CENTRAL SECURITIES DEPOSITORIES

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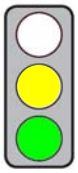
Centrum für Europäische Politik

KEY ISSUES

Objective of the Regulation: The Commission wishes to increase the safety of securities settlement and to reduce the costs of cross-border securities transactions.

Parties affected: Central depositories, credit institutions, central counterparties, trade venues and other financial market actors, European central banks in the EU.



Pros: (1) Recording securities in book-entry form enhances trading efficiency and safety.

(2) The obligation to settle on-exchange securities transactions no later than on the second business day after trading takes place reduces the default risk and facilitates cross-border securities trading.

(3) The fact that central depositories, central counterparties and trade venues are fundamentally obliged to grant each other non-discriminatory access promotes competition in securities trading.

Contra: The Regulation does not contain any objective and transparent criteria regarding the conditions under which central depositories may deliver banking services.

CONTENT

Title

Proposal COM(2012) 73 of 07 March 2012 for a **Regulation** of the European Parliament and of the Council **on improving securities settlement** in the European Union **and on central securities depositories** (CSDs) and amending Directive 98/26/EC

Brief Summary

- **General and objectives**
  - Central securities depositories (CSD) provide the following "core services":
    - Settlement of securities transactions: here the buyer receives the traded security and makes a payment to the seller. For this purpose the CSD operates a "securities settlement system" (Art. 2 (1) No. 3). Participants in the securities settlement system are in particular banks and central counterparties (Art. 2 (1) No. 10).
    - Maintenance of central securities accounts: these serve to register the holders of securities and any change of ownership (Art. 2 (1) sub-para. 1, Annex Part A).
    - Initial recording of securities in a book-entry system: newly issued securities are recorded in a CSD book-entry system (safe-keeping) (Art. 2 (1) sub-para. 1, Annex Part A).

    Each CSD must offer the settlement. At least one of the two other core services must be provided, otherwise it cannot receive the authorisation to act as a CSD.
  - Generally, there is one national CSD in each Member State; in Germany it is Clearstream. With Clearstream Group and Euroclear Group there are two "international" CSDs in the EU which specialise in issuing "international bonds" (Explanatory Memorandum p. 2).
  - The Commission criticises (Explanatory Memorandum p. 2, 3, 10):
    - higher risks and costs for cross-border securities transactions than for national transactions;
    - that the market actors have limited access to each other at both national and cross-border level, e.g. of securities issuers or trade venues to the CSD; and
    - limited competition between different national CSDs.
  - The objective of the Regulation is to open national securities settlement markets, to increase safety, in particular of cross-border securities settlement, and to reduce legal barriers which impede the settlement of cross-border transactions (p. 2, 3 and 4).
- **Scope**
  - The Regulation applies to all CSD (Art. 1 (2)).
  - Where the European Central Bank (ECB), the central banks of Member States and public debt management bodies perform similar services to those of the CSD, the Regulation also applies to them; exempted are the provisions on the authorisation, supervision and provision of banking type of ancillary services (Art. 1 (4)).
  - Single provisions of the Regulation – for instance those on the settlement discipline and on measures against failed transactions – also apply to central counterparties (CCP) and trade venues.
- **General separation between CSD services and banking type of ancillary services**
  - A CSD may provide non-banking type of ancillary services such as collateral management services and trade verification (Annex Part B).
  - Principally, a CSD must not provide "itself" any banking type of ancillary services such as the provision of cash accounts or securities lending (Art. 52 (1) Annex Part C). These services must be outsourced to a separate legal entity.

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– In exceptional cases, a CSD may exercise banking type of ancillary services if (Art. 52 (2)):
  - it has all the "necessary safeguards in place" and
  - upon the request of a national supervisory authority the Commission authorises it to do so.
  With the authorisation, the CSD is licensed to act like a credit institution and must comply with all prudential requirements for credit institutions and additional supervisory requirements for credit and liquidity risk minimisation (Art. (2) sub-par. 3, Art. 57 (2-4)).

