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RE: Proposal for a Regulation on Improving Securities Settlement in the EU and on CSDs

Dear Madame:

We write on behalf of the members of the Association of Global Custodians ("AGC" or Association") to provide you with members' views regarding the European Commission's draft Regulation dated 7 March 2012 on securities settlement and central securities depositories ("Reg CSD"). Members[1] welcome Reg CSD and its objectives, and we concur with much of the Reg CSD text. However, certain proposals raise issues or concerns that, members believe, call for adjustments and further clarification along the lines described below. With respect to your report to the Economic and Monetary Affairs committee of the European Parliament, scheduled to be submitted by the middle of July, our comments at this stage address the main issues members have identified. Members are likely to have additional comments at a later date regarding these and various other matters, and we will provide such comments when feasible.

We have structured our Reg CSD comments in line with the questions posed in your speech of 16 May 2012 at the AFME Conference, and we also highlight additional areas of concern regarding Reg CSD that members wish to address.

* * * *

[1] Members of the Association are listed on the letterhead above.

Question 1 **Are there exceptions to the T+2 settlement cycle?**

The AGC is supportive of the Commission's intention to harmonize settlement processes in the EU, including the introduction of a T+2 settlement cycle by 1 January 2015. We appreciate that this is an ambitious requirement given the large scale of planning and testing that will be needed for settlement cycle transitions across multiple markets. Members believe that careful analysis and a well-coordinated transition approach will be essential to avoid detrimental impacts to market participants and systemic risks. Impacts to several important market processes tied to settlement cycle mechanics (such as corporate action timings, executing currency exchanges, and securities lending activities) must also be appropriately addressed.

In addition, the AGC notes that the second paragraph of Art. 5 could be interpreted in varying ways. We therefore encourage co-legislators to clarify that the obligation to settle at the latest on T+2 applies only to trades executed on regulated markets, MTFs and OTFs that do not have the character of a securities lending or sale and repurchase transaction. Indeed, any requirement to settle on T+2 all transactions in securities that can be traded via the above venues could create serious problems for, among others, the repurchase-market and non-standard OTC trading activity. From members' standpoint, it is important that the regulation facilitate efficient repurchase and securities lending markets, and the flexible settlement dates in such transactions are used by market participants as key tools to manage risk and to ensure that cash and securities are available to fulfill the settlement of obligations.

The AGC suggests the following clarifying edits to Art. 5 in support of the arguments above.

Reg CSD	***AGC drafting suggestion***
Article 5	*Article 5*
Intended settlement dates	*Intended settlement dates*
1. Any participant to a securities settlement system buying or selling on its own account or on behalf of a third party transferable securities, money-market instruments, units in collective investment undertakings and emission allowances shall settle its obligation in relation to the securities settlement system on the intended settlement date.	*1. Any participant to a securities settlement system settling ~~buying or selling~~ on its own account or on behalf of a third party transactions in transferable securities, money-market instruments, units in collective investment undertakings and emission allowances shall settle its obligation in relation to the securities settlement system on the intended settlement date.*

2. As regards transferable securities referred to in paragraph 1 which are traded on regulated markets, MTFs or OTFs, the intended settlement date shall be no later than on the second business day after the trading takes place. [...]	*2. As regards transactions in transferable securities referred to in paragraph 1 which are executed ~~traded~~ on regulated markets, MTFs or OTFs and which do not have the character of a securities lending or sale and repurchase transaction, the intended settlement date shall be no later than on the second business day after the trading takes place. [...]*

Question 2 Is settlement failure really a problem?

The AGC believes that three main conclusions can be drawn from the findings included in Annex 6 of the Impact Assessment[2] accompanying Reg CSD (see Exhibit 1 on the following page).

[2] SWD(2012) 22 final

Exhibit 1

Annex 6 – Overview of settlement periods and efficiency in Europe

The table below provides an overview of settlement periods and settlement efficiency for selected European markets, according to the CSD Statistical Exercise undertaken by ECSDA in February 2010 and submitted together with the HSC working group's response to the public consultation.

