COMMISSION OF THE EUROPEAN COMMUNITIES

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PUBLIC CONSULTATION ON CENTRAL SECURITIES DEPOSITORIES (CSDS) AND ON THE HARMONISATION OF CERTAIN ASPECTS OF SECURITIES SETTLEMENT IN THE EUROPEAN UNION

Important comment: this document is a working document of the Internal Market and Services Directorate General of the European Commission for discussion and consultation purposes. It does not purport to represent or pre-judge the formal proposal of the Commission.

INTRODUCTION

There are two important areas in the field of securities post trading in which further coordination of rules at EU level is needed to enhance the safety of Europe's financial markets. They are "Central Securities Depositories" (CSDs) and "securities settlement rules".

(1) CSDs

CSDs are systemically important post-trading infrastructures. They perform crucial services that allow at a minimum the registration, safekeeping, settlement and efficient processing of securities transactions in financial markets. In many ways, they are a central point of reference for an entire market. Given the systemic importance of CSDs, there is a strong need for an appropriate regulatory framework for CSDs.

The need for an appropriate regulatory framework for CSDs is agreed internationally:

- Recommendations have been adopted by Central Banks and Securities Regulators both at global[1] and at European[2] level. These important rules are of a high-level and non binding nature and addressed to public authorities for the assessment of safety, soundness and efficiency of a CSD operating a "Securities Settlement System" (SSS);

- In its meeting of 20 October 2010, the Financial Stability Board re-iterated the call for updated standards for more robust core market infrastructures and asked for the revision and enhancement of existing standards for financial market infrastructures.

At the European level a CSD regulatory framework has already been envisaged twice:

- The proposal for a Regulation on "OTC derivatives, central counterparties and trade repositories" (EMIR) adopted by the European Commission on 15th September 2010 and currently discussed by the European Parliament and by the Council was originally intended to include CSDs in its scope of application. After discussion with Member States' experts it was agreed that further analysis was required and that CSDs would be dealt with in a separate piece of legislation to avoid delays in the adoption of EMIR. Once EMIR will have entered into force, all essential market infrastructures will be regulated at the European level (trading venues by the Markets in Financial Instruments Directive (MiFID) and central counterparties (CCPs) and trade repositories (TRs) by EMIR). The only systemically important major securities infrastructures that would remain regulated at national level would be CSDs;

- The future Security Law Directive (SLD) which will recognise the existence of and enforce "securities accounts" through positive rules as well as through a rule of conflict of laws will probably extend the licence for providing "securities account" to CSDs.

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1 Cf. the CPSS/IOSCO Recommendations for Securities Settlement Systems of November 2001, currently under review.

2 Cf. the ESCB/CESR Recommendations for Securities Settlement Systems in the European Union of May 2009.

(2) Securities settlement rules

There is a long-felt need to increase the safety and efficiency of the internal market for securities transactions by harmonising certain aspects of securities settlement:

- In 2001 and 2003, a High-level expert group chaired by Prof. Giovannini identified 15 barriers to an efficient market for post trading services in the European Union. The report pointed out a number of barriers that render the provision of cross-border post trading services (whether performed by CSDs or other market participants) more costly and less safe. These barriers have not yet been fully removed;

- In a joint letter of 8 June 2010, Chancellor Merkel and President Sarkozy invited President Barroso to consider the possibility of harmonisation of the time allowed for securities settlement and delivery related to trading on European markets.

Against this background, the Commission is considering a legislative proposal on CSDs and on harmonisation of certain aspects of securities settlement in the European Union. With this consultation, the Commission services set out for discussion the main policy areas at stake.

This consultation document is organised as follows:

Part 1: Appropriate regulatory framework for CSDs

1. Scope and definitions
2. Authorisation and ongoing supervision of CSDs
3. Access and interoperability
4. Prudential rules and other requirements for CSDs

Part 2: Harmonisation of certain aspects of securities settlement in the EU

5. Settlement discipline
6. Harmonisation of settlement periods
7. Sanctions

INFORMATION ABOUT THE RESPONDENT

In order to correctly assess responses received, respondents are requested to provide the following information:

- Name and address of the respondent, relevant contact details;

- If you are registered with the Commission as an "interest representative"[3] your identification number;

- Field of activity of the respondent:

  Please specify your field of activity. Please indicate if you:

  – conduct an activity that could be characterised as a CSD activity;

[3] https://webgate.ec.europa.eu/transparency/regrin/welcome.do

- issue securities through one or more CSDs[4]; if yes, which ones;
- participate to a securities settlement system (SSS) operated by a CSD; if yes, which one(s);
- carry out financial services, such as banking and/or investment services, safekeeping of securities, central counterparty (CCP) services.

- If the respondent is an association of stakeholders, how many members do you represent and what is your membership structure?

This consultation will open on **13/01/2011** and close on **1/03/2011**. Responses should be submitted to markt-consultation-csd@ec.europa.eu. The Commission services will publish on its website all responses received unless confidentiality is specifically requested.

The responses to this consultation will provide important guidance for the Commission services in preparing a formal legislative proposal, which is currently scheduled for adoption in June 2011.

All citizens and organisations are welcome to contribute to this consultation. Contributions are particularly sought from representatives of Member States' authorities, central securities depositories, account providers (credit institutions, investment firms and others), issuers and investors (including consumers).

[4] Any reference to CSDs in this document also covers international central securities depositories (ICSDs), when applicable.

PART I APPROPRIATE REGULATORY FRAMEWORK FOR CSDS

1. SCOPE AND DEFINITIONS

1.1. Personal scope and exemptions

(1) Personal scope

The main addressees of a policy initiative are central securities depositories. It is therefore important to provide for a clear definition of "CSDs". The definition could follow a *functional approach* by referring to the services that a CSD provides. Similarly to the approach taken for investment firms in MiFID, a CSD could be generally defined as any "person providing characteristic CSD services" (the definition of such services is discussed in section 1.3).

(2) Exemptions

There might be entities that, although they would generally qualify as a CSD, could be partially exempted. Given the systemic importance of CSDs, any exemption would have to be justified from a prudential point of view. For instance exemptions may be justified by Treaty provisions, such as the one governing central banks (Article 127) and the financing of government debt (Article 123). In this context, these entities might be:

- Central banks that perform CSD services;
- Government debt management offices[5].

Further thought could be given to what extent such entities should be only partially exempted (e.g. from "obligations" such as prudential requirements, but not from "rights" such as provisions on access and interoperability).

One should also be careful to avoid encompassing other market players that might be seen to perform services encroaching upon certain core functions (see section 1.2 on definitions), such as:

- Securities Registrars as well as bodies aiming at centralising information concerning other financial instruments or other negotiable products such as "emission allowances" (i.e. the future "trade repositories" for OTC derivatives, the registry systems for EU Emissions allowances governed by the "Registries Regulation" implementing the "EU ETS Directive");
- Account operators in the context of "direct holding" models;
- "Transfer agents" for UCITS.

[5] Government debt issued through CSDs covered by the legislation would not be out of scope.

1. **What is your opinion on a functional definition of CSDs?**

2. **What is your opinion on the scope of the possible legislation and providing for any exemptions (such as for central banks, government debt management offices, transfer agents for UCITS, registrars, account operators)?**

1.2. Definition of CSD services - Background

Following a functional approach from the point of view of financial market participants, CSD services can be broadly characterised as market support services. These services could be categorized into those that are vital for the basic functioning of a market ("*core services"*) and those that are rendered in connection with those core services ("*ancillary services"*).

Such a distinction could be important for two reasons:

(1) To define a CSD

One approach could be to characterise a CSD only with respect to the core functions, i.e. a CSD would be an institution that undertakes one, two or all core functions. The choice of how many core functions define a CSD is important as business models of current CSDs in Europe differ in the extent to which they provide such services. Furthermore, other market players perform one or several core functions in certain EU markets. For instance, the initial registration of registered shares can be performed by registrars in the UK or by Admitted Institutions in the Netherlands.

Exemptions could be considered for certain market players, if the definitions could be seen to include entities that should not be covered as CSDs (see section 1.1 above on exemptions).

(2) To frame the discussion on passporting of services

The section on authorisation discusses the various options for EU passporting of CSD services, which could include all or only certain items from the list of core and ancillary services (see section 2 below on authorization).

1.3. Core CSD services

A core service implies a central function for a particular securities issue. The Commission services have identified three core services:

(1) Notary function:

From a functional perspective, this function is characterized by maintaining the "central" *register*[6] for a particular issue *in view of enabling the settlement of the corresponding securities*. The market refers to this central register in order to be informed about settled transactions. This function is present in all securities markets that have established a CSD.

