Central Securities Depositories Regulation: 10 things you need to know

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The Central Securities Depositories Regulation ("CSDR"), Regulation (EU) No 909/2014, which is part of a suite of wider EU regulatory reforms, entered into force across EU member states on 28 August 2014. That said, a number of its key provisions are still being phased in and yet to become applicable. Often thought of as a piece of legislation targeted exclusively at financial market infrastructures, it has quietly swept under the radar of many market participants (such as custodians, brokers and other investment firms) who will directly be impacted.

CSDR provides harmonised rules governing the authorisation and supervision of central securities depositories ("CSDs") in the EU, their organisation, conduct and prudential requirements applicable to them. In addition, the CSDR introduces the requirement for mandatory dematerialisation/ immobilisation of transferable securities and common securities settlement standards applicable to all transactions in transferable securities. As such, CSDR aims to improve the safety and efficiency of securities settlement in the EU, to establish an enhanced level playing field between CSDs in the EU and to remove barriers to access through the introduction of an EU-wide passporting regime for CSDs in the EU.

This article sums up 10 important pieces of compliance information about CSDR and points out chief areas of focus for market participants.

1. What are CSDs?

CSDs form part of the financial market infrastructure. In very broad terms, CSDs provide one or more of the following services (the "Core Services"):

- they maintain the register in which ownership (i.e. legal title) to certain eligible securities is recorded in electronic form and ensure that the number of securities initially created equals the total number of securities in circulation;
- they operate securities settlement systems where the delivery of securities against cash is finalised (or fails) and each change in ownership of eligible securities is tracked; and/or,
- they provide safekeeping and certain administration services in respect of eligible securities.

In addition to the Core Services, CSDR also specifies:

- a range of banking-type ancillary services; and
- a range of non-banking type ancillary services

that CSDs may provide.

Previously, no uniform definition in respect of CSDs and their service offering existed and CSDR has introduced some much needed and welcome clarity in this regard although differences in the specificities of CSDs (such as those relating to intermediated and direct holding systems) continue to exist.

2. What financial instruments are covered by CSDR?

CSDR generally captures all financial instruments that fall within the scope of the Markets in Financial Instruments Directive ("MiFID"), including shares in companies, bonds and other forms of securitised debt and options (together known as "Transferable Securities"), money-market instruments, units in collective investment undertakings and emission allowances.

However, CSDR draws a distinction between requirements that apply to:

- all financial instruments; and
- those that apply to Transferable Securities alone.

For example, the provisions on securities settlement covering (amongst other things) mandatory dematerialisation and settlement discipline only apply to Transferable Securities. This distinction is important but also adds a level of complexity to the interpretation and application of CSDR.

Issuers of financial instruments, market operators and other entities subject to CSDR must ensure they correctly identify and apply the requirements impacting different categories of financial instruments.

3. Requirements for mandatory dematerialisation?

CSDR introduces significant changes regarding the form in which Transferable Securities can be held and traded. Today, UK shares can generally be held and transferred in uncertificated/ "dematerialised" form or in physical form (unless issued in wholly dematerialised form) and the CREST system has processes in place for the dematerialisation and rematerialisation of eligible securities. In the interest of greater settlement efficiency and to ensure the integrity of securities issuances, CSDR prescribes the recording in book-entry form of all Transferable Securities by 2025 which are admitted to trading or trading on EU trading venues. This will require securities to be held and transferred electronically, rather than in paper form, removing the need for investors to evidence ownership through paper certificates. In simplified terms, upon the settlement of a securities transfer, the change in ownership is recorded and evidenced through a change in the "accounting records" of the electronic register maintained by the CSD.

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CSDR is not prescriptive as to the method through which the recording of securities in book-entry form is achieved. This can be done either through immobilisation (i.e. where a global note representing the whole issue is deposited and individual entitlements recorded in book-entry form) or through dematerialisation (i.e. where the issue only exists in wholly uncertificated form). Whilst the recording in book-entry form upon issuance can be effected by entities other than CSDs (e.g. through registrars), once securities are transferred and traded on EU trading venues, they must be recorded in the systems of a CSD. This requirement does not extend to securities trading on non-EU venues.

The book-entry requirement (or "mandatory dematerialisation" as it is commonly referred to) has important implications for issuers. In practice, issuers must ensure that any in-scope securities issued after 1 January 2023 are recorded in book-entry form at the point of issuance. As of 1 January 2025, the book-entry requirement will apply to all Transferable Securities (i.e. including those that currently exist in certificated form only). This means that issuers must make appropriate arrangements to allow securities issuance in electronic form by amending their articles of association and/or issuance documentation accordingly. If they fail to comply, their securities will potentially become technically illiquid.

