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CSD Regulation White Paper

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BME BOLSAS Y MERCADOS ESPAÑOLES

LIQUIDACIÓN Y REGISTRO

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1. INTRODUCTION

The purpose of this document is to describe the **latest news and related requirements from the coming EU regulation on central securities depositories** (hereinafter "CSDs") and which may be of interest for IBERCLEAR participants and issuers. This regulation contains provisions which affect not only the CSDs, but also participants in their systems, securities issuers, other market infrastructures such as central counterparties and trading platforms, as well as the members of these infrastructures.

Effective application of these requirements will depend on when each CSD will obtain the authorization according to this regulation, with the exception of the regulation on the settlement discipline and internalised settlement which its entry into force is independent of this authorization. IBERCLEAR is currently in the process to obtain the authorization.

The European regulation is composed of the following **legal texts**:

- Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 (hereinafter "Regulation 909/2014").
- Commission Delegated Regulation 2017/392 of 11 November 2016 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on authorisation, supervisory and operational requirements for central securities depositories (hereinafter "Regulation 2017/392").
- Commission Delegated Regulation 2017/389 of 11 November 2016 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council regarding the parameters for the calculation of cash penalties for settlement fails and the operations of CSDs in host Member States (hereinafter "Regulation 2017/389").
- Commission Implementing Regulation (EU) 2017/394 of 11 November 2016 implementing technical standards with regard to standard forms, templates and

procedures for authorisation, review and evaluation of central securities depositories, for the cooperation between authorities of the home Member State and the host Member State, for the consultation of authorities involved in the authorisation to provide banking-type ancillary services, for access involving central securities depositories, and with regard to the format of the records to be maintained by central securities depositories in accordance with Regulation (EU) No 909/2014 of the European Parliament and of the Council (hereinafter "Regulation 2017/394").

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2. ITEMS OF INTEREST

As mentioned above, latest news and related requirements from the coming EU regulation on CSD's which may be of interest for IBERCLEAR participants and issuers are highlighted below. After the description of each of the obligations set in the European regulation, the actions that IBERCLEAR performs now, or where appropriate, the actions it seeks to implement, will be indicated for each case in order to allow for fulfilment of these obligations on the participants' and issuers' side. IBERCLEAR will keep the participants and securities issuers informed on possible developments or modifications to the explanations provided below.

2.1 RECONCILIATION

Article 37 of Regulation 909/2014 imposes CSDs to take reconciliation measures (set out in Chapter IX of Regulation 2017/392) to verify that the number of securities making up a securities issue or part of a securities issue registered in the CSD is equal to the sum of securities recorded on the securities accounts of the participants of the securities settlement system operated by the CSD. Regarding this, CSDs must carry out daily internal reconciliation procedures, which in turn obliges participants to carry out internal reconciliation. This ensures that the records of participants are aligned with the position recorded at the CSD.

A number of major aspects of reconciliation will be addressed below:

2.1.1 Reconciliation measures with participants

The frequency with which reconciliation measures must be taken is set out in Article 59.1 of Regulation 2017/392, and CSDs must compare the previous end-of-day balance with all the settlements processed during the day and the current end-of-day balance for each securities issue and securities account centrally or not centrally maintained by the CSD.

In order to carry out this daily reconciliation, a CSD must require its participants to reconcile their records with the information received from that CSD (Article 64.3 of Regulation 2017/392), and

thus CSDs must provide participants with the following information on a daily basis specified for each securities account and for each securities issue: (i) the aggregated balance of a securities account at the beginning of the respective business day; (ii) the individual transfers of securities in or from a securities account during the respective business day; and (iii) the aggregated balance of a securities account at the end of the respective business day.

In this respect, IBERCLEAR notifies its participants of the position and movements in securities accounts for each issue on a daily basis, using MT535/MT536 messages. Any participants that have direct connectivity with T2S may ask to receive this information directly from T2S. Participants are obliged to verify the information received from IBERCLEAR in order to report any discrepancies detected, pursuant to the provisions of Article 16.2 of IBERCLEAR Regulation.

2.1.2 Other reconciliation measures

In the event that other entities different from the participants are involved in the reconciliation of a particular issuance of securities, IBERCLEAR and these entities will organize measures of cooperation and exchange of information. In this sense, IBERCLEAR has established measures of reconciliation, among others, with agents of the issuers and the link entities and with the CSDs.

2.1.3 Suspension of settlement

Article 65.2 of Regulation 2017/392 stipulates that, when the reconciliation process reveals an undue creation or deletion of securities, and CSDs fail to solve this problem by the end of the following business day, the CSDs must suspend the securities issue for settlement until the undue creation or deletion of securities has been repaired. Suspension will be reported to all participants in an Informative Memo by IBERCLEAR. In addition to the foregoing, if IBERCLEAR maintains accounts opened in another CSD with which a link has been created, and the CSD suspends a securities issue for settlement pursuant to the aforementioned Article 65.2, IBERCLEAR will consequently suspend the securities issue for settlement.