[6] A central register does not necessarily correspond to a unique institution, as it is for example the case in certain member states where the task is shared between registrars and SSS operators.

Importantly, this function should be distinguished from the function of keeping the central *register for the issuer*, which usually provides information on beneficial owners and/or end-investors, also referred to as "the shareholders". The latter function is not present in all securities markets (e.g. not for bearer shares or debt instruments). Where it does exist, it can be performed by other entities that are not CSDs, e.g. registrars.

A definition of notary function could therefore be as follows:

> "Establishing and maintaining a system of initial bookkeeping that records the amount of a securities issue in a specific account in the name of the issuer and that enables securities transactions to be processed by book entry"

Consideration should be given to:

- whether this definition also captures the so called Eurobonds, which are issued into two very specific CSDs – the two ICSDs ("I" for international), Euroclear and Clearstream, rather than one central CSD (albeit via a "common depository" or a common safekeeper, i.e. a custodian bank mandated to record the securities in book-entry form);

- whether this definition should include the "integrity of the global issue amount" of a security as an "intrinsic" aspect of the notary function, or whether this should be addressed only as a subsequent prudential requirement common to all three notary, central safekeeping and settlement functions (see section 4.7 below).

(2) Central safekeeping function:

This function is characterized by being the central account provider for the entire market of the relevant financial instrument. The CSD enables market participants to deposit their securities by providing securities accounts on which transfers resulting from transactions are recorded. Linked to this function is the central administration of securities, e.g. the processing of "corporate actions" such as interest or dividend distribution, voting, shares split or tax services. Whether the role of CSDs in formatting corporate actions should be recognised within this central safekeeping function ("central administration"), or whether it should be attributed to the settlement function, is a matter opened to discussion. For instance, a broad definition of the central safekeeping function could be as follows:

> "Central account providing and central administration of financial instruments at the top tier of a book entry system"

As in practice the two functions of notary and safekeeping are mostly provided together, an alternative could be to consider integrating (1) and (2).

(3) Settlement function:

This function could be defined as the operation of a securities settlement system, i.e. a formal arrangement as defined under Article 2(a) of the Settlement Finality Directive[7] between three or more participants, governed by the law of a Member State chosen by the participants[8], and

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[7] Settlement Finality Directive 98/26

[8] The participants may, however, only choose the law of a Member State in which at least one of them has its head office

designated as a system and notified as such to the EU Commission. The definition could also be widened to include the operation of any other, non-designated securities settlement system, in order to encourage CSDs to apply for a notification and hence benefit from the full protection by the Settlement Finality Directive.

A definition of settlement function could therefore be as follows:

> "Operating a securities settlement system as defined in the first and second indent of Art. 2(a) of Directive 98/26/EC and whose business consists of the execution of transfer orders as defined in the second indent of Art. 2(i) of Directive 98/26//EC"

However, one might also consider whether the definition of securities settlement system should not be reviewed against the current practices. As a matter of fact, there is no SSS in Europe that has been effectively constituted as an arrangement between participants. All of them are constituted by a system operator which enters separately into an arrangement with each of their participants.

3. What is your opinion on the above description of the core functions of a CSD?

4. Which core functions should an entity perform at a minimum in order to be qualified as a CSD?

5. Should the definition of securities settlement systems be reviewed?

1.4. Ancillary CSD services

Many CSDs engage in business beyond providing core services. Any future legislation would need to consider the range of possible ancillary services which a CSD should be able to perform in addition to core services. Scoping such ancillary services could be based on certain governing principles:

- Given its role as a critical market infrastructure, a CSD should adopt a *low-risk business model;*
- Ancillary services should therefore have a *clear connection* with core services;
- Any list of ancillary services should take into account the activities of existing CSDs, to the extent that they are compatible with the principles above (and elsewhere in this document, for instance in the prudential framework);
- Any such list should not be exhaustive but flexible, and should allow CSDs' business models to evolve in compliance with the principles set herein.

The Commission services have identified a possible list of ancillary services which a CSD should be able to perform in addition to core services. It could be limited to certain *categories of services* but within each category, the list should not be exhaustive and leave room for other, similar types of services from the same category. For the time being, the Commission services have identified the following six categories of ancillary services:

(1) Services facilitating securities settlement:

This category could comprise services in which a CSD acts as a facilitator of securities settlement for the system which it operates, notably organising a securities lending mechanism or cash/collateral management for the participants of a securities settlement system. This would occur without the CSD acting as a principal, e.g. by organising a securities lending mechanism among participants of the system and by managing the corresponding collateralisation procedures. All of these services could be rendered by the CSD in order to facilitate the settlement of transactions in its system.

(2) Banking-type services facilitating securities settlement:

This category could comprise a list of specific banking-type services that a CSD renders in order to support its core business, i.e. to facilitate the settlement of transactions in its system. A CSD could act as a settlement bank and provide a cash account for participants of a securities settlement system. This account would serve as the correspondent account for the settlement of securities. A CSD could also extend credit (either in the form of securities or cash) to participants in order to facilitate settlement. Given the systemic importance of a CSD, any additional risks arising from these types of activities should be carefully managed and mitigated within a proper prudential framework (see section 4.11 on credit risks)

(3) Services facilitating the processing of corporate actions:

These services may include management of election processes, market claims, or buyer protection instructions.

(4) Banking-type services facilitating the processing of corporate actions:

These services may include pre-financing of payments such as income and redemption proceeds or tax reclaims.

(5) Other services provided to issuers:

A CSD could also provide services relating to the shareholder register which has to be maintained according to the provisions of national corporate law. A CSD may provide relevant information to those maintaining this register (e.g. registrars, issuers) or may itself maintain this register.

(6) Non-central safekeeping of financial instruments for the account of clients:

A CSD may also be an account provider for financial instruments for which it is not the "issuer CSD". Here, the role of an "investor CSD" would be similar to that of a custodian bank. As a consequence, the substantive rules of MiFID and of the Securities Law Directive[9] would apply.

6. What is your opinion of the above description of ancillary services of a CSD? Is the list above comprehensive? Do you see particular issues as to including one or several of them?

[9] A possible future Securities Law Directive is being considered by the Commission services

2. AUTHORISATION AND ONGOING SUPERVISION OF CSDS

2.1. Background

Given their status as systemically important market infrastructures, CSDs should be subject to an authorisation and supervision regime that ensures that they conform to high prudential standards when performing their activities. The Commission services consider that for the well-functioning of the internal market, it will be important that CSDs in the European Union are authorised and supervised according to a harmonised framework of conditions. Traditionally, market authorities and central banks have both been involved respectively in the authorisation and supervision and in the oversight of CSDs. A future regime must take due account of the competence of central banks as established by the Treaty (notably regarding the oversight of Security Settlement Systems), as well as that of market authorities and ESMA established by EU legislation.

2.2. Domestic and non-domestic activities of a CSD

As a starting point, an entity wishing to perform CSD services should be subject to an initial authorization and proper supervision. In general, any authorisation regime should take into account the possible impact of the business of a CSD on the systematic functioning of a given market. A business that only has an impact at a local level would call for the authorisation and supervision by a local authority applying the principle of "subsidiarity", whereas a business with a potentially external impact would call for a regime that encompasses the authorities of all Member States involved. Of course, the line between these two different approaches will depend on the definition of what is local and what is not local or "external".

The Commission services have identified the following business cases that have an element of externality which could impact on a future regime of authorisation and supervision of a CSD:

- The issuance of securities by an issuer from a different jurisdiction than the CSD;
- The participation of a member from a different jurisdiction to the settlement function operated by a CSD;
- The opening of a branch or subsidiary by the CSD in another Member State; the acquisition of an existing CSD in another Member State (group structures);
- The operation of a securities settlement system subject to the law of another jurisdiction than the CSD;
- The conclusion of access and interoperability arrangements between CSDs and/or other financial market infrastructures;
- The settlement in a currency different from the currency of the Member State of the CSD;
- Performing settlement through a common IT platform between CSDs of different Members States.

These cases, especially if they represent a substantial percentage of a CSD's business, potentially call for an authorization and supervision system in the EU which involves the authorities from more than one Member State, and that cannot remain fully national, at least

once certain thresholds of externality are reached, such as percentages of issuers or participants from other jurisdictions. However, the form and the methods used for such authorization and supervision systems may vary depending on the type of business case. For instance, the conclusion of access and interoperability arrangements need not be authorised through a cumbersome procedure, especially if the principles of free access are extended to interoperability, but should rather be subject to an assessment procedure. In the same manner, the supervision of a common IT platform would vary if the outsourcee is a public entity benefiting from a specific regime as envisaged under section 4.10 below.