Table 26: Settlement periods and efficiency (November 2009 data)

	Settlement period				Settlement efficiency	
Country	Equities	Bonds	Funds	Other	% settlement on ISD by volume	% settlement on ISD by value
Austria	T+3	T+3	T+3		95.07	92.84
Denmark	T+3	T+3	T+3	T+2	97.67	98.91
France (ESES)	T+3	T+3	T+3	T+3	97.92	99.36
Belgium (ESES)	T+3	T+3	T+3	T+3	97.43	96.88
Netherlands (ESES)	T+3	T+3	T+3	T+3	97.06	96.43
Finland	T+3	T+3	T+3		98.62	94.60
Germany	T+2	T+2	T+2	T+2	92.66	98.45
Greece	T+3	T+3	T+3	T+3	100.00	99.98
Hungary	T+3	T+2	T+3	T+3	90.00	93.00
Italy	T+3	T+2	T+3	T+3	99.60	99.06
Norway	T+3	T+3	T+3	T+2	99.07	98.67
Poland	T+3	T+2	n/a	T+0	99.62	99.93
Portugal	T+3	T+3	T+3	T+3	94.4	92.26
Romania	T+3	T+3 (T+2 for T-bills)	T+3	T+3	100.00	100.00
Spain (CADE)		T+3			99.99	99.99
Spain (SCLV)	T+3	T+3			99.75	99.67
Switzerland	T+3	T+3	Other	n/a	92.73	91.24
Slovenia	T+2	T+2	T+2	T+2	100.00	100.00
UK and Ireland	T+3	T+1	T+4	T+0	92.60	98.70

Source: CSD Statistical Exercise, ECSDA, February 2010
ESES = Euroclear's single settlement platform for Belgium, France and the Netherlands
SCLV and CADE represent the two platforms operated by the Spanish CSD, Iberclear, for equities and respectively for central and regional government debt
"Other" includes securities not listed as Equities, Bonds or Funds by the CSDs and may include Treasury-bills, other money market instruments, equity-linked products or other types of securities

The first conclusion is that overall settlement rates in the European Union are unsatisfactory and therefore can and should be improved.

The second is that settlement rates vary considerably by market and that specific features of different markets, such as the existence of physical securities, or differences in infrastructure functionalities, are a major explanatory cause for these differences.

The third is that high rates of settlement efficiency are not an objective by themselves, but are simply one characteristic of an efficient and low-risk settlement system.

In an efficient and low-risk settlement system, all securities settlement instructions arrive at the CSD for matching, for resource-checking, and subsequently for settlement. In less efficient and riskier environments, matching and resource-checking take place outside of the CSD; in such a case, the only settlement instructions that arrive at the CSD are those for which matching and resource-checking has already taken place; in such environments, published settlement rates at the CSD are typically very high.

The AGC believes that settlement discipline measures can be a useful tool to help improve settlement efficiency and that – as already identified in the context of the TARGET2-Securities project – a degree of harmonisation of settlement discipline measures across Europe is desirable. But members also believe that the settlement discipline measures are simply one tool; in many circumstances, for example, with the existence of physical securities or inadequate infrastructure functionalities, discipline measures by themselves will be inadequate to achieve the desired objectives. An over-reliance on this one tool, with, for example, "a sufficiently deterrent penalty mechanism", may well have perverse effects.

We highlight further below what we believe are the key regulatory considerations in the context of the Reg CSD's "settlement fail" concept.

2.1 Measures to prevent settlement fails

The AGC believes that in the overall context of improving settlement rates it is important to have a broad, clear and unambiguous definition of a 'settlement fail'. Accordingly, the AGC suggests that the words "due to a lack of securities or cash" be deleted in the definition of a 'settlement fail'.

At the same time, it is critical that the specific settlement discipline measures contained with Reg CSD be drafted in a manner compatible with this broad definition.

The AGC considers the last phrase of Art. 6, paragraph 3 to be unclear and problematic. If a CSD participant is positioned to settle a transaction, it will settle it, as it has an interest in settling it. If a CSD participant cannot settle a transaction, it would be inappropriate for a CSD to "require" that the participant settle the transaction. Such a requirement would, for example, oblige a CSD participant to self-fund a client obligation or perhaps "draw from the pool", i.e. use securities of one client to settle a transaction for a different client. Placing such obligations on a

CSD participant would be bad practice, would increase risk, and should not be encouraged by legislation or regulation.

In this context, it is critical to note that the CSD participants, which act as settlement agents on behalf of third parties, are responsible *to facilitate settlement* of a securities transaction only in so far as their third party clients have been able to provide them with the means to fulfill settlement – i.e. the securities to be delivered or the cash to be paid to the settlement counterparty, coupled with suitable instructions to effect settlement. The settlement obligation should be considered fundamentally an obligation of parties to the transaction – i.e., third party clients of CSD participants. Indeed, custodians' settlements typically involve movements of securities against cash between the client and its executing broker (or the broker's agent), with each movement effected pursuant to the client's specific instruction for the purpose of completing delivery and payment between the client and its broker. The obligation of settlement agents thus must remain "lower-ranking" vis-à-vis the obligations of the trading parties.

