

Global Clearing & Settlement

– A plan of action

Improving safety and efficiency of international securities markets



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Foreword

Securities clearing and settlement is a fundamental function upon which financial markets depend. Conceptually, it is a simple activity whereby the ownership of securities and cash is exchanged, yet the detailed mechanics by which numerous transactions are completed every day are highly complex and vary from market to market. The costs and risks associated with this activity are high, particularly in the cross-border environment, yet they are not generally well understood.

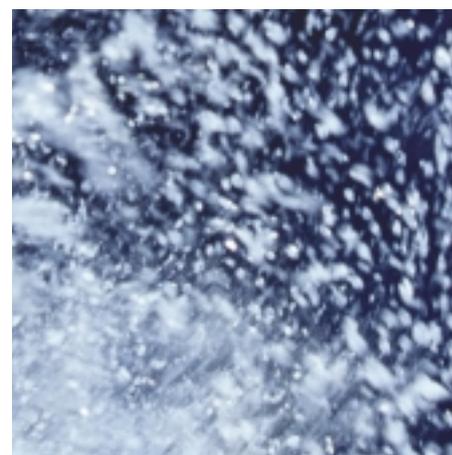
I was asked by the Group of Thirty (G30) in late 2000 to chair a steering committee set up to oversee a study of securities clearing and settlement. The steering committee comprised industry leaders from both public and private institutions and was representative of all major markets. We drew on advice from senior operational and technical experts from investors, broker-dealers, custodian banks and infrastructure providers. Considerable time, experience and intellect have been dedicated to the project. We are very grateful to PricewaterhouseCoopers, who played a central role in this study, researching and analysing the issues that participants in the clearing and settlement process face, and working with the steering committee and industry experts to draft the report's twenty recommendations that address these issues.

The report "Global Clearing and Settlement: A Plan of Action" articulates where opportunities for greater efficiency and risk reduction lie and sets out an ambitious and comprehensive plan of action for what needs to be done to realise these opportunities.

The 1989 G30 report on clearing and settlement helped transform financial

markets' infrastructure from predominantly manual, paper-based and time-consuming systems to the more automated and efficient processes that exist today in most domestic markets. Implementation of the twenty recommendations in this new report is expected to bring transformation of similar magnitude. Our vision is of fully automated and interoperable systems that connect to form a seamless global network for clearing and settlement, with fair access for all qualified users and sound risk management practices, overlaid by strong and effective governance and consistent supervision and oversight.

Sir Andrew Large
Chairman of the Steering Committee
Group of Thirty



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Introduction

In mid-2001 PricewaterhouseCoopers was asked by G30 to conduct a wide-ranging and in-depth market survey of over 40 organizations to establish the main concerns that they had in connection with clearing and settlement. The scope of the survey was very broad, covering all types of organizations from investors to broker-dealers, custodian banks and infrastructure providers, spanning the U.S., Europe and Asia Pacific and ranging from small, domestic firms to the largest global institutions. There was no fixed agenda, we simply asked people to discuss the issues they found most important. Despite this expansive scope and open dialogue there was a remarkable consensus on the most important issues and broadly how they should be addressed.



Our discussions with users and providers of clearing and settlement services across many markets highlight that they are anxious for the emergence, implementation and consistent use of global standards, which are central to the G30 report.

Together such standards facilitate interoperability, a term that the report does much to clarify and bring to life in the context of clearing and settlement. There is also a need to automate further the basic clearing and settlement model, eliminating paper and manual processes that still exist, with asset servicing and corporate actions consistently identified as a particular area requiring attention.

Securities industry participants are keen that competition be allowed to flourish between different service providers, with fair access and pricing for all users. Also, they articulate the need for financial, operational and legal risks to be clarified and addressed in a consistent fashion, allowing them to improve their own risk management practices and optimize the use of collateral.

The recommendations are firmly grounded in the expectations and wishes of participants in the securities industry. Technical experts and leaders from the industry analysed the issues and shaped the recommendations contained in the G30 report, ensuring that they were practical and founded in reality rather than theory. Collectively they embody many hundreds of man years of experience and knowledge.