7. According to you, could the abovementioned cases impact a future regime of authorisation and supervision? Yes? No? No opinion? Please explain why. Are there other cases which could have an influence on a future regime of authorisation and supervision?

2.3. Initial authorisation procedure

The application by an entity wishing to perform CSD services and seeking initial authorisation should specify, inter alia, the services (core and/or ancillary) the CSD intends to provide and the financial instruments it intends to deal with. It could provide for a list of the currencies into which it intends to settle its cash leg and how access to those currencies would be organized.

The procedure of authorisation of a CSD could be made without prejudice to the designation of the securities settlement system that a CSD operates under Article 10 of the Settlement Finality Directive. The designation as an SSS should be a condition for the authorisation of a CSD (see section 4.2).

8. What other elements should be submitted as part of the initial application procedure by a CSD?

9. According to you should the authorisation procedure of a CSD be distinct from the designation and notification procedure under Art. 10 of the SFD? Yes? No? No opinion? Please explain why.

2.4. CSD Register and temporary grandfathering

In order to improve market transparency, every authorisation of a CSD could be notified to ESMA. ESMA would be entrusted with publication and regular updating of a list of CSDs, detailing the scope of the activities for which they are licensed.

Member States could also notify automatically to ESMA those CSDs operating before the date of entry into force of future legislation. CSDs could seek authorisation for the purposes of future legislation within a certain period after entry into force of future legislation. Such an automatic grandfathering would avoid the already existing CSDs entering into the procedure of initial authorization described under section 2.3 above.

10. What is your view on establishing a register for CSDs?

11. What is your view on the above proposal for a temporary grandfathering rule for existing CSDs?

2.5. Capital requirements

Minimum capital requirements for CSD could be considered on the basis of several assumptions:

- For prudential reasons, it may be essential that the balance sheet has a minimum level of equity;

- The operational undertaking of a CSD requires a minimum initial capital that could vary depending on the size of the market considered, the risks taken by the CSD and the type of the services provided. CSDs are often required by customers to provide for insurance in order to cover errors, delays or definite loss of securities. If the CSD has no recourse to an external insurance, it will have to cover its responsibility through its own assets, which imply an adequate capital base;

- Those CSDs who provide banking services, if they are subject to a specific rule, could also be subject to distinct capital requirements, which would vary depending on whether such banking services were to be provided under a CRD or under a specific purpose banking licence, comparable to the one provided for "Payment Institutions" by the Payment Services Directive;

Since risks may vary considerably depending on the nature of services and of securities covered by a CSD, one might consider not adopting a lump sum, but instead providing for a calculation method of capital requirements.

12. According to you, does the above approach concerning capital requirements, suit the diversity of CSDs? Yes? No? No opinion? Please explain why.

2.6. Supervision

The competent authorities should have at all times sufficient supervisory powers in order to ensure that a CSD complies with the requirements that future legislation will set (prudential and other rules). The Commission services have identified the following powers which competent authorities should have:

- Regular review that a CSD complies at all times with the conditions for initial authorisation as well as with prudential and other rules;

- Collection of necessary data through appropriate means, such as reporting mechanisms or direct access by regulators;

- Review of the arrangements, strategies, processes and mechanisms implemented by a CSD;
- Organisation of on-site inspections, verification and investigations;
- Early identification of excessive risks through supervisory examinations programs with appropriate testing to assess their resilience in extreme but plausible market conditions and back testing to assess the reliability of the methodology adopted;
- Providing supervisory coordination and channelling information flows in emergency situations;
- Measures to induce appropriate changes in the organisation and governance of a CSD.

Furthermore, a future supervision framework on CSDs should provide rules concerning the exchange of information, in particular to ensure a high level of data protection.

In any case, these provisions should not prejudice the competence of central banks concerning the oversight of systems.

13. According to you, should the competent authorities have the above mentioned powers? Yes? No? No opinion? Please explain why.

2.7. Licence (passport regime)

A CSD providing only core services could be subject to a CSD licence only. Those CSDs that provide certain ancillary services such as providing credit and securities accounts are already covered by CRD and MiFID licensing rules. This raises the important issue of the relation between future CSD legislation and the existing requirements of CRD and MiFID. It should be noted in particular that the future Security Law Directive (SLD) will probably contain a provision specifying that account providing will be elevated to the status of "core service" in future MiFID and hence be subject to a licence that will follow the procedure of authorization provided under MIFID.

As concerns the cases requiring a passport, the licence should cover all non domestic activities of a CSD contemplated in section 2.2. However, the authorities involved in the passporting procedure could differ sensibly depending on the type of externality considered (see bullet points under section 2.2 above).

As concerns the extent of the passport, the Commission services consider that "banking type" services should be directly connected to the core functions. If these were performed through a CRD, they would be automatically passported in host Member States. The question arises whether such an automatic passporting of CRD banking services would be an appropriate solution for CSDs. Therefore, the Commission services consider the possibility of granting a special purpose banking license for the conduct of "banking type" activities by CSDs that would not necessarily benefit from a passport. Three basic passport regimes can be considered in this respect:

Full passport: a CSD could obtain an authorisation by the competent authority, which would be valid in the entire EU for all core and ancillary functions for which it has been licensed including "banking type" services.

Limited passport: a CSD could be authorised by the competent authority to provide abroad all services except "banking type" services which would be subject to a prior authorization of the host Member State competent authority.

Opt out regime: A full passport regime in general, but a host Member State competent authority would have the right to "opt out" regarding "banking type" services. For non discrimination and level playing field reasons, this would apply to all CSDs providing services in that host Member State.

14. Would a special purpose banking license be appropriate for "banking type services"?

15. Which of these three passporting options would you support? Full passporting? Limited passporting? Opt out regime? Please explain why.

3. ACCESS AND INTEROPERABILITY

3.1. Background

(1) Types of access and interoperability

Creating an EU internal market for settlement of securities requires that investors and issuers can easily access securities settlement systems across the EU. This also entails a certain degree of access between the relevant market infrastructures, mainly CSDs, CCPs and trading venues.

The policy options for access and interoperability depend on the level of desired market opening and the type of risk management provisions for access and interoperability.

The different types of interactions between CSDs, issuers, participants and other market infrastructures could be defined along the following lines:

- Access of market participants (investors) to CSDs;
- Access of issuers to CSDs;
- Access between the CSDs themselves;
- Access between CSDs and other market infrastructures like trading venues and CCPs.

Without any such access and interoperability rights, incumbent infrastructures will almost always have no incentive to open up for competition, in spite of the technical possibilities offered by cross border technical platforms such as Target 2 Securities (T2S).

(2) Existing legislation on access and interoperability

Certain steps have been taken already or are currently being taken in this direction at the EU level:

- MiFID gives certain access rights in the post-trade area to regulated markets and to investment firms in the EU[10]:
  - The right of a market participant to access remotely a foreign CCP and/or CSD;
  - The right of market participants to choose the settlement location for their trades provided the chosen settlement system has the necessary links in place to ensure an efficient and economic settlement;
  - The right of regulated markets to choose a particular CCP and/or CSD to clear and settle their transactions;
- EMIR provides a legal framework for interoperability between CCPs;
- The envisaged Securities Law Directive (SLD) will not contain rights of access but will harmonise the laws governing securities accounts, providing in particular rules of conflict of laws, which is of a critical importance to render the various access and interoperability agreements more safe since these are mostly based on the opening of securities accounts between the concerned institutions.

Besides this, soft law has also addressed the issue:

- ESCB/CESR recommendation 14 imposes CSDs to have objective and publicly disclosed criteria for participation that permit fair and open access;
- The market infrastructures themselves, represented by FESE, EACH and ECSDA have agreed a voluntary Code of Conduct ("Code") regarding, among other things, access and interoperability.

(3) Remaining gaps

It is clear that important gaps still exist. Measures for CSDs could consider addressing these gaps, by:

- Providing certain requirements for CSDs to grant access to participants (section 3.2 below);
- Removing certain barriers that restrict access by issuers to CSDs and the possibility of CSDs to offer their services to issuers (see section 3.3 below);
- Providing a legal framework at EU level for access and interoperability between CSDs (see section 3.4 below);
- And between CSDs and other market infrastructures (see section 3.5 below).