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2.2 BOOK-ENTRIES

The Article 3.1 of Regulation 909/2014, requires any issuer established in the Union that issues or has issued transferable securities which are admitted to trading or traded on trading venues, to arrange for such securities to be represented in book-entry form as immobilisation or subsequent to a direct issuance in dematerialised form. This obligation will be required from January 1, 2023 for issued securities traded after that date, and from January 1, 2025 for all securities traded.

This is not a new requirement in the case of Spanish regulation. Currently, Article 6 of the Consolidated Stock Market Law requires that the securities intended to be admitted to trading in an official secondary market or in a multilateral trading system must be represented through book-entries.

2.3 UTILISATION OF THE LEI (LEGAL ENTITY IDENTIFIER)

Regarding Article 29.1 of Regulation 909/2014, which stipulates that depositories shall maintain, for a period of at least ten years, all their records on their services and activities, Annex IV of Regulation 2017/394 states that participants and issuers must specify the LEI in the formats established for registers of operational and settlement instructions and registers of positions.

Concerning issuers, pursuant to the provisions of the Q&A document published by ESMA on 23 March 2018, in response to question 3 (b), ESMA specifically states in relation to the CSDs: "*The notary function is a core service provided by a CSD. The CSD has a responsibility to verify that it has the correct credentials in place for issuers that wish to issue securities into its system. The CSD should verify that the LEI is for the correct entity, and that it is current (i.e. the status of the LEI shall be either "Issued", "Pending Transfer" or "Pending archival"). If the CSD finds out that the LEI status of an issuer is not current, it should put in place enforceable rules according to which appropriate validation should be carried out upstream by an issuer's agents, so that accurate up-to-date details are provided. This should apply in relation to all the information that issuers have to provide to CSDs under CSDR."* In response to question 3 (f) in the same document, ESMA specifically states that: "*CSDs should require in their rules that all issuers obtain*

and provide current LEI codes. For issuers of securities issues that will occur after the entry into force of the requirements for CSDs to record LEIs for issuers, CSDs should not accept new securities issues from issuers which cannot provide the CSD with an LEI that is current. For issuers of securities issues that have occurred before the entry into force of the requirements for CSD to record LEIs, the CSDs should inform the issuers pertaining to the securities in respect of which the CSD provide notary service or central maintenance service of their obligation to obtain an LEI that is current (cf. point (b) above)."

Thus all IBERCLEAR participants and issuers must provide LEI data and keep them updated.

2.4 SETTLEMENT DISCIPLINE

The measures to prevent and address settlement failures are regulated in detail in Articles 6 and 7 of Regulation 909/2014. In general, the objectives of these measures are that the settlement instructions will be communicated by the participants involved as soon as possible, to be accepted (SF1) as soon as possible, in order that the matching could be performed as soon as possible to reach the irrevocability (SF2), so that the settlement instructions are settled in their intended settlement date (hereinafter, ISD), preforming the effective transmission of the security (SF3).

In general, in relation to measures to prevent settlement fails, CSDs must establish procedures to ease settlement of transactions on the intended settlement date, and must promote early settlement on the intended settlement date through appropriate mechanisms. In this regard, IBERCLEAR provides participants with measures such as automatic matching of settlement instructions, notification of allotted instructions, the possibility of establishing priorities for settlement, recycling, and the mechanism of *hold and release*.

Also, when settlement fails arise, CSDs must establish procedures for settlement for any non-settled instructions on the intended settlement date, including a penalty mechanism as an effective dissuasive factor for participants which cause settlement fails. It is important to highlight that these penalties have not nature of fees but to sanction, for participants that cause damage, and compensation for participants that have been affected.

In this respect, the penalty rates applicable to settlement fails are set out in the Annex to Regulation 2017/389.

The series of regulations for measures on settlement discipline will come into force 24 months after publication of standards on settlement discipline. Publication is scheduled for mid-2018.

2.5 TRANSPARENCY

With regard to governance, CSDs must have a User Committee (Article 28 of Regulation 909/2014), which must be composed of representatives of issuers and of participants. In this respect, IBERCLEAR is working on the design of the User Committee, which will be regulated by a Circular. In general terms, the functions of the User Committee will be to advise the management body on the essential provisions affecting the various categories of users accessing the ARCO System, and issue non-binding opinions on pricing structures.

Transparency obligations also address the criteria for access as participants and as issuers. In this respect, Article 33 of Regulation 909/2014 regulates participant's access, and the first section specifically establishes that CSDs must have publicly disclosed criteria for participation which allow fair and open access for all legal persons that intend to become participants. The article regulating access for issuers is Article 49 of Regulation 909/2014, the first section of which establishes that issuers have the right to arrange for their securities admitted to trading on regulated markets or MTFs to be recorded in any CSD established in any Member State.