Market-wide dematerialisation of in-scope securities will facilitate the overarching goal of CSDR relating to faster settlement through shorter settlement periods and easier reconciliation of holdings. Dematerialisation will also provide fewer opportunities for fraud and reduce the risk of accidental loss of, or damage to, paper certificates. Issuers, custodians and third parties will be able to identify more easily real-time changes in ownership upon settlement of security transfers. The increased centralisation of securities settlement in electronic form will also likely lead to a reduction of costs more generally although it is also associated with potential issues regarding concentration risk.

For certain markets and market participants mandatory dematerialisation of in-scope securities will bring about wide-ranging changes. It affects all EU issuers of Transferable Securities traded on EU regulated markets, MTFs and OTFs as well as issuers established in third countries who are looking to hold and settle their Transferable Securities in a CSD in the EU.

4. What issues does CSDR address for market participants?

In addition to mandatory dematerialisation, CSDR aims to create uniform settlement obligations for market participants through, in particular, the harmonisation of settlement periods and the application of measures to increase settlement discipline across the EU:

- Shorter settlement periods – mandatory settlement periods imposed by CSDR have been in place since 1 January 2015. These are applicable to any participant settling Transferable Securities, money-market instruments, units in collective investment undertakings or emission allowances in a securities settlement system subject to limited exceptions (as further described in point 5 below).

- Settlement discipline measures – these measures will become applicable from 13 September 2020 onwards and cover both preventive and penalty mechanisms. They will impact CSDs, EU trading venues and investment firms wishing to settle a transaction in financial instruments (i.e. Transferable Securities, money-market instruments, units in collective investment undertakings and emission allowances) that are admitted to trading on a trading venue, traded on a trading venue or cleared by a CCP. Financial instruments that are not admitted to trading and not cleared by a CCP are not subject to the preventive measures. Whilst CSDs and trading venues are already working on necessary changes to their operations and procedures to achieve compliance with the new

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requirements arising from CSDR's settlement discipline regime, system participants and investment firms involved in the settlement chain should also ensure that they are preparing for the implementation of the various requirements in the CSDR.

- Integrated market – CSDR intends to create an integrated market for securities settlement with no/little distinction between national and cross-border securities transactions. The common standards and measures referred to above are used as a means to seed and facilitate this integration.

Together the various requirements and measures are intended to increase the safety and efficiency of domestic and cross-border securities settlement across the EU through the introduction of common settlement standards, thereby removing the complexities resulting from a range of divergent local rules under which financial market infrastructures have been operating to date.

5. Requirements for settlement periods

CSDR imposes uniform time-periods for securities settlement across member states.

Since 1 January 2015 participants in a securities settlement system are required to settle transactions in Transferable Securities, money-market instruments, units in collective investment undertakings and emission allowances on their intended settlement date. For Transferable Securities this must be no later than the second business day after trading takes place (T+2). However, this time limit does not apply to transactions in Transferable Securities negotiated privately but executed on a trading venue and to transactions that are executed OTC but reported to a trading venue.

Also excluded are transactions in Transferable Securities that become subject to dematerialisation upon being first traded on an EU trading venue.

It has long been accepted that common settlement periods help reduce operational inefficiencies and risks in cross-border transactions which are linked to disparate settlement cycles. Shorter settlement windows generally reduce counterparty risk, lessening the likelihood of default and helping manage market volatility, benefiting all market participants. However, shorter settlement periods can raise issues when it comes to securing funding for transactions, where grace periods are no longer available, and liquidity must be sourced in shorter cycles.

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6. How CSDR seeks to prevent settlement fails?

CSDR imposes high-level obligations on CSDs, trading venues and investment firms directed at preventing settlement fails due to a lack of securities or cash. The more detailed requirements are set out in regulatory technical standards on settlement discipline (the "Settlement Discipline RTS"), Commission Delegated Regulation (EU) 2018/1229.

Trading venues must establish procedures that enable confirmation of relevant transaction details on the execution date.

CSDs are required to promote and incentivise timely settlement of transactions by system participants through (amongst others) the automated, continuous matching of instructions on a real-time basis, prescribed use of certain fields in the settlement instructions given by system participants, cancellation facilities, hold/release and recycling mechanisms for settlement instructions and through the provision of real-time information on the status of participants' settlement instructions. CSDs must apply these measures with minimum exposure of system participants to counterparty and liquidity risk.