- **CSD authorisation**
  – A CSD must be authorised by a national supervisory authority (Art. 9, 10 and 14 (2) in conjunction with Annex Part A and B). The authorisation applies to the entire EU ("EU Passport", Art. 21 (1)).
  – All core services and non-banking type of ancillary services which a CSD may exercise must be listed in the authorisation issued (Art. 14 (2) in conjunction with Annex Part A and B). If a CSD wishes to provide an additional core service or non-banking type of ancillary service, it needs for this a separate authorisation (Art. 17 in conjunction with Art. 15, Art. 28).
- **Further regulatory CSD requirements**
  – A CSD must "establish, implement and maintain a disaster recovery plan" (Art. 42 (3)) for their core services. It must ensure the recovery of transactions in case of disruption (Art. 42 (4)). To this end, the Commission may adopt regulatory technical standards (Art. 42 (7)).
  – Capital, together with the retained earnings and reserves of a CSD, must "proportional" to the risks stemming from the activities of a CSD and cover at least six months of its running costs (Art. 44 (1)). A CSD must retain plans for raising additional capital and for an orderly wind down or reorganisation of its operations (Art. 44 (2)).
- **Initial recording of securities**
  – As from 2020, all securities must, upon their initial issuance, be recorded in book-entry form – i.e. not in paper form – in central depository accounts (Art. 3 (1)).
  – This recording of securities must be carried out prior to the first trading day (Art. 3 (2)). In the case of securities traded on the stock exchange it must be recorded by a CSD, while all other securities may also be recorded by other companies, e.g. so-called registrars (Explanatory Memorandum p. 7).
- **Maturity of securities**
  – As from 2015, on-exchange securities transactions must be settled through delivery and payment no later than on the second business day after trading takes place (Art. 5 (2), Art. 70 (2)).
  – In the case of securities traded off-exchange, the trading partners are free to agree on their own settlement date. The agreed date is binding for both parties. (Art. 5 (1))
- **Settlement discipline and measures to prevent settlement fails**
  – In order to allow for the smooth processing of transactions
    - trade venues must confirm business transactions on the day of their receipt (Art. 6 (1)),
    - CSDs must be technically able to settle a transaction by the following deadlines:
      - principally, by the intended settlement date (Art. 6 (2)); or
      - upon the request of the CSD's "user committee", with intraday or real-time settlement (Art. 36 (6)).
  – A CSD must be technically able to record those transactions which fail to be settled "on the intended settlement date due to a lack of securities or cash" (Art. 7 (2) in conjunction with Art. 2 (1) Number 6).
  – A CSD must impose "sufficiently deterrent" penalty mechanisms on delayed settlement (Art. 7 (2) in conjunction with Art. 2 (1) Number 6). They may "suspend" any participant that fails "systematically" to deliver on the settlement date and disclose to the public its identity (Art. 7 (6)).
  – If a financial instrument is not delivered on the intended settlement date, the defaulting party, e.g. a bank or trade venue, must be subject to a "buy-in". With this, the financial instrument is bought on the market no later than four days after the intended settlement date and delivered to the acquiring party. Where a buy-in "is not possible", the defaulting party must compensate the acquiring party. The compensation must exceed the price of the financial instrument. (Art. 7 (1-5))
- **Further CSD requirements**
  – A CSD must be able to distinguish the securities of a participant from those of any other participant (Art. 35 (1)). Moreover, they must be able to distinguish each of the securities of the participant's clients ("individual client segregation"; Art. 35 (3)).
  – Cash payments of CSD participants should, "whenever practical and available", be settled through a central bank account, or otherwise through an account of a credit institution (Art. 37).
  – For each securities settlement system it operates, a CSD shall define rules and procedures for managing the default of a participant (Art 38 (1)). The European Securities and Markets Authority ESMA may issue the corresponding guidelines (Art. 38 (4)).
- **Conflict of laws**
  The financial instruments held by the CSD shall be governed by the proprietary law of the country in which the account is maintained (Art. 46 (1)). Where the account is used for settlement in a securities settlement system, the applicable law shall be the one governing that securities settlement system (Art. 46 (2)).

- **Access to market infrastructures**
  - Issuers may have their securities recorded in any CSD in the EU (Art. 47 (1)).
  - A CSD may refuse to provide services to an issuer if (Art. 47 (3))
    - such a refusal is based on a comprehensive "risk analysis" or
    - if the CSD does not have access to transaction feeds from the market on which the requesting issuer's securities are traded.
  - A CSD may open an account with any other CSD to facilitate the transfer of securities between their respective participants (Art. 2 (1) Number 20). For such a CSD link, the CSD intending to open the account needs the approval of the competent national supervisory authority (Art. 2 (1) Number 19, Art. 48 in conjunction with Art. 30 and Art. 17). A CSD may only refuse to set up an account in "justified" cases (Art. 30 (3)).
  - Trade venues and CCPs must grant a CSD access to their data. CSDs must grant trade venues and CCPs access to their settlement systems. Each access may be denied where it would "affect the functioning of the financial markets and cause systemic risk". (Art. 51 (3))

Changes to the Status quo

To date there has been no systemic EU Regulation for CSD. There is only a definition for settlement systems (Directive 98/26/EC, Art. 2 lit. a) and rules for the access to settlement systems (MiFID Directive 2004/39/EC, Art. 34).

Statement on Subsidiarity by the Commission

According to the Commission, EU action is needed in order to make the European securities market "safer and more efficient". It refers to the systemic relevance of CSDs and their "increasing interconnection".

Policy Context

On 20 October 2010, the Financial Stability Board (FSB) called for a strengthening of market infrastructures (trade venues, clearing through CCP, settlement through CSD) (see CEP Policy Brief MiFID II and MiFIR and CCP-Regulation). As early as December 2008 the FSB called for an improved safety of settlement systems and the removal of legal barriers in post-trading. In July 2008, the European Central Bank decided to launch the "Target2 Securities (T2S)" project, whose aim it will be to provide from 2015 on a cross-border common platform for securities settlement in Europe.

