outcome. This is especially true regarding the last version of the European Market Infrastructure Regulation (EMIR) which will be applicable as such when it is issued, and for which some areas are still to be agreed on.

We got to know and understand some of the existing market practices in the course of our recent launch of clearing services for Spanish debt. We envisage being able to offer by mid 2011 a full Central Counterparty (CCP) servicing in Spain for government bonds based on the same systemic risk management requirements.

We believe LCH.Clearnet SA is a clearing partner which could serve best your interests and accompany the Spanish market in this vast and crucial transformation. We will be actively involved in answering the CCP request for proposal from the Spanish community when it is issued, once the relevant necessary legislative changes in Spain have occurred. It will then be the right time to go into further details to sort out all the operational, functional, technical and legal points.

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We are quite aware that discussion with the market community but also amongst the infrastructure and the national authorities will be needed and we would like to stress that we have regular contacts with CNMV, Bank of Spain, MEFF, IberClear and the Spanish market players.

In any case, we will always be happy to contribute, be part of the discussion and help you as much as we can in defining the most appropriate scheme for Spain capital market within today's harmonisation and securitisation context, all the more since we are still very active at European level. We have already forecasted to mobilise a dedicated team to this end.

Memo

To CNMV and Bank of Spain

From LCH.Clearnet SA

Date 28 February 2011

Subject **Spanish CS system reform consultation document**

A consultation document on Spanish Clearing and Settlement system reform has been issued by the Spanish regulators (CNMV and Bank of Spain) on January 14th, 2011. The answers to the questions contained in that document should be answered by February 28th, 2011.

As a general comment prior to answering any of the questions, it should be noted that the answers provided are LCH.Clearnet SA point of view on February 28th, 2011 based on the information and knowledge it has at that time. It is notwithstanding any further legal and regulatory development which could occur, notably within the context of the different consultations on regulatory reforms like MiFID II, EMIR, CSD etc...

Furthermore, as we did in the past, we are keen on answering your specific questions and we will not go into all the details since the focus is on the main principles underlying this reform. We remain at your disposal should you need further information.

1. What do you think of curtailing the assignment process?

- a. Curtailing the assignment process would have some advantages in the sense that it would shorten the process compared to the current one which means that it would become more flexible and less burdensome than it is.
- b. What is described in CNMV document broadly corresponds to what is performed in the other European (and other) markets. When going into the details the different netting and settlement schemes will be described further and the most appropriate for the community will be chosen.
- c. Whilst it is not as secure as the current assignment process, LCH.Clearnet SA believes it still provides enough security and reliability under some conditions. If each infrastructure has a well defined scope of activities and liabilities and the same applying to its members, the full chain will be coordinated and the process will be safe. To this should be added the fact that multilateral netting will transform bilateral counterparty risk between members into bilateral counterparty risk between a member and the central counterparty, the latter being especially equipped for this purpose.
- d. LCH.Clearnet SA already provides those services and has experience in implementing them; each function (trading, clearing and settlement) is clearly identified and can thus be performed separately or jointly depending on each member's business model. The clearing members can also be trading members and perform the settlement of their transactions, or clear transactions executed by another party, and even use a third party, which is not trading or clearing member, to settle its transactions.
- e. See also question 36.

2. Do you think the aggrieved party should receive the penalty imposed, eventually, to the party in breach?

- a. It is a common principle in law that a party which does not fulfil its obligations should bear the corresponding consequences. This also applies as a primary remedy within the clearing activity. If the defaulting party does not oblige then the central counterparty will step in relying on its risk management tools: either the problem is interim and a simple fail management process is used or it is an important solvency issue and the default procedure is initiated. In many cases the party has not complied with its obligations in time but is finally able to do so and the damage of the aggrieved party is only temporary.
- b. It is at the CCP and / or CSD level that the failing counterparty can be identified in the chain of entities based on the balance that has not settled.
- c. Within the boundaries of the applicable regulatory and legal constraints, one should balance the need for a quick cure and the technical constraints which can sometimes slow down the process. A reasonable delay before the clearing house takes actions will need to be discussed and defined with all relevant parties to ensure such balance is fair to all and corresponds to the reality of the systems involved.
- d. On top of the compensation to the aggrieved party, the CCP should be compensated for the extra-work and corresponding costs that the fail / default management has incurred.
- e. LCH.Clearnet SA has in place some default / fail management devices including indemnities for itself and the aggrieved party(ies) (cf http://www.lchclearnet.com/Images/III.4-2_tcm6-48686.pdf and http://www.lchclearnet.com/Images/III.4-3%20VA_tcm6-48687.pdf). They have been defined based on market practice and regulators' point of view. They are reviewed whenever necessary.

