



Post-trade made easy

A guide on client impacts

The CSD Regulation

May 2016

The Central Securities Depositories Regulation (CSDR) may look, at first glance, as a specific piece of European Union (EU) legislation dealing with the prudential regulation of Central Securities Depositories (CSDs) only. However, the full title of the law is a 'Regulation of the European Parliament and of the Council on improving securities settlement in the EU and on central securities depositories'. This means that CSDR also affects market participants directly since it covers the dematerialisation and/or immobilisation of securities, the settlement period for securities trades and imposes a new and very wide-ranging settlement discipline on markets. It also affects CSDs' participants indirectly as a result of the requirements imposed on CSDs themselves.

This paper describes the main features of CSDR as we see them and the impact on our participants. It reflects our general interpretation of CSDR, and should not be relied on as a compliance, or formal implementation, guide by others. This paper should however, help you understand the likely implications of elements of the CSDR text for your business.

We will issue more detailed information on the impact of CSDR in the lead up to its implementation over the coming months.

Where we are now

Following the financial crisis of 2007-2008, the European Commission made it clear that no financial product and no market should remain without appropriate regulation and effective supervision. The G20 was instrumental in establishing the core elements of a new global financial regulatory framework that should make the financial system more resilient. This framework included reforms to strengthen the regulation of financial markets and infrastructures, especially through the compulsory trading and clearing of derivatives on well-regulated and transparent platforms.

Although CSDs performed well during the crisis and were regulated extremely tightly under domestic law and under international standards - the CPMI-IOSCO Principles for Financial Market Infrastructures (PFMIs) - they were not regulated consistently across the EU. The need for a consistent regulatory approach to settlement systems and settlement processes was made even more pressing by the development of the Eurosystem's Target2-Securities (T2S) project. It was therefore, inevitable and desirable that specific CSD legislation was implemented in the EU. The CSDR should be seen as complementary to both EMIR (in respect of CCPs) and MiFID2 (in respect of trading platforms). CSDR is generally consistent with the global PFMIs.

All Euroclear CSDs, including Euroclear Bank, are implementing CSDR with a view to obtain their licence as EU CSDs in 2017. Euroclear Bank is preparing to become a CSD with a banking licence.

Apart from regulating EU CSDs, CSDR includes a number of elements that aim at harmonising EU practices related to immobilisation/dematerialisation of securities, the settlement cycle (T+2 now implemented in almost all EU countries) and measures around settlement discipline aiming at improving the settlement efficiency. This last element is expected to remain the most debated amongst market participants over the coming months.

Next steps

The CSDR is in the process of being implemented and, as is common with most EU regulations, the implementation of some of its provisions will be phased. The table below gives you an idea of how and when the CSDR will be implemented. Some dates are still indicative, since the CSDR Delegated Acts with regulatory and implementing technical standards (RTS and ITS) are still to be finalised and published by the European Commission.

Date	Event	CSDR Article Reference
September 2014	Entry into force of CSDR, 20 days after publication in the Official Journal of the EU	
April 2016 (possibly) and annually thereafter	Annual Reports from ESMA and the EBA for the Commission on aspects of CSDR	Article 74
June 2016*	Entry into force of Regulatory and Implementing Technical Standards (RTS and ITS) other than Settlement Discipline Regime (SDR)	
June 2016*	Entry into force of Regulatory and Implementing Technical Standards on SDR	<ul style="list-style-type: none"> • CSDR - Title II – Chapter II Art 5, Chapter III Art 6 o 8 • ESMA final report on draft regulatory technical standards on settlement discipline published February 2016 • ESMA Technical Advice published in August 2015
December 2016*	Six months after entry into force of the RTS and ITS (other than SDR)	<ul style="list-style-type: none"> • Articles 69(2) CSDs to apply for authorisation and to notify CSD links • Article 69(3) Third Country CSDs to apply for recognition
June 2017*	Authorisation of CSDs	Title III, Title IV and Title V applied
June 2018*	Two years after entry into force of RTS/ITS on SDR	Implementation of Art 6 and 7 measures by market participants and CSDs and Art 9 (Internalised Settlement)
September – October 2019*	Five years after CSDR enters into force	Commission to prepare review report on various aspects of CSDR
1 January 2023	Article 3(1) Compulsory immobilisation or dematerialisation for newly issued transferable securities	
1 January 2025	Article 3(1) Compulsory immobilisation or dematerialisation for all transferable securities	