In addition, under Art. 5, paragraph 1, there is already a general obligation to settle on intended settlement date. The last phrase in Article 6, paragraph 3, is thus redundant.

The AGC would suggest in this light the following amendments to Art. 6, paragraph 3 as follows:

Reg CSD *Article 6* *Measures to prevent settlement fails*	***AGC drafting suggestion*** *Article 6* *Measures to prevent settlement fails*
3. *For each securities settlement system it operates, a CSD shall establish monitoring tools that allow it to identify in advance settlements of transactions in financial instruments referred to in Article 5(1) that are most likely to fail and it shall require participants to settle such transactions on the intended settlement date.*	3. *For each securities settlement system it operates, a CSD shall establish monitoring tools that allow it to identify in advance settlements of transactions in financial instruments referred to in Article 5(1) that are most likely to fail ~~and it shall require participants to settle such transactions on the intended settlement date~~.*

2.1.1 Article 7 paragraph 1 Reg CSD

Art. 7, paragraph 1 specifies that detailed CSD settlement fail reporting should be provided to the competent authority and to any other person with a legitimate interest. The

AGC believes that this paragraph needs to distinguish between information that is appropriate to share with a competent authority versus information that can be properly provided to other interested third parties.

It is normal that a regulatory and/or supervisory body receive appropriate information as to the number and details of settlement fails, including at the level of each CSD participant. With respect to other interested parties it would be more appropriate for a CSD to share aggregated information on overall settlement fails, and not the settlement performance of individual CSD participants. Settlement failure rates for each CSD participant largely depend on the type of underlying client it supports, and on the clients' type(s) of trading activity. Without such detailed and confidential background information, any comparison of the performance of different CSD participants by third parties may very well be misleading.

2.1.2 Article 7 paragraph 2 Reg CSD

Art. 7, paragraph 2 requires the introduction of a "sufficiently deterrent penalty mechanism for participants that cause the settlement fails." The AGC is concerned that this approach lacks sufficient precision and may therefore lead to the development of inappropriate regulatory technical standards.

Penalty mechanisms work best when they create appropriate incentives for the right behavior of all relevant parties. When a CSD administers a penalty mechanism, it takes the information that is available to it, uses this information to calculate penalties, and then passes these penalties on to legal entities with which it has a contractual relationship (namely, CSD participants). There are significant limits to the effectiveness of this process since CSD participants are not typically the direct cause of a settlement failure and a CSD can rarely see the underlying causes of a settlement failure. This means that any individual penalty attributed by a CSD may actually be attributed to an innocent party; it may also be the case that the party receiving a penalty does not have a mechanism to pass on the penalty to the party that actually caused the fail.

Because penalty regimes are simply a tool to achieve an objective, it is important that they be designed carefully. Any penalty mechanism can have negative implications, creating for instance incentives for parties to adjust their behavior by delaying transmitting instructions to the CSD, modifying instructions, or assuming additional risks in their settlement activities (for example, by releasing instructions for settlement before the relevant resources are fully available).

We suggest the following amendments to Art. 7, paragraph 1 and 2:

Reg CSD *Article 7* *Measures to address settlement fails*	***AGC drafting suggestion*** *Article 7* *Measures to address settlement fails*
1. For each securities settlement system it operates, a CSD shall establish a system that monitors settlement fails of transactions in financial instruments referred to in Article 5(1). It shall provide regular reports to the competent authority and to any person with a legitimate interest as to the number and details of settlement fails and any other relevant information. The competent authorities shall share with ESMA any relevant information on settlement fails.	*1. ~~For each securities settlement system it operates, a~~ A CSD shall establish a system that monitors settlement fails of transactions in financial instruments referred to in Article 5(1). It shall provide regular reports to the competent authority ~~and to any person with a legitimate interest~~ as to the number and details of settlement fails and any other relevant information. It shall at regular intervals make publically available aggregated data on overall settlement fails. The competent authorities shall share with ESMA any relevant information on settlement fails.*
2. For each securities settlement system it operates, a CSD shall establish procedures that facilitate settlement of transactions in financial instruments referred to in Article 5(1) that are not settled on the intended settlement date. These procedures shall provide for a sufficiently deterrent penalty mechanism for participants that cause the settlement fails.	*2. ~~For each securities settlement system it operates, a~~ A CSD shall establish procedures that facilitate settlement of transactions in financial instruments referred to in Article 5(1) that are not settled on the intended settlement date. These procedures shall ensure that participants have a financial incentive to settle transactions on the intended settlement date. ~~provide for a sufficiently deterrent penalty~~*

