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SECURITIES AND EXCHANGE COMMISSION
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Market Regulation Department

SEC-MRD Opinion No. 1
Series of 2008

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CITIBANK N.A.
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Fax: 894-7398

Attention: Atty. Angelica Pia Peña-Lacson, Director
Atty. Ma. Judith L. Castillo, Vice President

Subject: Delivery versus Payment (DVP)

Gentlemen:

This refers to your request for opinion on the issue whether or not the settlement arrangements of your bank (as dealer) with qualified institutional buyers (QIBs) achieve delivery versus payment (DVP) and are compliant with SEC Memorandum Circular No. 14, series of 2006, otherwise known as the *Rules Governing the Over-the-Counter Market (OTC Rules).*

In particular, you cited Section 20 (B) of the OTC Rules which provides that *"the clearing and settlement arrangement in the exchange of assets subject of the trade shall be delivery versus payment (DVP) scheme".*

In reply, herein below is our response to your query:

The process of clearing and settling securities trade includes several key steps. *First,* the confirmation of the terms of trade by the market participants. *Second,* the calculation of the obligations of the counterparties resulting from the confirmation process which is known as clearance. *Third,* the final transfer of securities (delivery) in exchange for the final transfer of funds (payment) in order to settle the obligations.

A DVP system is a securities settlement system that provides a mechanism that ensures that delivery occurs if and only if payment occurs. It is a procedure by which the buyer's payment for securities is due at the time of delivery. The purpose of DVP system is to ensure that counterparties are not exposed to principal risk, that is, the risk that the seller of a security could deliver but not receive payment or that the buyer of a security could make payment but not receive delivery.

There are several approaches to achieve DVP but the three most common models are as follows: [1] A system that settles transfer instruction for both securities and funds on a trade-by-trade (gross) basis, with final (unconditional) transfer of securities from the seller to the buyer (delivery) occurring at the same time as final transfer of funds from the buyer to the seller (payment); [2] A system that settles securities transfer instruction on a gross basis with final transfer of securities from the seller to the buyer (delivery) occurring throughout the processing cycle, but settles funds transfer instructions on a net basis, with final transfer of funds from the buyer to the seller (payment) occurring at the end of the processing cycle; [3] A system that settles transfer instructions for both securities and funds on a net basis, with final transfers of both securities and funds occurring at the end of the processing cycle. *[CPSS, Delivery Versus Payment in Securities Settlement Systems (BIS, September 1992)]*

Strictly speaking, DVP does not require simultaneous final transfers of funds and securities. When a central securities depository does not itself provide cash accounts for settlement, it first blocks the underlying securities in the account of the seller or his custodian. It then requests transfer of funds from the buyer to the seller in the settlement bank. The securities are delivered to the buyer or his custodian if and only if the central securities depository receives confirmation of settlement of the cash leg from the settlement bank. *[CPSS, Recommendations For Securities Settlement Systems (BIS, November 2001)]*

Securities markets in different jurisdictions achieve DVP in several ways. For better appreciation of this concept and to address peripheral issues in your letter, allow us to describe the existing securities settlement systems in the equities and fixed income markets in the country.

The trades at the Philippine Stock Exchange (PSE) for equities are cleared and settled through the facility of the Securities Clearing Corporation of the Philippines (SCCP) in continuous net settlement basis. This is a Model 3 DVP. Under the SCCP's system, all transactions that will settle on the same day are netted in a multilateral netting fashion to arrive at either a long or short position for either the security or cash element or both. And to eliminate the uncertainty in the clearing and settlement process, SCCP acts as the central counterparty to all trades that are eligible for settlement. In the netting process, the identity of the original parties disappears and the original contract is replaced by two new contracts, and SCCP becomes the buyer to every seller and seller to every buyer in all exchange trades. *[SCCP Rules and Operating Procedures, April 2006]*

On the other hand, the trades at Philippine Dealing and Exchange (PDEx) for fixed income securities are cleared and settled via the PDEx settlement facility (called the Expanded DVP System or eDVP), developed and operated by the Philippine Securities Settlement Corporation (PSSC). The eDVP system is a Model 1 DVP implementation wherein each trade settles independently of other trades without any form of netting, thus, Model 1 DVP is referred to as trade-for-trade settlement or gross settlement.

The eDVP is made possible through automated system interfaces with the depository system of the Philippine Depository & Trust Corporation (PDTC) and the Philippine Payments and Settlement Systems (*PhilPaSS)* which is the real time gross settlement (RTGS) system for peso payments operated by *Bangko Sentral ng Pilipinas* (BSP) and with the active participation of Cash Settlement Banks either through the eDvP system online confirmation facility or through an automated system interface to their systems. The PDEx also has straight-through interface to the Registry of Scripless Securities (RoSS and RoSS-NoR) of the Bureau of Treasury (BTr) to handle pre- and post-settlement transfers to/from the RoSS/RoSS-NoR accounts.