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[10] MIFID, articles 34 and 46

3.2. Access of market participants to CSDs

Future legislation could consider formally requiring CSDs to grant access to participants on an open and non-discriminatory basis. For instance MIFID articles 34 and 46 only provide for the right of participants to a certain market not to be obliged to use a certain CSD. But it does not provide for the right for such market participants to use any CSD of their choice. The sole restrictions that future legislation could envisage would be based on risk, in accordance with ESCB-CESR recommendation 14.

16. What is your opinion about granting a right for market participants to access the CSD of their choice?

3.3. Access of issuers to CSDs

Future legislation could consider abolishing the so-called "barrier 9", one of the barriers to an efficient post trading market in the EU identified by the "Giovannini reports". It would abolish two types of restrictions:

(1) Restrictions for issuers wanting to "export" a security to a non-national CSD due to:

- rules requiring securities to be initially entered into a local holding and settlement structure;
- rules requiring securities to be registered with a local registrar;
- or rules requiring securities to be acquired and disposed of through a local holding and settlement system.

(2) Restrictions for CSDs wanting to "import" a security from a non-national issuer due to:

- rules requiring securities which are not constituted under the local law to have the same form (dematerialised or certificated) as local securities;
- or rules that apply discriminatorily against securities which are not constituted under the local law with regard to holding, acquisition and disposition.

In practice, these constraints are mainly applicable to shares, as corporate and sovereign debt instruments, for historical reasons, are often not subject to the local registration requirements that appeared in the seventies and have since evolved in a more international context such as the "Eurobond market" or the "government securities market". As a consequence debt instruments can be exported relatively freely within the EU, although their importation may be hampered by legal or technical restrictions for "issuer" CSDs to accept only certain types of securities in their books.

The abolition of these restrictions would allow issuers the freedom of choice of CSD and it would allow the CSDs to compete for securities issuance. However, there are certain important considerations:

- It is widely accepted that an issuance of corporate shares through a foreign CSD would not change the applicable company law for the respective shares. The removal of restrictions would be "without prejudice to company law";

- Ideally the removal of restrictions would not be limited to new issues but would apply also to existing issues. An issuer could be allowed to "shift" an existing issue from one CSD to another, or to "split" an issue between more than one CSD. The important practical implementation and implications of such shifts or splits should however be considered. For instance would shareholder approval be required for the shift of an issue? Or how could the integrity of the issue be ensured in the case of a split, especially if common or global repositories are associated to the split?

17. What is your opinion on the abolition of restrictions of access between issuers and CSDs?

18. According to you, should the removal of Barrier 9 be without prejudice to corporate law? Yes? No? No opinion? Please explain why.

19. How could the integrity of an issue be ensured in the case of a split of an issue?

3.4. Access and interoperability between CSDs

Future legislation could consider widening the rights for "investor CSDs" to access an "issuer CSD" in order to be able to provide services for securities that are centrally deposited with that "issuer CSD".

For background information, the Code defines different types of access between market infrastructures[11], depending on the type of channel used for the transfer of securities, such as standard access (i.e. participation of a CSD to another CSD through a regular account), customised access (i.e. the same, but through a special account) and interoperability (advanced forms of relationships with impact on standard participants of the receiving organisation).

The Eurosystem defines the types of links between SSSs, depending on the number of SSS involved as well as their degree of integration, such as "direct links", "relayed links", "operated direct links" and "indirect links", the two latter ones not being used for the collateralisation of Eurosystem operations[12].

In any case such link arrangements create additional risks to the traditional risks identified under chapter 4 (see section 4.1 below). The combination between high volumes, involvement of foreign law and special procedures create specific liquidity, legal and operational risks. From a financial stability point of view, increased cross-border interconnection between CSDs would require special attention similar to cross border banking.

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11 https://www.ecsda.com/attachments/CoC/AccessInteroperabilityGuideline.pdf

12 http://www.ecb.int/paym/coll/coll/ssslinks/html/index.en.html

This is the reason for which the CPSS-IOSCO recommendations (currently under review) as well as the ESCB-CESR recommendations provide for a set of principles dedicated to links between CSDs.

Against this background, future legislation should provide a clear framework for access between CSDs, including for instance:

- Inter CSD links should be submitted to a reinforced legal assessment, covering in particular the consistency of proprietary and guarantee law between the jurisdictions of each CSD (see section 4.1 below);

- Ensure that the regulatory framework of the "issuer CSD" does not prevent the "investor CSD" to open "omnibus accounts" in the books of "issuer CSD";

- Clearly define access arrangements (terminology between access arrangements, interoperability and links), in order to allow a CSD entering a link to assess and put in place procedures for potential sources of risks;

- All CSDs participating into an interoperable arrangement or a multilateral common settlement platform should use the same rules concerning the moment of entry of transfer orders and moment or irrevocability (see also section 4.2 below);

- Provisional transfers across the link should be prohibited, in order to avoid misinterpretation concerning the moment of entry of transfer orders and the moment of irrevocability;

- CSD securities account structures should be harmonised;

- Any credit extensions between CSDs should be further secured and subject to limits (see section 4.11 and 4.12 below);

- Links between CSDs should permit intraday DvP settlement;

- Links between CSDs should not increase liquidity risks for their respective securities settlement systems;

- In order to encourage competition, future legislation should provide rights of access for different arrangements. The question arises whether the "receiving" CSD should always be obliged to accept the access request from the "requesting" CSD and under what conditions could such an access request be refused? Access rights should also include principles of non-discrimination;

- Cover remuneration of access for different arrangements, i.e. should access be free or if not, how should it be remunerated?

- Resolve any specific authorisation and/or supervision rules for different access arrangements (see section 2.6 above);

- Provide for requirements of cooperation between relevant authorities in assessing access arrangements (where applicable);

- Prohibit cherry picking arrangements as in the Code.

20. What is your opinion on granting a CSD access rights to other CSDs and what should their scope be?

3.5. Access between CSDs and other market infrastructures

Future legislation should consider granting two further types of access:

3.5.1. Access to CSDs by CCPs

In order to be able to provide services for securities that are centrally deposited with a CSD, a CCP needs access to that CSD as well as to the relevant data of that CSD, such as settlement data relating to the financial instrument that is object of a transaction (e.g. data on corporate actions of a pending transaction) or settlement data of the CSD's participants.

3.5.2. Access to CSDs by trading venues

MiFID grants to investment firms and market operators operating an MTF[13] the right to choose a settlement system of another Member State to settle some or all of the trades concluded under their systems subject to certain conditions. Future legislation could revisit these conditions and provide for similar rights of access for any trading venue, including regulated markets.

21. What is your opinion on a CCP's right of access to a CSD?

22. What is your opinion on access conditions by trading venues to CSDs? Should MiFID be complemented and clarified? Should requirements be introduced for access by MTFs and regulated markets to CSDs? Under what conditions?

3.5.3. Access by CSDs to transaction feeds

Future legislation could consider enabling a CSD to attract settlement volume or provide other CSD services by having access to transaction feeds, either directly from trading venues or from CCPs.

Future legislation could therefore grant the access to transaction feeds on the basis of the definition provided by the Code of conduct, which defines transaction feeds as another type of access between market infrastructures, that:

- includes trade feeds and settlement feeds;
- does not involve the opening of an account;

[13] MIFID, Article 35 and 37

- flows vertically (so in this case, from trading venues or CCPs to CSDs).

23. According to you, should a CSD have a right to access transactions feeds? Yes? No? No opinion? Please explain why.

24. What kind of access rights would a CSD need to effectively compete with incumbent providers of CSD services? Should such access be defined in detail?

4. PRUDENTIAL RULES AND OTHER REQUIREMENTS FOR CSDS

CSDs are subject to important risks which must be addressed and mitigated through EU common agreed standards to ensure the safety of the system. This section explains which risks exist and how they should be addressed.