	~~*mechanism for participants that cause the settlement fails*~~

2.1.3 Article 7 paragraph 3 Reg CSD

Under one possible interpretation, Art. 7, paragraphs 3 and 7, require that the participant in the securities settlement system that fails to deliver financial instruments be subject to a mandatory buy-in regime, and that this buy-in regime should apply to transactions executed on organized trading venues, to transactions cleared by CCPs, as well as to other transactions. Art. 7, paragraph 7, assigns responsibility for execution of the buy-ins to organized trading venues and to CCPs, but to no other parties. The AGC believes this requirement, in this interpretation, to be both contradictory and flawed. Buy-ins by their very nature *can only be addressed to trading parties*. A buy-in effectively and legally cancels a contract and replaces it with a new contract or obligation. Buy-ins accordingly can only be enforced by parties that have a contractual relationship with the trading parties, and that have the authority and ability to cancel the relevant existing contract and replace it. Buy-ins, for trades executed on a trading venue, can be executed by the trading venue, or by its agent, against its trading member; buy-ins, for trades cleared by a CCP, can be executed by the CCP, or by its agent, against its clearing member.

In contrast, a buy-in cannot be executed as such against a participant to a securities settlement system. Custodians, although significant participants in the securities settlement system, are not direct trading parties, and their settlement activities depend on their client's activities and settlement instructions. The settlement activity on a securities account with a CSD may well be the settlement of cash trading on exchanges, MTFs or OTFs; but it may also stem from other activity, such as client-side deliveries, OTC transactions, repos, collateral movements and securities lending.

Buy-ins as a settlement discipline tool are appropriate for trading in liquid securities on trading venues (exchanges, MTFs and OTFs); they are not appropriate for any other types of trading or financial activity such as securities financing or repurchase activity. Applying a buy-in regime to all trading or collateral transactions could significantly undermine trading liquidity especially in fixed income markets. As such, we disagree with the introduction of a general buy-in regime.

In addition, buy-ins that are imposed on trading in illiquid securities may in fact be counterproductive. The buyer will frequently not receive the securities (as the securities can not be readily acquired), and typically will receive cash compensation. Where there is an intention or a strict need to acquire illiquid securities, the buyer will have to re-purchase in the market, perhaps at a much higher price and the risk of further cash compensation. These effects will discourage trading in small caps and other illiquid securities, as both the buyer and the seller will be exposed to the dual risks of being unable to acquire securities and the added cost of paying cash compensation.

Finally, we stress that it is important for the buy-in requirements within Reg CSD to be consistent with the buy-in requirements in the "Regulation on short selling and certain aspects of credit default swaps." The Short Selling Regulation's buy-in requirements differ from Reg CSD in several respects, including in terms of timing. The former stipulates that the person not able to deliver the shares for settlement will be subject to a buy-in starting the fifth business day after the day on which settlement is due whereas Reg CSD requires respective financial instruments to be bought in the market no later than four days after the intended settlement date, which creates a gap of at least one day.

The Short Selling Regulation's recitals state that "for the proper functioning of financial markets it is essential to address wider aspects of settlement discipline in a horizontal legislative proposal" which seems to be the driver for the approach now taken in Reg CSD. However, we believe the current CSD proposal insufficiently recognizes the way different markets operate.

The Short Selling Regulation's accompanying impact assessment clearly indicates that rules need to be tailored, e.g., to reflect the needs of market makers in order to mitigate the potential negative impact on liquidity. In the US, buy-in rules vary according to the type of market and the settlement system supporting them. For Government and MBS repo, the Fed's Treasury Market Practice Group (TMPG) has developed market practices around failed settlements. FICC related transactions (FICC is a US CCP) are subject to an automated calculation and collection of the value of fails for any two counterparties on the system. However, transactions outside the FICC – between Broker and Buy side – are subject to a flexible regime allowing any two counterparties to negotiate claims on any particular transaction. The regime for equities is similar, i.e. an automated buy-in regime is employed only if transactions are settling through continuous net settlement (CNS) in NSCC. We note that none of the foregoing US conventions and systems impose a direct buy-in obligation on custodians when acting as settlement agent for clients' transactions, as described in part 2.1 above.