PricewaterhouseCoopers is pleased to have played a part in facilitating this process and in helping to bring together the substantial input from the many contributors into a cohesive and compelling plan of action. Implementing this plan is undoubtedly a significant

challenge, but one that will bring even greater benefit to industry participants.

On the following pages we have listed the recommendations from the executive summary of the G30 report. Alongside them we have reproduced the initial goals set out in chapter VI of the report: from recommendation to implementation*. These goals are high level. However, strategy and investment decisions will be taken and the impact and consequences of the recommendations will be felt at the individual organization level. We therefore also set out our analysis of some of the key actions that each organization should be considering now to ensure that they are engaged in industry-wide developments, are acting to utilize and benefit from ongoing and prospective changes, and will not be left behind as their customers, suppliers and competitors seek more efficient and lower risk processes.

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The Twenty Recommendations and Key Action

Creating a strengthened, interoperable network

Recommendation 1:

Eliminate paper and automate communication, data capture and enrichment

Infrastructure providers and relevant public authorities should work with issuers and securities industry participants to eliminate the issuance, use, transfer and retention of paper securities certificates without delay. All market participants should seek to automate elements of the process, such as confirmations and trade allocations, that introduce other forms of paper into the securities processing transaction flow as technology safely allows. All market participants should use electronic communication to transmit information for all instruments and transaction types. They should identify opportunities to streamline processes by avoiding duplicative recording of data and manual addition of supplementary information at each stage of the value chain.

Initial goals set by G30:

- For each major market, identify and publish:
 - Steps necessary to eliminate the use of paper securities certificates within a set time frame.
 - All regulations or laws that lead to a requirement for physical paper, along with proposals for eliminating them.
- Enunciate harmonized legal standards for recognition of electronic documents.

What individual organizations should do now:

- Map and evaluate processes to identify and establish the cause and impact of all procedures, communications and data processes where paper is used or manual intervention is required.
- Where inefficiencies are due to law or regulation, ensure input to industry working groups lobbying public authorities for change. For example, laws requiring/allowing paper securities certificates or physically evidenced trade confirmations.
- Assess whether inefficiencies introduced by customers and/or suppliers are properly factored in to business, service and pricing decisions (similarly, where your actions cause inefficient processes for others there may be scope to negotiate better pricing). For example, trade allocations communicated late and/or by non-automated means, such as fax or telex.
- Seek to remediate internal procedures and move towards zero intervention processing with automated exception handling. For example, ensure that all critical data is captured in automated systems at the time of trade.



The Twenty Recommendations and Key Actions

Creating a strengthened, interoperable network, continued

Recommendation 2:

Harmonize messaging standards and communication protocols

All market participants should adopt ISO 15022 (the data field dictionary and message catalogue for securities information flows) as the global standard for straight-through securities messaging across the entire securities life cycle.¹ Over time, XML (extensible mark-up language) should be used as the language to describe standardized messages.² All market participants should support and use communication networks that adopt open, standardized, IP-based protocols for securities transactions.³

Initial goals set by G30:

- Targets for ISO 15022 implementation and migration to an XML version already in place and coordinated through SWIFT.
- Any network operator not already operating an IP-based network to publish plans to do so within a defined time frame.

What individual organizations should do now:

- Catalogue the electronic message format used for each process. Assess the feasibility, cost and impact of changing the format or translating the message to an ISO 15022 compliant format to allow messages to be sent and received without avoidable manual intervention.

- Catalogue the network protocol used by each communication system. Assess the feasibility, cost and impact of changing the protocol of all systems to an IP basis to allow messages to be sent and received without avoidable manual intervention.
- Where third parties use non-standard or proprietary formats or protocols assess whether inefficiencies introduced by customers and/or suppliers are properly factored in to business, service and pricing decisions.
- Participate in industry groups that are developing standards, ensuring that all interests of the organization are properly represented where there is impact across business or functional lines.
- Ensure that future systems development strategy embraces full compliance with all relevant industry standards.

Recommendation 3:

Develop and implement reference data standards

Market participants should collectively identify, develop and adopt universal securities, counterparty and relevant generic reference data standards that fully meet the needs of all relevant users. Issuers, exchanges and other originators and distributors of data should make all relevant information available to the market in compliance with these standards for a fair price and on a timely basis.