Investment firms have an obligation to take measures to limit the number of settlement fails and must, as a bare minimum, have arrangements in place with their professional clients relating to (i) the confirmation of the terms of the transaction; (ii) the prompt communication of the relevant securities/cash allocations; and (iii) the confirmation of receipt of such allocation. Investment firms will therefore need to be clear about their role in each securities transaction – in particular where the transaction is between two investment firms (who, in such scenario, is the "professional client"?) or where the relationship involves EU and non-EU aspects (e.g. an EU investment firm with a third country branch).

Communication procedures and messaging protocols must also be agreed between investment firms and their professional clients; these should cover, for example, the permissibility of manual or automated communications and the consequences of any delay or failure to communicate.

Investment firms must require those retail clients who do not hold the relevant securities/cash with them,

to provide to the investment firm all relevant information necessary for the timely settlement of the transaction on the intended settlement date.

7. How does CSDR address settlement fails?

CSDR mandates various measures to address settlement fails, which place obligations on CSDs and have a wide-ranging impact on system participants.

CSDs are expressly required to monitor settlement fails and provide regular reports to the relevant authorities covering such information/aspects as are specified in the Settlement Discipline RTS.

Broadly, the measures to be used to address settlement fails and encourage settlement discipline comprise:

- *cash penalties* – participants causing settlement fails will be subject to a cash penalty imposed by the relevant CSD. The penalty will be calculated for each business day after the intended settlement date until the end of the buy-in process. Any cash penalty relating to a cleared transaction failing to settle will be payable by the relevant clearing member that caused the settlement fail;

- *buy-in process* – this is a mandatory process that will be applied for the purposes of effecting delivery of the relevant securities to the receiving participant within a set timeframe. The buy-in regime is complex, not least because different processes apply depending on whether the transaction was (i) cleared by a CCP; (ii) cleared by a CCP and traded on a trading venue; or (iii) cleared by a CCP and not executed on a trading venue, in each case with different obligations applying to the various parties involved such as receiving participants (and their clients), trading venue members, CCPs, operators of trading venues etc. Market participants will need to identify whether or not they are parties in the settlement chain affected by these provisions and, if so, what they need to do to be able to effectively discharge their obligations. This, for example, includes the obligation to appoint a buy-in agent and goes as far as requiring all parties in the settlement chain to have contractual arrangements in place with their relevant counterparties which cover buy-in process obligations and are enforceable in all relevant jurisdictions;

- *cash compensation* – can be chosen by the receiving participant where the buy-in process has failed; alternatively, the receiving participant may decide to defer the execution of the buy-in until a later day and, in the event of another failure, receive compensation after the deferral period;

- *mandatory suspension* – CSDs, CCPs and trading venues must also put in place measures to suspend participants who consistently fail to deliver financial instruments on the intended settlement date of the instructions. In certain circumstances the identity of such participants can be disclosed publicly.

Although financial market infrastructures already have settlement discipline measures in place today, the formalisation of settlement discipline through CSDR at European level will bring significant changes and raise compliance challenges for market participants in the run-up to the application deadline on 13 September 2020.

8. Requirements for internalised settlement reporting

CSDR for the first time imposes reporting obligations on custodians and intermediaries who are settling, on behalf of clients or on their own account, orders relating to the transfer of ownership of in-scope securities outside a securities settlement system.

For example, settlement internalisation can occur where a transaction in financial instruments takes place between two parties whose securities are held legally by the same custodian or intermediary, so that the transfer in beneficial ownership can be effected outside a securities settlement system through appropriate entries in the custodian's/intermediary's internal records.

Settlement internalisers across the EU must provide the relevant competent authority with quarterly reports comprising detailed information on the aggregated volume and value of internalised settlement instructions to the relevant competent authority. The regulatory technical standards on the content of internalised settlement reports specify the information that must be identified and reported.

In the UK, custodians/intermediaries were due to submit their first internalised settlement reports to the Bank of England in July 2019 (covering the period April 2019 to end of June 2019) through the Bank of England Electronic Data Submission ("BEEDS") portal.

Implementing internalised settlement reporting can potentially be onerous, time consuming and costly for firms. Firms must ensure that they have correctly identified the circumstances and scenarios in which they are subject to reporting obligations, including with regards to in-scope and out-of-scope transactions. This analysis may not always be straight-forward as internalised settlement reporting can occur at different levels of a security holding chain. Firms who are settlement internalisers may also need to effect significant changes to their IT systems in order to be able to comply fully with their data reporting obligations.