3. Do you consider that the elements described above are sufficient to enable CCPs to be managed professionally, independently of their ownership structure? Do you consider additional factors should be added?

- a. One of the most important features of a central counterparty is that it should be independent and use high state-of-the-art standards to ensure an objective and efficient risk management. Regulation, supervision, good governance scheme and competition are definitely part of the equation to reach such a goal.
- b. The separation of trading, clearing and settlement functions in different infrastructures promotes proper competition and less conflict of interest so it could be a principle on which the clearing house for Spanish securities market could be based.
- c. Being user owned and user governed allows sticking to the community's needs but it is not the only possibility. In any case strict regulation and supervision should be set-up to ensure that the community does not lower standards to increase benefits. The focus should be on risk management which is definitely the core asset for systemic security.

- d. The CPSS-IOSCO standards facilitates ensuring market interest and systemic risk are preserved. LCH.Clearnet SA is fully CPSS-ISCO compliant and as a bank is submitted to the corresponding regulation. This puts risk management at the centre of its enterprise with a fully reliable and tested risk administration. It is user owned and governed and independent from the exchanges and settlement infrastructures whilst working closely with them.

4. Do you think it should be legally binding to channel multilateral trades in equities listed in the stock exchanges via a CCP?

- a. The first remark is that central counterparties should define the products it can clear by themselves, in good faith and taking into account market interest. Then the CCP is in a position to offer those services to the exchanges, MTFs or directly to OTC market participants. This topic should be discussed in risk committees to which the relevant parties are taking part. For securities the capacity to clear is easier to decide since the risk model is more easily determined. On
- b. The relevant regulatory framework can impose clearing for some transactions (e.g. regulated market) and leave it optional for others (e.g. pure over-the-counter transactions). When the transactions are anonymous, which is the case for multilateral trading facilities some kind of clearing is needed.
- c. The users have more and more incentives whether they are regulatory (e.g. Basel III), risk related, operational or else, to maximise their netting efforts and optimise their balance sheets.
- d. LCH.Clearnet SA accommodates markets for which clearing is compulsory but also clears transactions on a case by case basis depending on the two parties agreeing to use it. The scope and width of services provided can also vary: going from full guarantee service to just technical straight through process without position, risk and settlement management.

5. Do you think the reform should be addressed on a joint basis so that the CCP handles both equities and fixed-income securities? If so,

- a. Most of the reasoning described in the consultation document is applicable whatever the security involved. Market practices for equities and fixed income can be different but the core principles related to risk management apply. Specific adjustments for each activity would be done when necessary.
- b. From a business and economical perspective encompassing bonds together with equities should also allow economies of scale and cross-products synergies not only for infrastructures but also for market participants.
- c. LCH.Clearnet SA clients benefit from such economies and risk management safety for many different kinds of products and markets. It works on the same core principles and has specific provisions for one product or the other when appropriate.

6. Do you think the use of the CCP should be optional in markets where trading is not multilateral (e.g. fixed-income outside the electronic platforms, block trades, OTC trades in equities)?

- a. As long as the CCP is offering the service and the parties agree, clearing should be available on an optional basis for trades for which it is not compulsory. Again the main argument is safety (financial and operational via straight through process...) and transparency. Multilateral trading is an example where a clearing house is needed however this does not prevent market participants to be interested in benefiting from the corresponding advantages even for bilateral trades.
- b. LCH.Clearnet SA provides compulsory and also optional clearing services depending on the trading venue and the kind of trades for each trading venue. For example clearing is compulsory for normal transactions executed on NYSE Euronext securities market (except for securities which are explicitly excluded by LCH.Clearnet SA based on its risk policy) but are optional in case of block trades on the same market.
- c. See question 4.