4.1. Background

Securities settlement systems as well as the CSDs that operate them are subject to a number of key risks, as summarised in particular by the CPSS-IOSCO recommendations from November 2001 (which are currently subject to a review encompassing all Financial Markets Infrastructures). One can notably identify the following risks:

- Legal risk – the risk that one party to a trade suffers losses because laws or regulations do not support the rules of the SSS or the property rights and other interests held through the settlement system, including the risk of diverging conflict of laws regimes;

- Pre-settlement risk – the risk that an outstanding transaction for completion at a future date will not settle because one of the counterparties fails to perform on the contract or agreement during the life cycle of the transaction before settlement;

- Settlement risk – the risk that settlement in an SSS will not take place as expected, either because of the default of a payer or because of a delay for whatever reason;

- Custody risk – the risk of loss of securities held in custody due to the insolvency, negligence or fraudulent action;

- Liquidity risk – the risk that the participants in a SSS providing cash settlement arrangements do not receive payment of funds or delivery of securities when due and may have to borrow or liquidate assets to complete other payments/deliveries of securities;

- Operational risk – the risk of unexpected losses to the SSS participants or the CSD as a result of deficiencies in systems and controls, human error or management failure;

- Systemic risk – the risk that the inability of one institution to meet its obligations when due will cause other institutions to fail to meet their obligations when due.

In addition, CSDs are themselves subject to additional risks specific to the other functions they carry on:

- Investment risk – in placing their assets CSDs incur certain risks (e.g. foreign exchange risk, interest rate risk, liquidity risk) as a by-product of their investments. This is a relatively small risk when the CSD does not provide banking services;

- Credit risk – the risk that the participant to whom credit was extended defaults; a risk incurred by those CSDs that extend credit to participants, which is much more important and can challenge the sustainability of the CSD.

From a financial stability point of view, these risks converge into two more fundamental risks which are liquidity risk (due to a delay in settlement) and settlement risk (due to an absence of settlement).

The CPSS-IOSCO recommendations have been endorsed at the EU level through the ESCB-CESR recommendations. The risk framework below is based on the ESCB-CESR recommendations, with certain additional elements added regarding the risks faced by the CSDs.

Type of risk	Measures to address risk	ESCB-CESR
For SSSs		
Legal risk	Legal framework (ensure SSS has a well founded, clear and transparent legal basis)	1
Pre-settlement risk	Securities lending	5
Settlement risk	Book entry form	6
	DVP (to be implemented for all transactions between direct participants in a CSD)	7
	Cash settlement assets (use central bank money where practicable and feasible. If commercial bank money is used, manage risk of failure of cash settlement agent)	10
Custody risk	Reconciliation and protection of customers' securities	6, 12
Operational risk	Operational risk controls	11
	Governance	13
	Outsourcing	11
Risks for cross-system links	*Addressed in section 3.4*	19
For CSDs		
Operational risk	*As above*	11, 13
Liquidity and market risk	Liquidity reserves and investment policy measures	-
Credit risk	Credit risk controls (for securities and funds lending)	9

4.2. Legal framework

Future legislation could contain specific provisions aiming at reducing legal risks encountered by CSDs.

Legal risks arise particularly for cross-border transactions and may cause one party to a trade to suffer losses because the legislation of its Member State does not support the finality rules of the securities settlement system or the property rights and other interests held through a settlement system governed by the law of another Member State.

(1) Improve the legal framework

The Settlement Finality Directive, the Financial Collateral Directive, as well as the design for a possible future Securities Law Directive allow or will allow the cross border enforcement of most finality rules and property rights created in these contexts. The Settlement Finality Directive (SFD), in particular, protects the participants to a notified system ("cash" or "securities" systems) against any retroactive cancellation of final orders entered by insolvent participants. Furthermore; enforcement would be improved by the adoption within a possible "Securities Law Directive" (SLD) of a clear conflict of laws rule governing all these aspects.

However this framework might be complemented by further rules specific to CSDs and SSS. It is essential that the legal environment of interoperability arrangements between CSDs be subject to stricter rules than the ones provided under the SFD. As a matter of fact, the SFD imposes interoperable systems to arrange for compatible rules for the moment of entry and of irrevocability of transfer orders stemming from one system into another system. The particular systemic nature of Securities Settlement Systems, as well as the recourse to DVP methods, should call for a strengthening of these compatibility requirements. One could therefore consider imposing identical interoperability rules concerning the definition of the moment of "entry" into the system and of the moment of "irrevocability".

(2) Improve the supervision and oversight of the legal framework

However, the increasing complexity of interoperability arrangements between CSDs requires the supervisor and the overseer to permanently assess the legal framework in order to characterise the respective legal position of the infrastructures and of their participants:

- In particular, it is essential that all systems operated by CSDs are designated and notified to the European Commission by the Member States, which is presently not the case since the SFD provides for a designation of systems only on a voluntary basis. As a consequence, the operation of settlement activities outside of the protection offered by the SFD exposes to systemic risk the participants to such activities as well as the participants to notified systems interconnected to non-notified systems.

- Secondly, the consistency of assessments of settlement systems and of their links by the competent national authorities could be coordinated at EU level (without prejudice to the statutory competences of the central banks in this matter). More and more settlement systems admit directly foreign participants or indirectly foreign securities, with different insolvency, ownership and guarantee regimes, which must be assessed through detailed and standardised legal opinions. In particular, the planned start of T2S in 2014 will significantly increase the volume of transfers processed through link arrangements, which requires a systematic and effective assessment of the legal environment of such arrangements.

25. Do you think that the legal framework applicable to the operations performed by CSDs needs to be further strengthened?

26. In particular should all settlement systems operated by CSDs be subject to an obligation of designation and notification?

4.3. "Securities lending" to tackle pre-settlement risk

Future legislation could impose that securities lending facilities are put in place in order to tackle pre-settlement risk.

Pre-settlement risk is a risk that stems from the market: before settlement, many transactions are agreed between market participants while the seller does not possess the securities at the time of the trade. The proposed regulation on short selling[14] already frames short selling and, in particular, restricts sharply "naked" short selling by obliging the seller (except certain market makers) to be covered by a lending agreement enforceable on the day of the settlement. The provision of such a securities lending facility is all the more necessary when the settlement occurs through a CSD, since a settlement default may have systemic consequences. This is the reason for which it is advisable that CSDs facilitate securities lending, whether central or bilateral, at least for certain types of settlement facilities such as SSS.

However, securities lending implies that the lender, whether it is the CSD who acts a principal or whether it is another institution, takes a risk. This is the reason for which securities lending is not counted among core services, leaving CSDs to decide whether they should intervene as principal or not.

There are therefore three key elements to prudential requirements in respect of securities lending:

- CSDs should facilitate securities lending, whether central or bilateral, and whether the CSDs themselves take principal risk or not;
- Securities lending facilities should be protected by adequate risk controls (see sections 4.11 and 4.12);
- Securities lending facilities should be freed by national legislators from any impediments (e.g. legal, tax and accounting).

Further principles of securities lending, such as those listed below, could be addressed in the legislation or in separate technical standards:

- Where a centralised facility exists, all participants in the settlement system should be granted equal access in a transparent manner;
- The choice between centralised and bilateral securities lending facilities at the time of settlement should be left to each market.

27. What do you think of the general elements of these requirements, particularly with respect to the obligation for CSDs to facilitate securities lending and the obligation of counterparties to securities loans to put in place adequate risk controls?

[14] Proposal of Regulation on Short selling adopted by the Commission on 15 September 2010

4.4. Book entry form

Future legislation could contain specific provisions aiming at imposing the issuance of securities in book-entry form through CSDs.

ESCB-CESR recommendations include within the measures to tackle settlement risk a specific recommendation for legislators to ensure the "immobilisation" or the "dematerialisation" of securities, i.e. the creation of securities into a book-entry form through CSDs. The purpose of such a recommendation is to encourage the recourse by issuers to CSDs which are best placed to put securities into book-entry form. The recourse to book entry securities reduces the settlement risks since book entry securities are much easier to deliver than paper based securities. The reduction of the length of the settlement period facilitated by book-entry securities also reduces liquidity risk. Last it favours the reconciliation tasks conferred to CSDs (see section 4.7 below).

Such a recommendation is quite feasible within the European Union, where almost all securities processed by CSDs are entered into a book entry form; even when the issuance of the securities is based on a paper certificate, the securities are transformed by the CSD into book-entry securities. Such a recommendation would also match the scope of a possible Securities Law Directive which covers all financial instruments capable of being entered into a book entry form.

However, not all issuers are capable of accessing a CSD, and not all CSDs are capable of covering all existing securities.

Future legislation would have to be clear on what securities are covered:

- Future legislation could list the categories of securities that would be subject to such a book entry form. For example: only listed securities, or securities with an ISIN code, or equities. Alternatively, if an ex-ante listing of the categories of securities appears too difficult, future legislation could provide for an "eligibility" approach, involving issuers, CSDs as well as the European Commission in the process of defining securities "eligible" for compulsory book-entry form;

- This requirement would be subject to a grandfathering clause, whereby non book-entry securities issued before the entry into force of this legislation would be exempted.