9. Protecting securities held and settling in a CSD

In the interest of better asset protection, CSDs are required to provide an account structure that enables CSD participants to hold securities belonging to different clients in a single omnibus account or in individually segregated accounts.

Similarly, participants in securities settlement systems have an obligation to offer their clients a choice between omnibus client account segregation and individual client account segrega-

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tion. This obligation applies to all CSD participants from the time that the relevant CSD of which they are a participant is formally authorised under CSDR. While certain CSDs are already so authorised (such as the Spanish Iberclear or Euroclear France), at the time of writing of this article the formal recognition by the Bank of England of Euroclear UK & Ireland (being the operator of the CREST system) as a CSDR-authorised CSD is still pending.

How individual account segregation can be achieved will depend on the holding and account structure in the relevant CSD. In this regard the account segregation guidance published by Euroclear UK & Ireland Limited in October 2019 is helpful for CREST participants as it explains the various account structures that can be utilised within the CREST system to support participants' business needs and asset segregation requirements (See "Euroclear UK & Ireland account segregation guidance (October 2019)").

Clearly, the new mandatory requirements brought in by CSDR will have a potentially significant impact on participants' back office operations as system changes and new processes and procedures are likely to be needed. The burden on resources and compliance costs is expected to be immense for some participants. If not already done so, CSD participants need to work out now who their "clients" are for CSDR purposes and how they intend to provide them with a choice between omnibus and individual client account segregation. Participants need to consider how they will make their offering available to their clients and the documentation changes needed to reflect this. In addition, CSD participants will be subject to certain disclosure documentation which they need to prepare and make publicly available.

10. What are the Brexit implications?

As if the complexities of CSDR were not enough to cope with, Brexit adds another layer of complexity that will impact on CSDR.

In the event of a so-called hard Brexit (i.e. if the UK were to leave the EU without a deal), directly applicable EU legislation, such as CSDR, will be treated as forming part of domestic law provided that the relevant regulations are "operative immediately before exit day". As set out above, because CSDR is being phased in at different stages, certain aspects of it will not be included in so-called UK onshored legislation. For example, the settlement discipline regime which will become applicable in September 2020 under CSDR will not automatically be part of UK onshored legislation (assuming the UK leaves the EU on 31 January 2020). The obligation for a UK issuer to issue its securities in book-entry form will also not apply until after exit day and the UK would need to implement this requirement separately to stay aligned with CSDR.

The European Securities and Markets Authority ("ESMA") has, in consultation with local EU regulators, decided to recognise the UK CSD (i.e. Euroclear UK & Ireland Limited) as an equivalent third country CSD under CSDR which will enable it for an interim period to continue providing services in the EU.

However, the uncertainty around Brexit and the current turbulent political climate makes it difficult to anticipate the final implications and requirements under CSDR with any certainty. At this stage, we recommend that market participants continue preparing for CSDR compliance in accordance with CSDR timelines and on the assumption that the UK will have identical/similar requirements in place given the systemic importance of settlement systems for the securities markets in the EU and the need to have harmonised settlement standards in place to effect cross-border settlements safely and efficiently.

Conclusion

CSDR is a key piece of legislation forming part of a wider EU regulatory reform. It has wide-ranging implications not just for market infrastructures including CSDs, trading venues and central counterparties but also directly impacts issuers, trading parties, custodians, intermediaries and other market participants.

It is designed to increase the efficiency and security of securities settlement through the introduction of common settlement standards, to provide a level playing field between CSDs and better safeguards in the event of CSD insolvency. With its harmonised procedures on authorisation, supervision and relations with third country CSDs, CSDR has introduced a welcome uniform regime for the provision of settlement services across the EU in the post-trade markets which, traditionally, have evolved nationally and been characterised by domestic rules, leading to fragmentation and limited competition. Whilst CSDR is expected to create more competition between CSDs leading to a decrease in the cost of holding and settling securities on both a domestic and cross-border level, there is also a potential risk that greater consolidation may ultimately result in less choice for participants in the settlement market.

For CSD participants, issuers and firms subject to the new requirements, CSDR triggers a significant compliance burden and costs which should not be underestimated. Firms should already be assessing the impact of CSDR and how they intend to deliver the outcomes that CSDR brings into force; if they are not then, they face the risk of being non-compliant with their obligations when these become applicable.

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