7. Do you consider that the conditions set out above about the CCP's corporate governance are sufficient?

- a. The bodies dealing with risk management, audit and regulatory relationship should be under special attention since those are the main areas where some arbitrage and conflict of interest could occur.
- b. The risk committee is definitely one of the key governing bodies, its composition and decisional process must be defined precisely. On the one hand, external members participation as described in EMIR is a good means to avoid conflict of interest and ensure some independence vis-à-vis the management. On the other hand, internal representatives are compulsory to provide expertise and the proper vision of the day to day activity.
- c. In the end, some liability for the central counterparty will flow from the risk committee decisions and the internal representative should thus have voting rights to ensure the interest of the central counterparty are preserved. LCH.Clearnet, through EACH, has forwarded this point of view to the European Commission in the context of EMIR consultation.
- d. See question 3.

8. Do you think it is necessary that the CCP have access to overnight liquidity from the Eurosystem?

- a. In case of default by a clearing member the CCP might urgently need liquidity to handle the corresponding actions (liquidation...). The assets provided by the relevant clearing member and the rest of the community, need to be quickly transformed in cash or creditworthiness. It should be noted though that, for equities and fixed income markets, as opposed to derivatives markets, where only mark to market is exchanged, the need for liquidity usually can be quite high due to the realisation of potential need to replace / liquidate the assets underlying the transactions.
- b. Intraday liquidity would cover part of this need but overnight liquidity would definitely enhance the effectiveness of and quicken the default management process. Quickly having access to liquidity directly with a central bank seems to be the easiest means to cover an important need for cash.

- c. LCH.Clearnet SA has had the experience of default management and thanks to its banking licence within the Eurozone it has benefited from access to overnight liquidity which was very helpful.

9. Do you consider the proposed mechanisms for managing failed transactions to be appropriate?

- a. It is true that in theory buy-in and loans can be used to cover a failed transaction. Timing for implementing one and / or the other will need to be decided. One should balance the need for a quick cure and the technical constraints which can sometimes slow down delivery processes. A reasonable delay before the clearing house takes actions should be defined with all parties involved to ensure such balance is fair and corresponds to the systems reality.
- b. Lending or borrowing by the CCP itself is harder to put in place, less certain and more risky. The CCP bears the risk vis-à-vis the lender and has not settled its rights vis-à-vis the defaulter. Borrowing by the defaulter to another party (e.g. the CSDs), can preventively reduce the number of fails.
- c. Let alone the legal constraints, using the collateral provided by other clearing members does not seem appropriate to cover a fail: the likelihood that missing securities have been provided by one of the members is low, contagion risk increases and the set-up would be complicated from a practical point of view (which clearing member to choose...). The only possibility is to use the defaulting clearing member's own collateral to cover the breach of its obligations vis-à-vis the CCP.
- d. LCH.Clearnet SA offers buy-ins and sell-outs in case of transaction failure (cf http://www.lchclearnet.com/Images/III.4-2_tcm6-48686.pdf). If in the end the securities are not delivered, a cash compensation is paid to the aggrieved party. This does not prevent the defaulting seller from using external lending and borrowing facilities to cover their shortfall before the buy-in mechanism is initiated (intended settlement date plus 8 days).
- e. Liquidity is all the more important in case of a fail by a buyer: the need for cash can be obtained by selling the bought securities, by using the collateral provided by the clearing member (especially in cash), by accessing liquidity or credit lines within banks or central banks or at the very end by using its own capital.
- f. LCH.Clearnet SA also has a thorough default procedure in place (cf http://www.lchclearnet.com/Images/IV.5-2%20gb_tcm6-48729.pdf) and documentation stating all resources it can use to cover a default (cf http://www.lchclearnet.com/Images/IV.5-1%20VA%2020100527_tcm6-48746.pdf).
- g. See question 2.