28. What do you think about the requirement for issuers to pass their securities through a CSD into a book entry form? If such an obligation were considered, which securities should it concern? Only listed securities? All securities with an ISIN code? Only equities? Eligibility approach?

29. What is your opinion with respect to grandfathering ?

4.5. Delivery versus Payment (DVP)

Future legislation could contain specific provisions aiming at imposing the recourse to DVP settlement.

DVP settlement is a key measure to reduce settlement risk and liquidity risk of the participants since it submits the final settlement of the cash leg to the settlement of the securities leg of a transaction. In practice, DVP complements the Settlement Finality Directive, since it protects all the participants against the settlement risks before insolvency, whereas the SFD protects the "surviving" participants against the settlement risk after the insolvency of one or several of them. DVP presents however one initial constraint since it obliges the counterparties to immobilize their respective securities and cash during the "matching period", but it accelerates the settlement, once the matching requirements have been met. DVP does not necessarily mean that the transfer of the cash and securities legs will occur simultaneously. Indeed, especially in those systems that work on a net basis, a certain time lag may occur between the transfer of the two legs (although still intraday).

Future legislation could require, in line with the ESCB-CESR recommendations, the use of DVP for all securities transactions against cash between direct participants of a CSD, irrespective of the DVP model chosen (as defined by CPPS, "Delivery Versus Payment in Securities Settlement Systems", 1992).

A unilateral general requirement to have recourse to DVP would be easy to implement in Europe, at least for the currently notified systems which all comply with DVP principles.

Certain complementary principles could also be formulated:

- CSDs should put in place a technical, legal and contractual framework that ensures that each transfer of securities is final if and only if the corresponding transfer of funds is final;

- CSDs should put in place DVP procedures that allow a sound and effective electronic connection between the cash settlement agent/payment system and securities settlement system (where applicable);

- For reasons of safety and efficiency, settlement systems should minimise the time between completion of the blocking of the securities, the settling of cash and the subsequent release and delivery of the blocked securities (real time);

- The previous requirement may however allow batches during night time, where the securities are blocked for a longer period pending the transfer of cash;

- Furthermore an exception could be provided for certain “Free of Payment” transfers, especially in the context of processing of corporate actions, and certain cross border operations connected to monetary policy.

The above mentioned more detailed requirements, some of which contain exceptions to the DVP principle, could however be entrusted to secondary legislation.

A grandfathering clause could be considered in order to let those (not yet notified) systems that do not yet settle in a DVP manner to adapt. This grandfathering clause would however need to be conditioned by the implementation of limits or of a guarantee fund fed by the

participants and covering the default of the most important payer (as already recommended by standard CPSS principles).

30. What do you think about the requirements above for DVP? Do you see any issues in respect of the different DVP models?

31. What are your particular views on the grandfathering principle coupled with the requirement for the introduction of a guarantee fund?

4.6. Settlement of the cash leg in central or in commercial bank money

Future legislation could contain specific provisions concerning the settlement of the cash leg of securities transactions.

Failure of the settlement agent to settle payment obligations could disrupt settlement and result in significant losses and liquidity pressures for CSD members. This risk can be mitigated by using a cash settlement vehicle that carries no credit or liquidity risk, such as central banks accounts. Currently, most CSDs settle the cash leg of their operations on accounts opened in the books of central banks, whether these are dedicated accounts or standard accounts directly opened in the books of a notified cash settlement system (such as Target2).

However, it may not always be practicable to use the central bank of issue as the single settlement agent. For instance, the cash settlement in non EU currencies, as well as the participation of institutions that have no direct access to central bank accounts would support the recourse to commercial bank money. In the latter case, the opening of commercial bank cash accounts would occur either on cash accounts opened directly in the books of the CSD (if authorised), or on cash accounts opened in the books of a distinct bank, acting as cash settlement agent. The principles below cater for both situations:

- Central bank money should be used whenever practicable and feasible for transactions denominated in the currency of the country where the settlement takes place, and where the relevant central bank has made available its cash accounts;

- If commercial bank money is used, a risk management framework should pay attention to the robustness of the bank(s) used;

- Where both central and commercial bank facilities are offered, the choice should be at the sole discretion of the participant;

- If the CSD acts as settlement agent it must put in place appropriate credit and liquidity risk procedures (discussed in the sections on credit and liquidity risks);

- The settlement of the cash leg of securities should be available for recipients to use as soon as possible within the business day as defined by the Settlement Finality Directive;

- In order to avoid liquidity problems, the payment systems used for interbank transfers among settlement agents should themselves be notified in compliance with Article 10 of the Settlement Finality Directive.

The introduction of such principles in future legislation will be necessary as from the start of Target2 Securities (T2S) which will run exclusively in central bank money. In order to avoid a two speed system, it is important that the settlement in commercial money through alternative platforms is based on safe and sound principles. The above principles could be transposed unchanged in the future legislation, subject to the CSDs settling in commercial bank money carrying the burden of the proof of their compliance with these principles.

32. What do you think about a preference of settlement in central bank money? Should such a preference be applied equally to all types of securities?

33. Do you think that the principles outlined above could be transposed in future legislation?

34. What is your opinion about the extent of the requirements that should be imposed when commercial bank money is used?

4.7. Reconciliation and protection of customers' securities

Future legislation could contain specific provisions aiming at reconciliation and segregation.

CSDs have originally been set up in order to provide for an inventory of existing securities through two specific tasks: the first task is called "reconciliation" or "integrity of the issue", which consists in checking that there are no more securities circulating in the economy than there are securities actually issued. The second task is called "segregation" or "protection of customers" and consists in imposing an obligation on the CSDs' participants that they segregate the securities they maintain for their own account from the securities they maintain for their customers. Both tasks aim at tackling fraud as well as errors. In practice however, the scope of such a requirement varies depending on the Member State, either limited to the sole CSD level or extended to the whole book-entry system up to the intermediary of the ultimate account holder.

Future legislation would follow the ESCB-CESR approach contained into recommendations 6 and 12, whereby the scope of the obligation of reconciliation and of segregation would be limited to the sole CSD level, since it corresponds to a minimum common denominator currently observed among European CSDs.

(1) Reconciliation:

- Best accounting practices and end-to-end audit trails (complementing the ones envisaged in a future Securities Law Directive);

- At least once a day, a CSD should carry out a reconciliation to ensure that the amount settled by the investor in the CSD equals the amount issued in the CSD;

- CSD should put in place adequate cooperation and information exchange with other entities involved in the reconciliation process.

(2) Segregation and protection of customers' securities in custody

- A CSD should provide and allow for the segregation within its participants accounts between the assets belonging to the customers of the participants and the participants' assets;

- If it maintains securities for itself, a CSD should segregate the assets of its customers in its books (from its own securities);

- A CSD should audit its books on a regular basis to certify that the sum of a balance in a given security of all the participant's accounts maintained in the CSD books equals the total amount of the security issued in the CSD, and, if needs be, equals the total amount of the security issued with other CSD's, registrar's or depository's books;

- A CSD should not use customer securities for any purpose, even in the context of securities collateralisation, unless they have obtained the customer's express consent;

- In no case shall securities debit balances or securities creation be allowed by a CSD;

- These rules should be without prejudice of the relevant MiFID rules applicable to providers of investment services.

35. What do you think about the rules above?

36. Are further rules needed in order to ensure reconciliation and segregation?

4.8. Operational risk controls

Future legislation could contain specific provisions imposing on CSDs adequate operational risk controls.

Operational risk controls for the SSS and for the CSD operating the SSS are intertwined so they are both addressed in this section. CSDs have recourse to heavy equipment, complex procedures and key personnel and at the same time, handle sensible information and considerable volumes of financial assets. Therefore, these operational risks have a systemic dimension and should be submitted to the most comprehensive operational risk management framework designed to identify and mitigate all plausible sources of operational risk, both internal and external. A corresponding provision could provide that:

- Operational risk policies and procedures should be clearly defined, frequently reviewed, updated and tested to remain current;

- Roles and responsibilities for operational risk should be clearly defined;
- Business continuity and disaster recovery plans, including the setting up of a second site;
- Adequate crisis management structures;
- A CSD should also identify, monitor and mitigate the risks associated with its participants, and could therefore establish minimum operational requirements for its participants;
- Last, CSDs should also ensure a high level of data protection for their customers.