Key provisions of the CSDR and their possible implications for participants

Participants can be impacted by CSDR in three different ways:

1. The main areas that affect participants are related to the elements of harmonisation that are contained in Title II (which in effect covers all of the market-wide settlement provisions).
2. CSDR Title III includes other requirements which should be complied with by participants directly.
3. Some of the specific CSD requirements however, may also have an indirect impact on CSD participants.

We also provide some insight on the provisions that are related to CSDs with a banking licence (covered in CSDR Title IV).

The CSDR contains 76 Articles divided into six key sections (or 'Titles') and an Annex as follows:

Title I – Subject matter and scope

Title II – Securities settlement

Title III – CSDs – authorisation, supervision and service provision

Title IV – Provision of banking-type ancillary services for CSD participants

Title V – Sanctions

Title VI – Delegated powers and other provisions

Annex – List of CSD services

Elements of harmonisation related to securities settlement (Title II)

CSDR aims to improve the efficiency and safety of settlement in the EU through mandating both the recording of securities in book-entry form and the implementation of settlement discipline and buy-in regimes.

Dematerialisation and immobilisation of securities

CSDR requires (Article 3 (1)) that any issuer in the EU that issues (or has issued) transferable securities, which are admitted to trading or traded on trading venues, should be represented in book entry form through immobilisation or dematerialisation.

The vast majority of securities in the EU are already issued in such form. In the UK and Ireland, retail investors have had the option of holding their securities in materialised (or certificated) form. There are only around 3,000 certificated trades each day in the UK and Ireland combined. Euroclear UK and Ireland (EUI) has been working closely with the registrars, the UK and Irish authorities and the

market to ensure that a settlement model can be implemented by 2023 (for new securities) and 2025 (for existing securities) with minimal implementation costs for those participants who currently hold certificated securities. Further details of this model will be made available to the market for consultation in due course.

T+2

All EU markets (apart from Spain) migrated to T+2 on 6 October 2014 or shortly thereafter. Spain intends to migrate as part of the wider Spanish market reform and announced the date of 27 June 2016 for the move to T+2 settlement cycle for equities business.

Settlement Discipline

CSDR requires participants to settle their transactions on intended settlement date, and requires CSDs to take measures to:

- encourage and incentivise the timely settlement of transactions by its participants through different settlement features
- monitor settlement fails and provide regular reporting to the competent and relevant authorities
- prevent and address settlement fails through mandatory cash penalties and buy-in mechanism

In practice this means a mandatory settlement discipline regime across a wide range of securities. This section of CSDR will affect all participants of every CSD in the EU and will have a widespread market impact. Settlement Discipline is covered in CSDR Articles 6 and 7 and upcoming Commission Delegated and Implementing Acts (for which ESMA published its advice to the Commission in February 2016). Settlement Discipline measures must be implemented 24 months after the entry into force of the Delegated Acts (currently expected by June 2016).

At the time this paper is written we understand that informal talks at EU level could bring further delay in the adoption of Delegated and Implementing Acts which could arrive late in the autumn 2016. We continue closely looking at evolution and will update participants accordingly .

Measures to prevent settlement fails

CSDs will be required to implement a number of measures to increase settlement efficiency. Some of these measures already exist in some CSDs and are currently used by participants, some others will be new and will have a client impact: e.g. mandatory matching with few exceptions, mandatory matching fields, bi-lateral cancellation, a hold and release mechanism, partial settlement, etc.