Initial goals set by G30:

- Establish detailed objectives and terms of reference for coordinated and coherent formulation of asset, counterparty, and generic reference data standards.

What individual organizations should do now:

- Identify the organization's requirements for each type of reference data, for example the elements of data that the organization needs across all business lines and support functions in connection with each security or with each customer.
- Determine cost of compiling, checking, maintaining, distributing and using reference data across the organization.
- Evaluate indirect and opportunity costs of inaccurate or incomplete reference data.

¹ ISO, the International Organization for Standardization, is a confederation of national standards institutes that works in partnership with public and private institutions to develop standards to be used consistently as rules, guidelines, or definitions of characteristics and to ensure that materials, products, processes, and services are fit for their purpose.

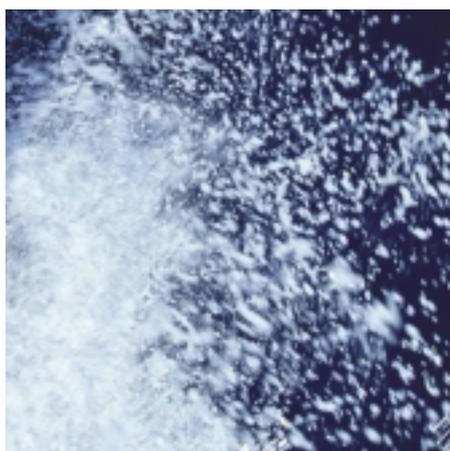
² XML (extensible mark-up language) is the universal language for describing structured documents or data on the Internet.

³ IP (Internet protocol) is a suite of protocols developed for and used by the Internet and by private networks as the open, global standard for electronic communication.

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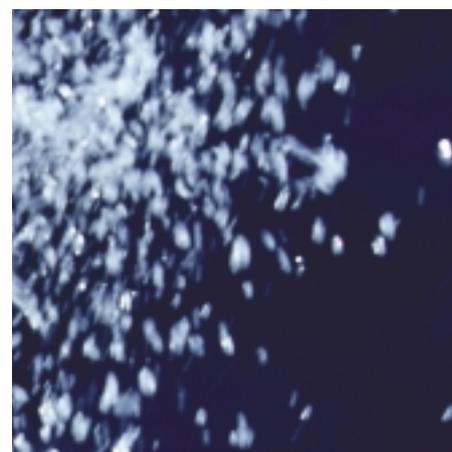
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- Assess current process for compiling complete, accurate and up to date reference data sets, e.g. considering where there may be areas of duplication (e.g. securities data used by both cash and derivatives businesses) and evaluating the potential for a single, centralised reference data set meeting all needs of the organization.
- Participate in industry groups developing standards for reference data, ensuring that all interests of the organization are properly represented where there is impact across business or functional lines.



Recommendation 4:
Synchronize timing between different clearing and settlement systems and associated payment and foreign-exchange systems

Providers of clearing and settlement services, and linked or otherwise associated payment and foreign-exchange systems should collectively ensure that their design, procedures, operational timetables and funding and cut off times are such that the operation of one system does not materially reduce the efficiency or increase the risk of settlement in another. Market participants should work together to develop a comprehensive action plan to increase the efficiency and safety of cross-border securities transactions where the foreign-exchange settlement cycle is not synchronized with the securities settlement cycle.



are not synchronized with the security settlement cycle and develop plan to address inefficiencies.

- Lobby for changes to synchronize payment and settlement systems.

Initial goals set by G30:

- Identify all critical timing interdependencies and establish detailed objectives for synchronizing timing, with terms of reference for carrying work forward, on a country, regional, and/or global basis, as appropriate, to address respective interdependencies.

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What individual organizations should do now:

- Collaborate with service providers to identify critical timing interdependencies for cross-border transactions where foreign-exchange settlement cycles

The Twenty Recommendations and Key Actions

Creating a strengthened, interoperable network, continued

Recommendation 5:

Automate and standardize institutional trade matching

Market participants should collectively develop and use fully compatible and industry-accepted technical and market-practice standards for the automated confirmation and agreement of institutional trade details on the day of the trade.