However, given the rapid evolution of the benchmarks and of the risk environment, it may be preferable that level 1 legislation is limited to the six above principles, while leaving to secondary legislation any further specifications.

37. Do you think that these six basic principles cover sufficiently operational risks?

4.9. Governance

Future legislation could contain specific provisions aiming at warranting a transparent governance of CSDs.

The central and systemic position of CSDs requires them to be subject to clear governance arrangements. Such governance arrangements should be applicable to user-owned CSDs as well as to private or public owned CSDs. The future legislation could impose the six following governance arrangements:

- Robust governance arrangements, with well defined and transparent lines of responsibilities;
- Transparent objectives and major decisions;
- Senior management and board of sufficient expertise, experience and reputation;
- Accountable management with appropriate remuneration policy;
- Independent Board members;
- Clear reporting lines between management and Board;

Two further elements could be considered:

- Whether certain requirements should be set on how many independent directors there should be on the Board;
- Whether the participants to a CSD should participate to a risk committee in order to assess their settlement risks.

38. What do you think about the eight principles above, particularly with respect to board composition and the need for a risk committee?

4.10. Outsourcing

Future legislation could contain specific provisions aiming at limiting outsourcing by CSD to certain tasks under specific conditions.

(a) Principle of full control and responsibility by the CSD

The outsourcing of certain activities by CSDs is a matter of authorization, as well as of prudence.

The outsourcing of "functions" relates to authorization, and it should therefore not be allowed. As a consequence a CSD should not outsource the responsibility linked to the notary, central safekeeping and/or settlement functions for which it has been authorised. The responsibility, whether operational or of custody should therefore remain with the CSD which is the primary warrantor of these functions.

The outsourcing of "tasks" (e.g. IT systems) necessary to the performance of such functions relates to prudential rules and should therefore be assessed against the prudential rules only. However the distinction between CSD functions and the corresponding tasks is often difficult to address. Therefore the recourse to outsourcing should in any case be subject to the control of the supervisor.

This would lead to the setting up of two principles:

- CSDs should maintain full control and responsibility for the outsourced service with all that entails (appropriate monitoring and reporting procedures, expertise retained, clear lines of communication, clear contractual arrangements, etc.);

- CSDs should only outsource certain operations, such as settlement operations after having obtained prior approval from competent authorities.

(b) Possible exemptions

Certain exemptions to the above principles could however be considered when:

- a CSD outsources or relocates certain of its operations to public entities;

- which contributes to the performance by such public entities of tasks attributed by the EU legislator or by the EU Treaty;

- and provided that an appropriate legal, regulatory and operational framework is governing this arrangement.

Such exemption would be consistent with a possible exemption from the scope of this legislation for public entities providing CSD services (see section 1.1 above). It would also cover the current T2S project undertaken by the Eurosystem, which prima facie could be assimilated to an outsourcing of IT tasks necessary for the performance of the settlement

function, but which is upheld by public entities, may result into significant benefits for the economy, contributes to the performance of Eurosystem tasks and is subject to a framework agreement containing numerous safeguards.

39. According to you, should CSDs be subject to a principle of full responsibility and control on outsourced tasks? Yes? No? No opinion? Please explain why.

40. Should there be any other exemptions from the principle of responsibility and control of CSDs on outsourced tasks?

4.11. Financial risks directly incurred by CSDs

Future legislation should contain specific provisions aiming at reducing financial risks directly incurred by CSDs, whether they provide or banking type of services or not.

(a) Liquidity and market risks when CSDs do not provide banking type of services

Even when CSDs are not providing banking type of services, they are subject to liquidity and market risks. Although their effects are limited to the sole balance sheet of the CSD, their occurrence, in particular a fatal issue such as the bankruptcy of a CSD can have an impact on the performance of the CSD's core functions and therefore a detrimental effect for the market as a whole.

These limited risks are:

- Liquidity risk from non-payment of fees by clients. These are limited amounts, considering both the frequency of billing and the CSDs' relatively broad customer base. This could be addressed by requiring the CSD to hold enough liquidity reserves (for instance equity capital equal to a certain number of months of expenses) to cover such risks;

- Liquidity and market risks from depositing their cash surpluses. This could be managed by restricting the CSDs' investment policy to financial instruments of high credit quality, high liquidity and low price volatility;

- Custody risk – the risk of loss of securities held in custody due to insolvency, negligence or fraudulent action. This custody risk could also imply, depending on the law applicable, an obligation for the CSD to buy in the missing securities. More generally any remittance of securities, as well as any breach in the level of services provided by the CSD, increases the level of responsibility of the CSD.

(b) Credit and liquidity risks when CSDs provide banking type of services

CSDs that extend credit to their participants as a principal, under the form of cash or under the form of securities, incur a specific credit risk on their own assets.

- CSDs should therefore have a robust legal framework for managing their ensuing credit risks:

- In particular such credit should be fully collateralised with adequate assets, comparable to the ones required by central banks for the collateralisation of monetary policy operations, complemented with provisions on haircuts, regular testing and legally binding arrangements;

- The credit framework should be part of a notified system in order that its collateralisation benefits from the protection provided under Article 9 of the Settlement Finality Directive;

- The possible legislation could also consider imposing certain liquidity requirements for those CSDs that extend credit to participants, to ensure they maintain a sufficient level of liquid resources to cover liquidity needs:

  - The size of such requirements could be linked to the potential default of the participant (or participants) that would cause the largest liquidity need;

  - Liquid resources could include cash deposits with central banks or with creditworthy commercial banks as well as first demand guarantees provided by the latter;

  - As concerns securities lending, no overdrafts or debit balances should be allowed: securities lending should be allowed only under the form of positive credit;

  - One could also consider limiting the type of credit granted to very short term credit, for instance intraday or less than 24 (or 48) hours. By definition, credit should already be limited to credit provided in connection to the core services, therefore in practice it is necessarily very short term anyway;

- Whether the CSD provides credit or opens cash accounts, it will also be subject to rules deriving from its banking licence:

  - If the full banking licence option is chosen, the CSDs with a banking licence would of course be subject to the prudential requirements of the CRD in respect of these risks;

  - If a special purpose banking licence comparable to the one provided for "Payment Institutions" by the Payment Services directive, is chosen, a specific framework would have to be considered, with particular implications on capital requirements (see section 2.5 above);

  - If a Member State chooses to opt out (see section 2.7 above), the CSDs prevented from granting banking services in that Member State will of course not be concerned by the above obligations concerning credit risks.

41. What is your opinion on the above prudential framework for risks directly incurred by CSDs?

4.12. Credit risk controls when CSDs act as facilitators

Future legislation could contain specific provisions aiming at setting credit risk controls when CSDs act as facilitators.

Even in the case where the CSD is not granting credit as a principal (in the form of funds or securities) and acts only as facilitator (in particular if its competent Authority has opted out in accordance with section 2.7 above), it should put in place certain credit risk controls on its participants, inspired by the ones suggested under section 4.11 above:

- Robust credit risk management framework, including appropriate risk management tools assessing their resilience in extreme but plausible market conditions and assessing the reliability of the methodology adopted. At a minimum, the controls put in place should ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle;

- Credit extensions should be fully collateralised (see section 4.11 above) and collateral should be subject to haircuts and legally binding arrangements;

- If credit facilities are organised on the basis of the cash deposited by participants, it should be subject to transparent and balanced arrangements;

- The credit framework should be part of a notified system in order to benefit from the protection of the Settlement Finality Directive;

- In case of securities lending, no overdrafts or debit balances allowed in securities;

- Limitation to short term credit (see section 4.11 above).

42. What do you think about the principles above?

4.13. Price transparency and service unbundling

In the interest of proper governance, and strengthening the transparency and efficiency of CSDs' activities, it could also be desirable to include provisions addressing price transparency and service unbundling. Such provisions would fall in the classical range of provisions aiming at fostering competition between CSD, as well as informing market actors and final investors:

- Disclosure of services and prices;

- Disclosure of discount and rebate schemes, if any;

- Price examples;

- Billing reconcilability;

- Unbundling of services and fees;

- Account separation and disclosure to competent authorities of costs and revenues for each unbundled service.

These elements are already addressed in the Code (see section 3.1 above).

43. What do you think about including these elements of the Code in legislation?

PART II: HARMONISATION OF CERTAIN ASPECTS OF SECURITIES SETTLEMENT IN THE EUROPEAN UNION

The introduction of the Euro has been a catalyst for demand of cross-border investment in securities. The smooth functioning of cross-border investment is dependent on the harmonisation of key post trading processes. Divergences of national rules and practices increase the risk of operational failure, impede multi country presence, raise back office costs, require costly custom made solutions, prevent straight through processing (STP), and are a potential source for regulatory arbitrage. The Commission services consider for the time being two areas which would benefit from harmonisation: different settlement discipline regimes and different settlement periods.