Legislative Procedure

7 March 2012	Adoption by the Commission
13 July 2012	Submission of the Draft Report by the ECON Committee
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Parliament, entry into force

Option for Influencing the Political Process

Leading Directorate General:	DG Internal Market
Committees of the European Parliament:	Economic and Monetary Affairs (in charge), rapporteur: Kay Swinburne (ECR Group, UK); Legal Affairs
Committees of the German Bundestag:	Finances (in charge); Affairs of the European Union; Economy and Technology; Budget
Decision mode in the Council:	Qualified majority (approval by a majority of Member States and at least 255 out of 345 votes; Germany: 29 votes)

Formalities

Legal competence:	Art. 114 TFEU (Internal Market)
Form of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Legislative procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

The Commission's objective to increase the safety of the securities settlement system is to be welcomed in principle, also in view of the systemic relevance of central securities depositories. For such safety is an essential prerequisite for the smooth trading of securities and is indispensible for the functioning of the financial markets. Therefore, consistent authorisation procedures and supervisory obligations are mandatory. However, the need for additional authorisations for new non-banking type of ancillary services not covered by their first

issuance is only appropriate if the new activities are associated with additional risks for the CSD. Where new non-banking type of ancillary services do not increase this risk, additional authorisation procedures should be waived.

Banking type of ancillary services of CSD such as securities lending can contribute to the safe and timely securities settlement: if at a due date a business party cannot deliver the necessary securities, it may borrow it from the CSD and thus ensure delivery in due time. Therefore, **it is principally justifiable that the Commission allows a CSD in exceptional cases to execute banking services**. Of course such activities also entail risks, in particular credit risks. These may have a negative impact on the CSD's ability to provide its core services. Therefore, **exceptions for banking type of ancillary services within a CSD** should only be possible if they do not change significantly the risk profile of a CSD. Moreover, **stringent supervisory rules must** apply to these cases due to the systemic relevance of CSD.

The fact that the Regulation does not contain any objective and transparent criteria for special case authorisations increases regulatory uncertainty and incorporates the danger of political opportunism. It is therefore imperative that these special case authorisations must be put in concrete terms. If in a specific case the risks accompanying banking services are too high, a complete and strict ownership separation becomes necessary. However, this is reasonable only if the full shifting of risks from the CSD to the newly established credit institution is ensured.

The fact that as of 2020 **securities may only be recorded in book-entry form enhances the efficiency and safety of securities trading**: Settlement can be automatised and expedited and the risk of theft and securities losses is reduced, as these are no longer physically transferable.

The obligation to settle on-exchange securities transactions no later than on the second business day after trading takes place reduces the transaction costs and **facilitates cross-border securities trading**. **Moreover, the risk that a contract party fails** before settlement **(default risk) is reduced**. In addition, a security's value may fluctuate; hence a short maturity period minimises the price risk for the trading partner. The fact that the due date rule of two days does not begin until 2015 enables market actors to adjust their infrastructures. This is of particular relevance for cross-border transactions, since many of their market actors are involved in the business transactions, which makes a fast settlement more difficult.

The permission to record securities with every CSD in the EU strengthens cross-border competition among the currently more nationally oriented CSD.

The fact that CSDs, CCPs and trade venues are principally obliged to grant each other non-discriminatory access promotes competition in securities trading. This regulatory intervention is justifiable if the trading, clearing and depository markets have the structure of an unchallenged natural monopoly and are integrated vertically. In such a case, the access obligation can prevent a natural monopolist on the (upstream) trading market from transferring their market power to the (downstream) depository market, thereby assuming a monopolistic position there, too. Access should, however, be denied, as provided for by the Regulation, if it were to jeopardise the safety of the system.

Legal Assessment

Competency

Art. 114 TFEU (Internal Market) is the relevant legal basis.

Subsidiarity

Unproblematic.

Proportionality

Unproblematic.

Compatibility with EU Law

Unproblematic.

Compatibility with German Law

As the Regulation is directly applicable in each Member State (Art. 288 sub-para. 2 p. 2 TFEU), no implementing acts are necessary. In order to clarify the legal situation, the German law, in particular the German Banking Act, must be adjusted accordingly.

Conclusion

It is justifiable to enable CSD to operate banking activities on the basis of exceptional authorisation. However, the Regulation should contain objective and transparent criteria for this authorisation. The fact that as of 2020 securities can only be recorded in book-entry form enhances the efficiency and safety of securities trading. The obligation to settle on-exchange securities transactions at the latest on the second business day after trading reduces the risk of default and facilitates cross-border securities trading. The fact that CSDs, CCPs and trade venues must grant each other non-discriminatory access promotes competition in securities trading. The permission to record securities at every CSD in the EU strengthens cross-border competition.