Initial goals set by G30:

- Publish a working paper on globally applicable technical and market practice standards for trade matching and confirmation, building upon work in the U.S. market by the Securities Industry Association.

What individual organizations should do now:

- Participate in industry groups developing standards for institutional trade matching.
- Understand and evaluate impact of matching utilities on the business model and operations, both internally and on external interfaces with customers and service providers.

Recommendation 6:

Expand the use of central counterparties

Market participants and relevant public institutions should collaborate to assess the potentially substantial risk reduction and efficiency improvements of using a central counterparty. These benefits are expected to outweigh their costs in most markets. Where this is so, market participants should seek either to use the services of an existing central counterparty or to establish one of their own, whichever has the better risk, cost and benefit profile.

Initial goals set by G30:

- In each market without a CCP, publish a paper for comment setting out the risks, costs and benefits of using a CCP, with a preliminary conclusion and proposed course of action.

What individual organizations should do now:

- Participate in industry efforts to evaluate the establishment and use of CCPs.
- Understand and evaluate the impact of CCPs on the business and operational model.
- Evaluate how the current supply, demand and usage of collateral may change.

Recommendation 7:

Permit securities lending and borrowing to expedite settlement

Relevant authorities should permit securities lending and borrowing as a method for expediting the settlement of securities transactions.

Initial goals set by G30:

- In each market where securities lending and borrowing is limited or prohibited:
 - Identify all regulations, laws or market practices that serve as impediments.
 - Propose steps to remove them in a defined time frame, including amendments of law and regulation, as necessary.

What individual organizations should do now:

- Lobby relevant authorities to change regulations and laws that prohibit stock lending and borrowing.
- Evaluate and plan to exploit opportunities to offer new or improved services arising from changes allowing stock lending and borrowing.

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Recommendation 8:

Automate and standardize asset servicing processes, including corporate actions, tax relief arrangements, and restrictions on foreign ownership

Issuers, providers of clearing and settlement services, and other relevant market participants should advise investors of all details of corporate events that they require in an automated, timely manner and in compliance with accepted industry standards so that each investor can make a timely decision on the action to be taken and in full knowledge of the facts. Market participants and public authorities should work together to minimize the administrative costs to each party involved in the tax relief arrangements through standardization and automation of procedures and communication of information and through the use and acceptance of electronic data and documentation. Relevant public authorities, infrastructure providers and market participants should work together to harmonize and make transparent the processes, documentation, and communication of information in connection with foreign-ownership restrictions and reporting requirements.

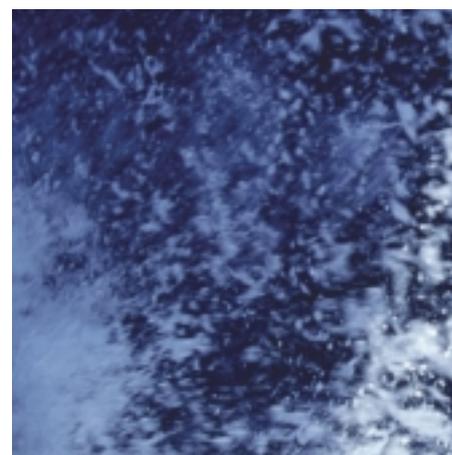
Initial goals set by G30:

- Develop and publish plan to enable standardized, automatic transmission of corporate action information in ISO 15022 format in each market within a specified time frame.
- Establish detailed objectives for harmonization of national tax documentation and processes and set terms of reference and time frame for action.

- In each market, publish clear rules on foreign ownership restrictions and reporting requirements, and make all relevant information freely available to ensure compliance.

What individual organizations should do now:

- Carry out actions proposed under Recommendation 1. Asset servicing should be subject to particular focus as our industry survey suggests most organizations will have considerable scope for achieving significant efficiency gains and risk reduction through improving processing, risk management and internal controls related to corporate action processing, associated tax relief arrangements and other asset servicing activities.
- Participate in industry-wide lobbying for changes to legal, tax and regulatory frameworks in the countries where these are a significant source of problems.