10. Do you consider appropriate the proposed model of settlement by balances and the elimination of the RR?

- a. Most of the fixed income and equities settlement system work with settlement on balance (also known as book entry) and this complies with the way Target2Securities (T2S) will work.
- b. Eliminating RRs will ease and quicken the settlement process. Whilst it will not be as secure as the current assignment process, LCH.Clearnet SA believes it will provide enough security and reliability thanks, amongst others, to the supervision by the central system and delivery versus payment process.
- c. If each infrastructure and type of market actors has a well defined and complementary scope of activities and liabilities, the full chain will be safe.

- d. LCH.Clearnet SA works today with settlement systems using book entry, on delivery versus payment basis, as recommended by CPSS-IOSCO.
- e. See also question 33.

11. Do you consider it necessary to impose solvency requirements on participants in the proposed settlement system?

- a. The way the new settlement system will work will impose more liabilities on its participants. The central settlement system will not have a view on and control over each participant's client's account, the participant will be liable for its clients accounts. They will not be considered as simple technical agents anymore but as systemic actors and should thus be imposed capital requirements.
- b. Many European CSDs have an admission process by which its participants must comply with some requirements, some of them are financial.

12. Do you consider the participant's proprietary account should be used to cover shortfalls in securities in its customers' accounts?

- a. The participants will be the direct member of the central settlement system on which the latter will have view and powers unlike the customers of the participants.
- b. If the customers' assets are clearly technically segregated from the participants' ones, using or not the assets of the participants to cover the shortfall of one of its customers will be possible. However this should be considered carefully and decided in compliance with the applicable law and should be covered by specific contractual provisions between the participants and its clients. It should be clearly stated in the rule of the central settlement system for the participants to assess and cover the corresponding risk.

13. Do you consider that the proposed failed transaction management mechanisms are appropriate?

- a. Whilst the CSDs do not guarantee the settlement instructions it receives it is vital that its internal settlement efficiency be as high as possible to never come to a deadlock, and that instructions do not stay unsettled forever. In case of bilateral transactions it should thus cancel the instruction and in case there is a clearing house both would decide which one does it.
- b. The CSD is a crucial element of ensuring liquidity and proper settlement of securities. Those should be increased by implementing some smoothing mechanisms like:
 - lending and borrowing, whereby the CSD offers, with the help of some "liquidity providers", to its participants to borrow securities to cover their temporary shortfall.
 - partial settlement, whereby the CSD also supports partial delivery or payment for one settlement instruction through which the settlement instruction remains unsettled for a lower amount/quantity. This avoids big settlement instructions being blocked whilst some securities/cash are available to ensure as much liquidity as possible is available within the system.
- c. In parallel other such mechanisms can be set-up by the clearing house to further enhance the process like
 - shaping whereby it cuts a large settlement instruction into much lower ones to increase the likelihood of their settlement
 - Continuous Net Settlement whereby it nets fails with the position to be settled to lower the amount of fails.

14. Do you consider that there should be a mechanism of alternative compensation?

- a. The only relevant and fast compensation for the party suffering from the non execution of the settlement instruction is cash compensation. The settlement instruction will be cancelled.
- b. As any penalty process it should be clearly stated in the rules of the CSD and be applied on an objective non-discriminatory basis.

15. Do you consider it appropriate to establish a penalty system so as to discourage settlement failures?

- a. The rationale for penalties at CSD level is the same as for those which should be in place at the CCP level, they could be cumulated as long as they do not cover the same damage for the same party or punish the same breach.
- b. Again safety and reliability are compulsory for the system and bad recurring behaviour cannot be tolerated.
- c. The point of the penalty unlike the compensation to the suffering entity is to deter participants from failing; this should be a first step and could be reinforced by more stringent and compelling measures going as far as the suspension or termination of membership.

16. Do you think that the CSD should publish information on trades where settlement failed?

- a. Some information and statistic on transaction failure are usually published by the settlement system and they can be of interest not only for clients but also market infrastructure and of course regulators. Quarterly reports are usually provided.
- b. The level of details will surely depend on the persons who will have access to those figures and the confidentiality obligation of the settlement system. Usually regulators have specific reporting which is much more detailed than what is available to the public or even the participants.

17. Do you have any other legal comments on this issue?

- a. Again all this will need to be seen in the light of the outcome of the current European regulatory discussions (EMIR, CSDs etc...) and of the applicable Spanish law. The basic rule regarding separation between house and client holdings is in line with LCH.Clearnet SA (and the internationally accepted) current process.
- b. The possibility to have the balance-based registry system configuring rights in rem is indeed an option. In France for example the right in rem for an investor, materialises by the balance in the accounts it has with its bank.