Documentation concerning the criteria and procedures for participants and issuers access is posted on IBERCLEAR's website in the "Regulation and access" section, under "Accessing IBERCLEAR":

http://www.iberclear.es/ing/Regulacion/Interoperabilidad.aspx

Finally, in relation to transparency, Article 34.1 of Regulation 909/2014 obliges CSDs to publicly disclose the prices and fees associated with the core services that they provide, along with discounts and rebates. In this respect, IBERCLEAR's prices are posted on IBERCLEAR's website in the "Regulation and access" section, under "Price transparency":

http://www.iberclear.es/ing/Regulacion/TransparenciaPrecios.aspx

2.6 RISK MANAGEMENT

Risk management is based on three basic criteria: (i) monitoring of fails; (ii) identification of key participants; and (iii) segregation of accounts.

With regard to the management of fails, Article 7 of Regulation 909/2014 obliges CSDs to establish a system that monitors settlement fails of transactions in financial instruments, money-market instruments, units in collective investment undertakings and emission allowances. In this regard, they must provide regular reports to the competent authority and relevant authorities as to the number and details of settlement fails and any other relevant information, including the measures envisaged by CSDs and their participants to improve settlement efficiency. Those reports must be made public by CSDs in an aggregated and anonymised form on an annual basis.

With regard to identification of key participants, this obligation on CSDs is set out in Article 67 of Regulation 2017/392, and they must permanently identify the major participants in their systems on the basis of the following factors: (i) transaction volumes and values; (ii) material dependencies between their participants and their participants' clients, where the clients are known to the CSD and might affect the CSD; and (iii) their potential impact on other participants and on the securities settlement system of the CSD as a whole in the event of an operational problem affecting the smooth provision of services by the CSD. When these participants have been identified, the CSD must identify, monitor, and manage the operational risks that it faces from key participants on an ongoing basis. In addition, the CSD must collect information of the clients of those key participants when they have been categorized as significant.

Article 38 of Regulation 909/2014 sets out a set of obligations in relation to the segregation of accounts. CSDs must keep records and accounts to enable them, at any time, to segregate in the accounts within the CSD, the securities of a participant from those of any other participant and, if applicable, from the CSD's proprietary assets. Having said that, in the case of Spain this is not a new requirement, as it had already been imposed by Spanish law (the Securities Market Law). With respect to segregation, IBERCLEAR is working on the publication of a document setting out

the various levels of protection at the present time, together with the costs associated with each one. Participants must proceed in the same manner. Taking into account that as from the entry into force of the Royal Decree 878/2015 the segregated accounts offer is available, participants must publish a document setting the different levels of protection available with the cost associated to each of them.

With regard to participants, mention should be made to the Q&A document published by ESMA on 23 March 2018, answer to 5 a), which states: "*Participants should be ready to "offer their clients at least the choice between omnibus client segregation and individual client segregation and inform them of the costs and risks associated with each option" at the time of the authorisation of the CSD that operates the securities settlement system in which they are participants. CSDs should be able to prove to their NCAs that they comply with Article 38 of CSDR, as this is one of the conditions to be granted authorisation under CSDR. This implies that CSDs need to coordinate with their participants (before they are granted authorisation under CSDR), in order to ensure that they take the necessary measures to be compliant with Article 38 of CSDR."*; and the answer to b): "*All clients (existing and new) should be offered the choice between omnibus client segregation and individual client segregation, and be informed of the costs and risks associated with each option*"; and the answer to e): "*Article 38(5), first paragraph, of CSDR only requires a CSD participant to offer its clients a choice between omnibus client segregation and individual client segregation, and does not impose to offer a specific type of individually segregated securities account. In addition, Article 38(4) of CSDR provides that a CSD shall keep accounts enabling a participant to segregate the securities of any of its clients "as required by the participant".*

3. INTERNALISED SETTLEMENT

Under article 9 of Regulation 909/2014, credit institutions and investment services companies are required to report quarterly the volume and aggregated value of the transfer orders of securities settled outside the securities settlement systems.

These settlements are out of the functions attributed to IBERCLEAR, as the legal entity handling the settlement system. IBERCLEAR does not perform any monitoring or control functions related to these settlements.

However, in the interest of any participant that might perform internalised settlements on IBERCLEAR securities using other means than those established in the ARCO system, or on foreign securities held through custodians and settled on their own books, it could be convenient to highlight the implementing regulations describing the content and format of the reporting required under article 9 of Regulation 909/2014:

- Commission Delegated Regulation 2017/391 of 11 November 2016 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards specifying in greater detail the content of the information that must be disclosed on internalised settlements (hereinafter "Regulation 2017/391").

- Commission Implementing Regulation 2017/393 of 11 November 2016 establishing technical implementation rules for the templates and procedures to be followed in the reporting and transmission of information on internalised settlements, in accordance with Regulation (EU) No 909/2014 of the European Parliament and of the Council (hereinafter "Regulation 2017/393").

The first report on volume and aggregated value must be submitted by the internalisers within ten working days starting from the end of the first quarter after 10 March 2019.

With regard to these obligations, ESMA recently prepared a series of guidelines for the competent authorities, which are expected to enter into force two months after they have been published on the ESMA website in all the official EU languages (pending). For more information: https://www.esma.europa.eu/sites/default/files/library/esma70-151-1258_final_report_-_csdr_guidelines_on_internalised_settlement_reporting.pdf.

4. CONTACT

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