The Twenty Recommendations and Key Actions

Mitigating risk

Recommendation 9:

Ensure financial integrity of providers of clearing and settlement services

Providers of clearing and settlement services should manage their risks and set standards and controls around the use of those services that allow them to conduct business in a safe, sound and prudent manner consistent with their business model and all relevant supervisory and regulatory requirements. The need to operate prudently within the risk boundaries inherent within the business model requires risk management processes and standards, which should be applied objectively and consistently in determining compliance with risk measures, in three broad areas: the counterparty due diligence process, the procedures and techniques used to measure, monitor and control risk exposure, and the minimum financial and liquidity requirements. Each organization should publish a report, at least annually, that describes the business model, risk framework and underlying risk management processes, controls and standards, together with the results of independent testing of those procedures. The report would thereby reassure users that the organization has operated effectively, and would provide greater transparency to the market.

Initial goals set by G30:

- Each provider to publish outline of business model, risk framework and underlying risk management processes and standards.

What individual organizations should do now:

- Infrastructure providers and other organizations providing clearing and settlement services should ensure that their risk framework is appropriate to the scope of the business, its operations and the associated risks, is approved by the Board of Directors, includes a set of quantitative and qualitative measures and is tested.
- Develop and enhance counterparty due diligence controls following the guidance contained in the G30 report, including business, financial, operational, legal and other risk management assessments.
- Strengthen day-to-day risk management practices, including limits on/monitoring of risk and activities, collateral management, stress and scenario analysis.
- Plan to supply customers and other relevant stakeholders with independently validated, transparent reporting of risk framework and control procedures for financial and operational risk management processes:
 - Determine control objectives and ensure that controls in place meet these objectives and appropriately mitigate risks.
 - Strengthen documentation of controls in place and ensure they are demonstrable and evidenced.
 - Seek external validation and testing of controls to provide assurance to third parties, e.g. through SAS 70 style reporting.

Recommendation 10:

Reinforce the risk management practices of users of clearing and settlement service providers

Organizations that use, or are considering using, providers of clearing and settlement services should establish robust due diligence and counterparty risk management controls and processes that appropriately evaluate, measure, monitor, and control the risks inherent in such activity and in associated customer-related business.

Initial goals set by G30:

- All organizations to establish appropriate due diligence and risk management controls.

What individual organizations should do now:

- Ensure that its risk framework is appropriate to the scope of the business, its operations and the associated risks, is approved by the Board of Directors, includes a set of quantitative and qualitative measures and is tested.
- Develop and enhance counterparty due diligence controls, including business, financial, operational, legal and other risk management assessments. Ask service providers for evidence that an appropriate control framework is in place and has been independently tested, e.g. through requesting a SAS 70 style report.
- Strengthen day-to-day risk management practices, including limits on/monitoring of risk and activities, collateral management, stress and scenario analysis.
- Understand risk framework and underlying risk management processes and standards of service providers.

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Recommendation 11:
Ensure final, simultaneous transfer and availability of assets

Providers of securities settlement services should reduce to the lowest possible level the credit risk created if securities or cash are delivered without receipt of corresponding assets, by linking securities transfers to funds transfers in a way that achieves effective delivery versus payment (DvP) and by making transparent the point at which finality of transfer is achieved. Once finality of transfer is fully assured, the rules should enable a receiver to re-use securities and cash without further delay.

Initial goals set by G30:

Each provider to publish report covering:

- Nations to sign and ratify the Hague Convention.
- How providers will specify the moment of finality specified in rules and contracts in plain language.
- Rules for transfers and re-use of cash and securities once finality is achieved.

What individual organizations should do now:

- Understand and evaluate settlement and legal risks for all systems in which the business participates.
- Where the organization uses (and in many cases may also be an owner of) organizations that operate systems that do not accord with the recommendation, use influence to encourage compliance.

Recommendation 12:
Ensure effective business continuity and disaster recovery planning

All market participants should, and all systemically important institutions must, regularly review, update and test their business continuity and disaster recovery plans, including evaluation of reliance on third parties, to ensure with reasonable certainty that critical operations will continue with a high level of integrity and sufficient capacity following a disruption or disaster.

Initial goals set by G30:

- Each provider to publish outline of business continuity plan, including the scenarios considered, testing performed and the results of that testing.