18. Do you agree with the introduction of the pro rata rule into Spanish law as the method for resolving securities shortfalls in the event of insolvency of a participant?

- a. As stated previously, this rule should be the last resort: the participants should be liable vis-à-vis its clients of the proper registration of their rights and thus bear all corresponding costs, except when they are bankrupt / do not exist anymore.
- b. It is true that based on non-discriminatory and clarity principles the pro-rata rule seems to be the most appropriate. As suggested it is in line with the way other CSDs handle such cases and with T2S forecasted model.

19. Do you agree with introducing this rule? If so:

- a. The timing and effects of this precedence rule need to be studied as it would potentially undermine the position of the CCPs (or other parties) claim on the proprietary balance held by a participant going into insolvency. It is quite important point it will have some impacts on other creditors rights: the sequencing and scenario should be carefully described to define the rule.
- b. Such study should be done in line with the applicable law, the outcome of the current European regulatory discussions (EMIR, CSDs etc...) and of the applicable Spanish law, defining, amongst others, which rights are attached to the registry.
- c. See also question 12 which principles would also be applicable here.

20. Do you consider that a rule such as the one proposed should be formulated such that all the securities in the insolvent firm's proprietary account may be used to cover any overall shortfall in securities in third-party accounts? or, on the contrary

- a. If the rule of precedence is adopted it should be clear and easy to implement. Applying it fully to any shortfall rather than limiting it to a shortfall in the same security would make it more predictable for the market and easier to apply for the administrators.
- b. Furthermore there is no specific rationale, unless expressly stated in the applicable corpus of law, to restrict this rule to a class of security.

21. Should the attachment of securities in the proprietary account be limited to the shortfall in third-party accounts of the same class of security?

- a. See question 20.

22. Which of the optional modes of record-keeping do you believe might be a suitable alternative to consider, and which do you believe should be ruled out?

- a. It seems important to align the proposals with other legislation underway which seems to move in the direction of offering some degree of segregation and linked portability. However, a situation with large numbers of individualized accounts does not seem practical nor required since it would reduce the possibilities for aggregated processing, which is delivering tangible benefits in most cases.
- b. A setting offering some persons or entities segregation at CSD appears most appropriate. This will be linked to the status, business model, legal and regulatory constraints including reporting obligations, of the relevant parties.
- c. In any case, LCH.Clearnet SA can support various forms as required.

23 Do you agree with the need for harmonised discipline that regulates the accounts and book-entries, and that variations used by participants should be valid vis-à-vis the system?

- a. By becoming a participant to the registry system the entities will abide by a set of rules and the corresponding technical and functional requirements. The system should definitely work on standards applicable to all. It may be useful to suggest adhering to the ISO based standards (cf T2S ones), where applicable.
- b. The higher the degree of standardization the easier it will be to operate on a full STP basis. Some degree of flexibility should also be envisaged: different options should be offered when advisable but always within the validity of the system rules.
- c. Changes and updates, based on market requests and needs are a means to have the system evolving in a proper way as long as they are done with reasonable notice.

24. Do you agree with these general principles on the distribution and identification of tasks and responsibilities between Iberclear and the participants?

- a. The general principles between Iberclear and the participants seem quite appropriate. Those broad principles will need to be detailed in finer rules which will be shared and made public. Ensuring protection of the actual holders of the securities and mitigating risks should be kept in mind whilst doing so.
- b. The consequences of the breach of those rules will also be of interest.
- c. The scheme will be combined with the tasks and responsibilities of the local regulators.

25. Do you agree with the proposed approach to control, cross-checks and daily and regular verification?

- a. The points in this section seem broadly in line with the European CSD consultation paper. However, it may be worth identifying to what extent they will be subject to harmonized European legislation, in which case Iberclear will have to copy / paste those into its own rules and regulation.