44. According to you, is the above described harmonisation of key post trade processes important for the smooth functioning of cross-border investment? Yes? No? No opinion? If yes, please provide some practical examples where the functioning of the internal market is hampered by absence of harmonisation of key post trading processes. If no, please explain your reasoning.

45. Do you identify any other possible area where harmonisation of securities processing would be beneficial?

5. SETTLEMENT DISCIPLINE

5.1. Background for improving and harmonising settlement discipline

The broadly agreed definition of "Settlement discipline" points in the direction of a regime, typically run by a CSD and including *agreed market standards (*or *practices),* with the aim of achieving timely matching and settlement of securities transactions.

There is a common expectation among market participants that settlement processes should function smoothly and in a foreseeable way. Future legislation could tackle the issue of improving settlement discipline in the European Union. This would be in line with the proposed regulation on short selling. Strong settlement discipline rules could be in place in order to ensure the timely matching and settlement of transactions in financial instruments.

A high degree of settlement discipline has at least three advantages:

- It reduces the counterparty risk, or more specifically liquidity risk and replacement risk, which exists between the trade and settlement dates;
- It reduces the overall costs to all participants of settlements by maximising operational efficiency and reducing liquidity costs to handle exemptions (such as fails), thus contributing to overall market efficiency and stability;
- And it contributes to the fairness of the financial markets as it encourages equal treatment and behaviour by all market participants. In particular in an increasingly cross-CSD environment the existence of non-harmonised national discipline regimes may imply that *regulatory arbitrage takes place*: i.e. Market participants may re-direct settlement volumes between CSDs due to "softer" discipline and penalty regimes.

Settlement fails can have different causes. *Failed communication* can occur all along the chain of communication between trade and settlement. The risk of failed communication can be reduced through highly standardized communication systems, e.g. systems that automatically capture all relevant trade details for participants. Other courses can be *operational failures*, such as computer errors or system breakdowns. Most settlement fails occur because of a *seller's inability* to deliver securities it expected to receive from an unrelated transaction, which can lead to a "daisy chain" of settlement fails. A final reason for fails can derive from a *short selling strategy*, where a seller sells a security it does not own, and where there are insufficient incentives to avoid a failed settlement by borrowing it to make delivery. The following four areas could be foreseen for establishing common EU rules on settlement discipline:

1. Early matching of settlement instructions
2. Early settlement on intended settlement date (ISD)
3. Prevention of fails management
4. Settlement of fails after ISD

5.2. Definition of settlement fails

Currently, there is no common definition among market participants of what constitutes a settlement fail. A high level definition would be beneficial in order to design a coherent framework for improved settlement discipline in the EU. Such a high level definition could focus on failed settlement resulting from a lack of securities or the lack of the right security on the side of the seller or of a lack of cash on the side of the buyer. A more detailed description of settlement fails for different asset classes could be made by technical standards.

46. According to you, is a common definition of settlement fails in the EU needed? Yes? No? No opinion? Please explain why. If yes, what should be the key elements of a definition?

5.3. Scope of a harmonised regime on settlement discipline

Future legislation could promote measures to reduce settlement fails. It could aim that settlement occurs as much as possible on the intended settlement date. Future legislation could include *ex-ante measures* aimed at preventing settlement fails from occurring and *ex-post measures* that sanction settlement fails once they have occurred. It would also call for a reporting and monitoring regime of settlement fails.

Future legislation could envisage high level rules aimed at settlement discipline in the European Union. While aiming at a minimum standard, any rule would have to take into account existing market structures, i.e. the fact that depending on the relevant market, settlement discipline is achieved by different means and different actors. Such rules would also have to take into account the competences of the ESCB concerning the safety and the soundness of systems as underlined by Article 127 of the Treaty.

47. According to you, should future legislation promote measures to reduce settlement fails? Yes? No? No opinion? If yes, how could these measures look like? Who should be responsible for putting them in place? If no, please explain.

5.4. Ex ante measures for settlement discipline

Future legislation could propose high level rules relating to ex-ante measures, e.g. encouraging CSDs to incentivise early settlement by participants through an appropriate tariff structure, requiring the use of pre-matching procedures and early matching by participants, requiring the use of straight-through-processing (STP) technology, harmonised operating times and cut-off times. Beyond such specific measures, future legislation could also oblige CSDs to install a harmonised monitoring and reporting scheme for settlement fails. Such a regime would maintain data regarding settlement fails and participants and make this data available to regulators and/or the market. Harmonisation of the data collection process would ensure the avoidance of unfair comparisons between markets and CSDs. It could serve as a tool to improve settlement discipline in the market. In addition, regulators (in an EU coordinated way) may be empowered to set targets for overall settlement efficiency (e.g. target rates for settlement on intended settlement date) applicable across all EU CSDs.

48. What do you think about promoting and harmonising these ex-ante measures via legislation?

5.5. Ex post measures for settlement discipline

Regarding ex post rules against settlement fails, future legislation may contain high level rules on a harmonised *penalty regime* as well as harmonised *enforcement rules* such as buy-ins and cash-compensation rules. This legislative approach could build on article 13 of the Proposal for a short selling regulation adopted by the Commission of 15 September 2010 which foresees specific measures arising from patterns that factor in late settlement into a trading strategy. The scope of this article 13 is limited to shares or sovereign debt admitted to trading on a trading venue, i.e. a regulated market or an MTF in the European Union. One approach would be to extend the scope of application of Art. 13 both in terms of financial instruments and in terms of trading venues covered.

49. What do you think about promoting and harmonising these ex-post measures via legislation?

6. HARMONISATION OF SETTLEMENT PERIODS

Markets in the European Union follow different rules on settlement periods, i.e. the time span between the conclusion of a transaction and its settlement. In the context of a single market, any difference in settlement periods is likely to increase costs, complexity and operational risk, especially in the processing of corporate actions entitlements on pending transactions

(also known as CA transaction management or CA on flows) across different markets and CSDs.

Future legislation may therefore propose measures to harmonise the settlement periods in the European Union. Such a harmonization should ideally be based on the shortest settlement period existing in the European Union, in order to avoid that participants working with a short settlement period are obliged to move back to longer period. Currently, some Member States already work in a T+2 (rather than T+3) environment or intend to move to T+2. Future legislation might therefore impose T+2 as a new target.

50. According to you, is there a need for the harmonisation of settlement periods? Yes? No? No opinion? Please explain why

51. In what markets do you see the most urgent need for harmonisation? Please explain giving concrete examples

52. What should be the length of a harmonised period? Please explain your reasoning

Settlement periods are usually set by trading venues. Any future legislation would have to decide what types of trading venues should be included, e.g. regulated markets, MTFs or other organised platforms.

53. What types of trading venues should be covered by a harmonisation? Please explain your reasoning

Another issue concerns the scope of future harmonisation, i.e. which types of financial instruments and transactions should be covered. Already today, some markets are able to settle faster than the standard settlement period. In order not to hamper highly efficient settlement structures, future legislation should give sufficient room for transactions to settle at shorter periods.

54. What types of transactions should be covered by a harmonisation? Please explain your reasoning

In order to give market participants that are impacted by the harmonisation of the settlement period sufficient time to adapt their systems, future legislation would have to consider an adequate time lag before the legislation enters into force. Ideally, such a time lag should however be no later than the launch of T2S.

55. What would be an appropriate time span for markets to adapt to a change? Please explain

7. SANCTIONS

The financial crisis has put into doubt whether financial market rules are always respected and applied as they should be across the Union. Ensuring proper application of EU rules is the task of national authorities, who need to act in a coordinated and integrated way. Efficient and sufficiently convergent sanctioning regimes are the necessary corollary to the new European Supervisory Authorities which will be set up on 1 January 2011, to also bring improvements in the coordination of national authorities' enforcement activities. On the 8th December 2010, the Commission has issued a communication that sets out possible EU actions for achieving greater convergence in and reinforcement of national sanctioning regimes in the financial services sector. All stakeholders are strongly invited to express their views and opinions on this important Communication, and to consider in particular how the principles examined in the Communication might apply in the CSD and securities settlement environment.

56. According to you, how should the principles examined in the communication on sanctions apply in the CSD and securities settlement environment?

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