What individual organizations should do now:

- Review, update and test business continuity and disaster recovery plans, including evaluation of reliance on third parties. Ensure the plan includes crisis management, dependencies on people, particularly those responsible for key processes, assessment of the impact of failure of key service providers and that it incorporates lessons learned from September 11.
- For functions critical to the market as a whole, evaluate the need for a split operations model whereby one processing site actively backs up the other, with each site having all key resources, capabilities and functionality, including appropriately skilled and experienced people.

- Understand and comply with legal and regulatory business continuity requirements in the jurisdictions in which the organization operates.
- Coordinate with key suppliers to evaluate the effectiveness of the measures they have taken to ensure continuity of service to their customers in the event of a disruption.
- Collaborate with other users to ensure individual business continuity and disaster recovery plans are consistent with industry-wide efforts and determine where collective action may be needed.
- Provide reporting to customers regarding contingency plans so market participants can make reasonable judgments as to the risks to which they in turn are exposed.



The Twenty Recommendations and Key Actions

Mitigating risk, continued

Recommendation 13:

Address the possibility of failure of a systemically important institution

Market participants in each financial center should work together to identify those institutions, or parts thereof, that are systemically important to the clearing and settlement process. User groups should be established to address how they would react if, despite strengthened business continuity and disaster recovery plans, there were a failure for whatever reason at one of these institutions. Ways of mitigating the risks created should a systemically important institution fail, such as building a real-time data depository, should be evaluated. Where it is determined that effective and feasible solutions may exist, detailed business cases setting out the costs and benefits should be built up, and decisions on future actions and investment decisions should be taken accordingly. As well as enforcing suitably high standards of business continuity and disaster recovery planning in systemically important institutions, regulators and overseers should encourage this process of industry-wide contingency evaluation and planning.

Initial goals set by G30:

- Identify systematically important institutions and evaluate how the risk of their extended failure could be mitigated.

What individual organizations should do now:

- Participate in user groups to identify systemically important institutions and evaluate ways of mitigating the impact on the market of their possible failure.

Recommendation 14:

Strengthen assessment of the enforceability of contracts

Market participants should ensure that due diligence procedures examine contract enforceability, including basic formation and validity, as well as power and authority to contract.

Initial goals set by G30:

- All organizations to establish appropriate legal due diligence and risk management controls.
- Enunciate appropriate standards of legal due diligence and identify deficiencies in law that could potentially impair contract enforceability.

What individual organizations should do now:

- Evaluate, and where necessary reinforce, legal due diligence procedures, which should form an integral part of all new product or new business evaluations.
- Ensure board members, business heads and risk managers understand legal and associated risks to which the organization could be exposed through an inadequate legal due diligence framework.

Recommendation 15:

Advance legal certainty over rights to securities, cash or collateral

Market participants must be able to determine, with certainty and reasonable cost and effort, what law defines and governs their rights to securities, cash or collateral in a clearing and settlement system or other intermediary, what those rights are, and how to perfect and enforce them.

Initial goals set by G30:

- Complete agreement on PRIMA in the Hague Convention and embody in national laws.
- Confirm seniority of account holder's rights over creditor's and simplify rules governing pledging and realization of collateral.
- Providers to specify moment of finality in rules and contracts.

What individual organizations should do now:

- Assess legal risks and uncertainty in each jurisdiction or set of jurisdictions and evaluate contractual arrangements to ensure that they minimize legal uncertainty where it exists.

The Twenty Recommendations and Key Actions

Improving governance

Recommendation 16:

Recognize and support improved valuation and closeout netting arrangements

Market participants should ensure that all master agreements provide that upon the early termination of a transaction or group of transactions, the determining party will have the flexibility to value such transactions by the method that is most likely to produce a commercially reasonable valuation at the time of termination. Market participants should include closeout netting provisions in their contract documentation. Relevant authorities in each jurisdiction should ensure that their laws give effect to closeout netting for all central counterparties, brokers, end users and other market participants, and for all entity, transaction, and asset types.

Initial goals set by G30:

- Standard master agreements for all significant transaction types should embody consistent close out netting and valuation provisions.