26. Do you agree with the proposed approach to dealing with corporate/financial transactions?

- a. In the context of the European CSD consultation paper the CSD should indeed be the only one handling corporate information (e.g. corporate actions) in order to make it possible for these functions to be centralized in due time.
- b. This would allow consistency within the market infrastructures and avoid lengthy reconciliation process when information comes from several sources. All infrastructures will be coordinated and the CSD will globally be recognized as the reference.

27. Do you consider that this is the right approach or can you propose substantial changes?

- a. LCH.Clearnet SA believes this is the right approach.
- b. See question 26.

28. Do you agree with the foregoing approach?

- a. This rule will have to be seen in the light of the other current or future applicable law and regulations. However it appears logical that if you accept a responsibility (keeping accurate records) this comes along with also accepting liability in case things go wrong due to actions that can be attributed to the participant.
- b. The possibility to raise the participants' liability in case of breach of its obligations should be available for the CSDs, for the participants amongst themselves and for their clients (based on the applicable agreement) The suspension or termination of membership should be possible in case the breach is serious or recurring misbehaviour.

29. Do you agree that the participants of the settlement system should cover shortfalls in securities in their customers' accounts out of their proprietary accounts?

- a. See questions 12 and 19.

30. In your opinion, does any other aspect of finality need to be considered at this time?

- a. The main aspects of finality in the CSD are considered here.

31. Which of the three options for the time of finality at the CSD do you consider to be most appropriate from the standpoint of protecting the system?

- a. The applicable provisions for finality should be in line with the current relevant European Directive 2009/44 amending Directive 1998/26, which should have been implemented in all the European Union member states by now.
- b. At LCH.Clearnet SA level, for securities markets, the finality occurs upon novation which itself is upon registration of the transactions in its systems. The rule is so since LCH.Clearnet SA does not work on open offer basis. In its CSDs, within Euroclear Group, finality occurs when the instructions are matched and registered into their systems. The credits and debits are irrevocable once the cash movements have been executed within the national central bank.
- c. The sooner the finality the better the stability and security, however some flexibility is essential to deal with exceptional circumstances.

32. Do you think overall system costs will be lower than at present?

- a. Based on the principles stated above the overall costs should be lower, economies will be made by the CSD, but also by the participants themselves. The number of settlement instructions will drop, the administrative work will be reduced, so will the workload etc ...Of course, current and planned future size of the Iberclear system will play a major.
- b. It should also be noted that, in parallel market activity may increase (as capital is better utilized).

33. In your opinion, will eliminating RRs make settlement and registry processes cheaper?

- a. Simplifying the process but eliminating RRs should lead to lower cost. Competition between CSDs as supported by the European CSD consultation paper and the removal of Giovannini barriers 6 and 9 allowing issuers to select the CSD of choice competition will increase and fee should lower.
- b. See also questions 10 and 32.

34. Do you think the changes to be introduced by the reform will reduce the number of entities performing these activities?

- a. In line with the developments in other regions the answer is probably yes, the number of entities will be reduced, amongst others because of the new requirements that will be imposed on the different actors at the different levels, together with new liabilities. The increase in competition could also be a reason for consolidation or specialization.
- b. The possibility to use third party to perform activities outside their core business will also lead to specialization and thus limit the number of players per function.

35. What other changes do you think the reform may produce in the current configuration of post-trade activities?

- a. The forecasted changes could make the Spanish market more attractive for foreign investors / entities active in the clearing and settlement space.
- b. For all players the easing, smoothing and securing of the process should allow freeing some capital hence increasing the activity.

36. Do you consider the introduction of non-settling market members to be a good idea?

- a. LCH.Clearnet SA offers the possibility to be active in clearing only and use another entity for the settlement functions. This possibility is broadly used by market participants and clearers. Again this allows rationalization and specialization for some entities which can thus benefit from central counterparty risk weight, amongst others, without having to handle the post trade chain.
- b. On the contrary, some companies with a well developed settlement activity will be in a position to offer those services to others.
- c. See also question 1.

37. Do you think separating settlement from custody/registry activities may be beneficial for some entities?

- a. It is already the case today for other markets where to some extent some participants to the settlement systems are not all custodians.
- b. Following the logic applied above LCH.Clearnet SA believes the answer could be yes, and it could support it (settlement agent functionality in place today).