We will keep participants informed about the exact impact they can expect in order for them to set up their systems accordingly. Impact will differ across CSDs depending on current market practices and implementation of T2S. For CSDs joining T2S most

of measures to prevent fails will be available in the T2S platform, though further adaptations at T2S level may still be required for CSDs to comply with CSDR requirements.

Measures to address settlement fails

CSDs will implement a penalty mechanism for settlement fails which will serve as an effective deterrent for participants that cause settlement fails. Cash penalties will be calculated on a daily basis for each business day that a transaction fails to be settled after its intended settlement date until the moment of the actual settlement date or until the end of buy-in process. Details of the implementation of this regime and related operational processing will be communicated separately.

CSDs will gather data on settlement fails for provision to the relevant Competent Authorities, as they do now, and will also have to publish aggregated data on an annual basis to the public.

Cash penalties will not be considered as a source of revenue for the CSDs. CSDR allows the CSDs to apply fees to cover the building and running of the penalty mechanism.

Buy-ins

CSDR imposes a mandatory buy-in process on any financial instrument which has not been delivered within a set period of the intended settlement date. This period is dependent on the asset type and liquidity of the relevant financial instruments i.e. up to four days for liquid securities, seven days for illiquid securities and up to 15 days for transactions on SME growth markets.

CSDs will not have any active role in the buy-in execution (to protect their risk-profile). The exclusive responsibility for buy-ins remains at the trading level and with the trading parties. The CSD will make buy-in reporting based on information received from the relevant trading venue or the central counterparties in case of cleared trades. CSDs will also be involved in the reporting of the buy-in to the relevant Competent Authorities.

CSDR articles which require direct client compliance (Title III)

Other aspects of CSDR have to be complied with by CSD participants directly. Participants should consider carefully how they can best comply with these requirements:

Investment firms should take measures to prevent settlement fails for their professional and retail participants (CSDR Art 6§2 – Art 2 in ESMA RTS on Settlement Discipline)

Investment firms need to ask their professional participants to send them written allocations of securities or of cash for the accounts of that client that have to be debited or credited. Art 2 of the ESMA standards includes specifications on these allocations.

Retail participants and Settlement Discipline (ESMA RTS on Settlement Discipline Art 3)

Investment firms must require retail participants to send all relevant settlement information for a transaction at the latest by 12:00 CET on the business day after the transaction has taken place in the time zone of the investment firm - unless that client holds the relevant financial instruments and cash at the investment firm. This may have implications for participants in the UK and Ireland who hold certificated shares outside of the settlement system.

Internalised settlement (CSDR Art 9)

CSDR requires so-called 'settlement internalisers' to report to their Competent Authorities on a quarterly basis the aggregated volume and value of all securities transactions which they settle outside of CSDs. ESMA has drafted technical standards to establish the forms, templates and procedures for the reporting and transmission of this information to the relevant Competent Authorities. These provisions do not apply to CSDs themselves since the definition of a settlement internaliser is an institution which executes transfer orders on behalf of participants or on its own account other than through a CSD. CSDs will not be giving guidance on these provisions.

Reconciliation (CSDR Art 37 – ESMA standards on CSD requirements Art 64§3)

CSD participants should reconcile their records with the information received from the CSD on a daily basis.

Protection of securities of participants and those of their participants (CSDR Art 38)

CSDs should keep records that enable a participant to segregate the securities of any of their participants if and when required by that participant. This is in line with existing practices across the Euroclear CSDs today.

However, Article 38(5) also places a new obligation on a CSD's participants to offer its participants at least the choice between omnibus segregation and individual client segregation and inform them of the costs and risks associated with each option. There is a specific exception granted for direct holding markets (like Finland). In addition, CSD participants (as well as the CSDs themselves) must publicly disclose the levels of protection and the costs associated with the different levels of segregation.

We will be communicating directly with our participants on this aspect of CSDR later this year.

Legal Entity Identifiers (LEIs) (CSDR Art 29 - ESMA ITS Annex IV – Formats of CSD records)

CSDs are required to collect the LEIs of all of their participants to facilitate reporting to the Competent Authorities in the required format. In addition, CSDs are also required to collect LEIs from issuers.