What individual organizations should do now:

- Ensure that transaction documentation and master agreements include appropriate and enforceable valuation and close out netting provisions as articulated in the recommendation.

Recommendation 17:

Ensure appointment of appropriately experienced and senior board members

Members of the boards of securities clearing and settlement infrastructure providers should, individually and collectively, be of a weight in terms of experience and seniority to discharge the enlarged strategic, risk and operational management oversight responsibilities described in this report.

Initial goals set by G30:

- Develop guidelines by which to evaluate experience and seniority of board members.

What individual organizations should do now:

- Ensure that representatives on boards of infrastructure providers meet the criteria in the recommendations.
- Encourage active participation of senior management on boards of infrastructure providers and in industry organizations to keep informed about industry initiatives and represent the interests of the organization, their customers and other stakeholders.

Recommendation 18:

Promote fair access to securities clearing and settlement networks

Boards of securities clearing and settlement service providers, other organizations providing similar services, and public authorities should ensure that rules and other requirements that control or limit access to securities clearing and settlement services are accepted only where they are necessary and are designed exclusively for the purpose of controlling financial, operational, reputational or regulatory risks; maintaining the safety of the system; or achieving other reasonable public policy objectives. Networks and services should be accessible to all users that pass risk and safety evaluations and enjoy appropriate financial standing, and users should be free to select the mix of functions and services that they wish to use on the basis of straightforward, transparent and fair tariff policies grounded on the principle of user pays.

Initial goals set by G30:

- Providers to publish report on access rules, detailing inconsistencies with recommendation and specifying plans for remediation within a specified time frame.

What individual organizations should do now:

- Identify all markets where access to service providers is limited or is subject to conditions that are not related to objective risk or safety considerations and which cause additional cost or risk. Lobby service providers to change unfair or anti-competitive practices.

The Twenty Recommendations and Key Actions

Improving governance, continued

Recommendation 19:

Ensure equitable and effective attention to stakeholder interest

Board participation should represent different stakeholder interests fairly and equitably. Provision should be made for regular review of, and for changes, as necessary in, board composition to ensure continuing balanced representation of varying stakeholder groups, including users.

Initial goals set by G30:

- Providers to publish mechanism designed to ensure fair user representation and timetable for implementation of this mechanism if not already in place.

What individual organizations should do now:

- Organizations should identify those services critical to their business and operations, evaluate how their interests are communicated to the respective service providers and seek to improve their representation where necessary.
- Organizations should assess the impact of service providers on their business and operations, and ensure that their collective participation in the various governance structures is coherent with the organization's strategy.

Recommendation 20:

Encourage consistent regulation and oversight of clearing and settlement service providers

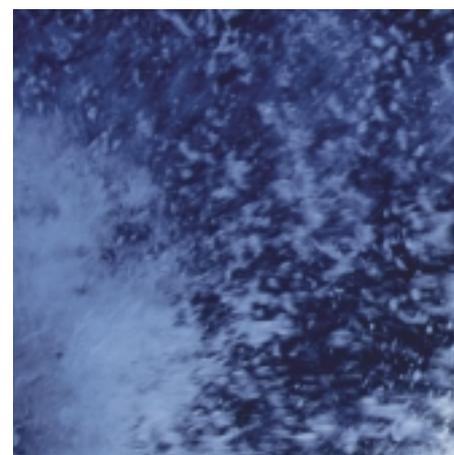
Providers of securities clearing and settlement services should be subject to consistent and transparent regulation and oversight, which should focus on the activities undertaken and risks incurred. Standards of regulation and oversight of cross-border activity should be complementary and consistently applied across all relevant jurisdictions. As a long-term goal and where coherent with other public policy objectives, regulatory and oversight standards should be harmonized.

Initial goals set by G30:

- Clarify regulatory and oversight responsibilities for each provider.
- Establish supervisory principles based on activity and risk based definitions and analysis.

What individual organizations should do now:

- Evaluate the impact that consistent regulation and oversight would have on the business and its operations, e.g. on the level of regulatory capital required.
- Lobby for changes to regulation and oversight where inconsistent rules cause inefficiencies or are inappropriate to activities and risks.



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