All PDEx trading participants are settlement Participants. They are required to open a depository settlement account with PDTC for their securities settlement. PDTC effects the securities settlement of trades by initially earmarking then eventually debiting and crediting the securities in the depository settlement accounts of settlement participants. Also, settlement participants who are *PhilPaSS* members are required to use their demand deposit accounts (DDA) as their cash settlement account for settlement of trades. If settlement participants are not *PhilPaSS* members, they must designate a cash settlement account from any cash settlement banks authorized by PDEx.

Generally, trades by both buyer and seller are settled in the following process: (a) Earmarking of securities in the seller's depository settlement account; (b) Debiting of payment from the buyer's cash settlement account, if the buyer is not *PhilPaSS* member; (c) Debiting of *PhilPaSS* demand deposit account of buyer or demand deposit account of its cash settlement bank and Crediting the *PhilPaSS* demand deposit account of the seller or demand deposit account of its cash settlement bank as applicable; (d) Crediting the payment to the seller's cash settlement account, if the seller is not *PhilPaSS* member; (e) Debiting of the seller's earmarked securities and Crediting the same to the buyer's depository settlement account. *[Rule 6, PDEX Rules for the Fixed Income Securities Market as amended, January 2008]*

PDEx interbank government securities trades constitute settlement instruction to the RoSS-*PhilPaSS* DVP system. On settlement day, settlement instructions are sent to RoSS. Trades are settled via RoSS-*PhilPaSS* DVP system wherein the securities are moved from the RoSS account of seller to RoSS account of buyer, while the cash are moved from BSP-DDA of buyer to BSP-DDA of seller. Then, RoSS sends settlement result to PDEx.

Now, you seek confirmation that the settlement arrangements which you generally described in your letter dated 8 April 2008 and the safeguards outlined in your letter dated 16 June 2008, achieve DVP.

In response, we **confirm** that the settlement procedures of your bank (as dealer), as illustrated and explained in the said letters, relative to your government securities trades with QIB clients indeed achieve **DVP** and compliant with the OTC Rules. The letters are hereto attached for reference.

In general, based on your presentation of the various scenarios, we note that the securities are transferred to the accounts of the buyers directly or through their custodians, only upon confirmation that the corresponding funds are available to settle their obligations with the sellers. Moreover, funds are immediately paid only after confirming that the securities have been transferred.

Specifically, with regard to QIB clients with RoSS accounts, we observe that while funds are earmarked, there is no final transfer or delivery yet until after the confirmation of purchase (COP) and/or confirmation of sale (COS) have been sent to the BTr and no negative feedback is received by the seller from the BTr. If the BTr does not advise the seller prior to the cut off time, the securities transfer will be deemed implemented as the parties have already authorized the BTr to act in accordance with their instructions. Funds will then be delivered simultaneously or as close to the cut off time as possible. If negative feedback is received and the BTr cut off time can no longer be met, the parties will discuss alternative arrangements. In the meantime, funds previously earmarked will be released.

Similarly, as regards your QIB clients settling through the RoSS accounts of their third party custodians, while funds are earmarked, there is no final transfer or delivery yet until after the parties have acknowledged the transaction and Telerate confirms the transfer of securities. Funds will then be delivered simultaneously or as close to the cut off time as possible. And if the securities transfer is not posted by 1:30 PM, the parties will discuss alternative arrangements. In the meantime, funds previously earmarked will be released.

These procedures and safeguards ensure that each transfer of securities is effected only when payment occurs or assured within the settlement cycle. As earlier mentioned, DVP does not require simultaneous final transfers of funds and securities. It is essential though that the securities are delivered to the buyer or his custodian if and only if it is confirmed that the cash aspect of the transaction is paid. Thus, in our view, the settlement arrangements described in your letters achieve DVP.

It is understood though that the foregoing opinion is rendered based solely on the facts you disclosed and described in the query and relevant solely to the particular issue raised therein and shall not be used in the nature of a standing rule binding upon the Commission in other cases whether of similar or dissimilar circumstances. *[SEC Memorandum Circular No. 15 (2003)]*

Finally, you are directed that the attached detailed description of the settlement procedures be made part of your records and that the same shall be disclosed to your counterparties and form part of the client agreement.

For your guidance.

Very truly yours,

VICENTE GRACIANO P. FELIZMENIO JR.
Officer in Charge

PAID: OR # 0157461, April 11, 2008
Filing Fee: P5,000.00

Attachment:
Detailed description of settlement procedures per letter dated 16 June 2008.