Operational risk requirements (CSDR Art 45 – ESMA RTS Art 67/75)

CSDs have obligations to monitor operational risks that may be posed by key participants. They are therefore required to identify their key participants and, potentially, the underlying clients of those key participants. This builds on the so-called Tiered Participation requirements of Principle 19 of the 2012 CPMI/IOSCO FMI Standards.

They are also required to test their IT systems and may need to involve participants in such tests.

Protection of securities of participants and those of their participants (ESMA standards on CSD requirements Art 55§3b)

The ESMA standards also introduces the requirement for the identification of the type of segregation involved in each securities account held in the CSD.

Suspension of settlement in case of reconciliation error

A CSD may need to suspend an ISIN for settlement in case of severe reconciliation error. While we expect such situation to be exceptional, participants will be impacted by such suspension.

Provision of banking-type ancillary services for CSD participants (Title IV)

What the banking provisions actually say

One of the most complex parts of the CSDR is Title IV (Articles 54-60) which sets out the detailed requirements for the provision of banking-type ancillary services to CSD participants. In effect these provisions deliver a legal framework to govern the provision of commercial bank money settlement by CSDs to their participants. In summary these provisions achieve the following effects:

- A CSD is permitted to provide commercial bank money services to its participants either through:
 - a credit institution under Directive 2013/36/EU which is actually the same legal entity as the CSD

- a separate legal entity, authorised as a credit institution under Directive 2013/36/EU, which is located either within, or outside, the group of which the CSD is a part
- In either of the above options, the credit institution is subject to very tight restrictions on the banking business which it can undertake and to a very intensive supervisory regime.
- There is an exception to these limitations, but it only applies where the credit institution is providing credit for settlements which are less than 1% of the CSDs total annual transaction volumes and not exceeding €2.5bn per year. We believe that only the EU's very smallest CSDs will be able to benefit from this exemption.

The effects of these provisions

These provisions will have significant effects on all CSDs that currently provide commercial bank money settlement and not just those that have a banking licence today. These effects can be summarised as follows:

- Those CSDs which currently also operate as a bank (such as Euroclear Bank, Clearstream Banking Luxembourg, Clearstream Banking Frankfurt, Keler in Hungary and OeKB in Austria) will have to comply fully with these provisions and will have to apply for authorisation under CSDR. The authorisation process for the banking licence will require discussion with a college of regulators, although the authorisation decision will remain with the CSD's Competent Authority. Euroclear Bank will ensure it is fully compliant with all the provisions of the CSDR and the relevant EBA RTS on banking in a way which minimises the effects on our participants to the greatest extent practicable.
- Those CSDs which currently offer their participants commercial bank money services of a value greater than the limitation set down in the exemption described above, and which use the services of third party settlement banks, will also have to

restructure their services. This is because those third party banks, which are all full service banks under Directive 2013/36/EU, will have to comply with the limited purpose banking provisions of Title 4. This means that they will have to restructure and/or create new limited purpose banking subsidiaries to support commercial bank settlement in a CSD. This is likely to be uneconomic, and so we expect such commercial bank services provided by CSDs to be either restructured or to be discontinued entirely.

- As an example, Euroclear UK and Ireland which currently offer US Dollar settlement for its participants supported by a number of US Dollar settlement banks is in the process of restructuring its services in discussion with the UK and US authorities to achieve full CSDR compliance from the time of EUI's authorisation under CSDR (which is expected mid-2017)
- Title IV of the CSDR should not apply to those banks which provide correspondent or other banking services to those CSDs which are also banks, like Euroclear Bank. This is because Title IV only covers the provision of banking services for the participants of a CSD, not the CSD itself.

Conclusion

The above describes the main areas of the CSDR which we believe will affect participants directly. The rest of the text of the CSDR applies predominantly to the authorisation and prudential supervision of CSDs themselves and, while a significant compliance burden, should not affect the delivery of services to participants in any material way.

If you wish to discuss the implications of the CSDR for your business, please contact your Relationship Manager.



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