The AGC suggests in the light of the commentary above the following amendments to Art. 7, paragraph 3:

Reg CSD *Article 7*	***AGC drafting suggestion*** *Article 7*
3. A participant to a securities settlement system that fails to deliver the financial instruments referred to in Article 5(1) to the receiving participant on the intended settlement date shall be subject to a buy-in whereby those instruments shall be bought in the market no later than four days after the intended settlement date and delivered to that receiving participant and other measures in accordance with paragraph 4.	*3. A participant to a trading venue (regulated market, MTF or OTF) ~~securities settlement system~~ that fails to deliver the financial instruments referred to in Article 5(1) to the receiving participant on the intended settlement date shall be subject to a buy-in in accordance with the procedures laid down in Article 15 of the Regulation of the European Parliament and the Council on short selling and certain aspects of credit default swaps ~~whereby those instruments shall be bought in the market no later than four days after the intended settlement date and delivered to that receiving participant and other measures in accordance with paragraph 4.~~*

2.1.4 Article 7 paragraph 7 Reg CSD

The AGC recognizes that this paragraph can be interpreted in two possible ways:

(a) The buy-in obligation applies to all trades (no matter where traded) in securities (a) that can be traded on regulated markets, MTFs or OTFs, or (b) for which trades can be cleared by a CCP; or

(b) The buy-in obligation applies just to trades executed on regulated markets, MTFs and OTFs, and to trades cleared by a CCP.

As set out in the commentary above, it is important that the second interpretation be the correct interpretation, and that there be an exemption for illiquid securities.

The AGC suggests in this light the following amendments to Article 7, paragraph 7:

Reg CSD *Article 7*	***AGC drafting suggestion*** *Article 7*
7. Paragraphs 2 to 6 shall apply to all transactions of the instruments referred to in Article 5 (1) which are admitted to trading on regulated markets, traded on MTFs or OTFs or cleared by a CCP. *For transactions cleared by a CCP before being settled within a securities settlement system, the measures referred to in paragraph 3 to 5 shall be executed by the CCP.* *For transactions not cleared by a CCP, the regulated markets, MTFs and OTFs shall include in their internal rules an obligation on their participants to be subject to the measures referred to in paragraph 3 to 5.*	*7. Paragraphs 2 to 6 shall apply to ~~all~~ transactions executed on regulated markets, MTFs or OTFs in ~~of the~~ instruments referred to in Article 5 (1) for which trading liquidity exceeds a certain minimum level as defined by the regulated market, MTF or OTF ~~which are admitted to trading on regulated markets, traded on MTFs or OTFs or cleared by a CCP.~~* *For transactions cleared by a CCP before being settled within a securities settlement system, the measures referred to in paragraph 3 to 5 shall be executed by the CCP.* *For transactions not cleared by a CCP, the regulated markets, MTFs and OTFs shall include in their internal rules an obligation on their participants to be subject to the measures referred to in paragraph 3 to 5.*

Question 3 **Is there any quantifiable reason why dematerialization or immobilization of shares shouldn't be progressed towards rapidly?**

The AGC endorses dematerialization or immobilization of shares.

As mentioned previously, the AGC does see the existence of physical securities as a factor contributing to a less than optimal settlement efficiency rate.

As under certain circumstances it is not always possible for securities to be deposited in the CSD before trading, the AGC suggests the following amendment to Art. 3, paragraph 2:

Reg CSD	***AGC drafting suggestion***
Article 3	*Article 3*
Book-entry form	*Book-entry form*
2. Where the securities referred to in paragraph 1 are traded on regulated markets, traded on multilateral trading facilities (MTFs) or organized trading facilities (OTFs) or are transferred following a financial collateral arrangement as defined in point (a) of Article 2 of Directive 2002/47/EC, those securities shall be recorded in book-entry form in a CSD prior to the trade date, unless they have already been so recorded.	*2. Where the securities referred to in paragraph 1 are traded on regulated markets, traded on multilateral trading facilities (MTFs) or organized trading facilities (OTFs) or are transferred following a financial collateral arrangement as defined in point (a) of Article 2 of Directive 2002/47/EC, those securities shall be recorded in book-entry form in a CSD on or before the intended settlement date ~~prior to the trade date~~, unless they have already been so recorded.*

Question 4 **What are your views on the provision of banking services by CSDs?**

The AGC believes that wherever possible there should be a clear separation of CSD services from banking services in order to avoid undue risks to the financial system.

We note the proposal in Art. 52 paragraph 2 enabling a derogation from this principle. In our view, there is the risk that such a derogation may exacerbate level playing field concerns -- CSDs that currently have a banking license are more likely to benefit from the derogation at the expense of other market players.

Furthermore, the opportunity for derogation is likely to create issues around the provision of services in another member state (Art. 21). For example, would a national regulator that does not allow a domestic CSD to offer banking services be comfortable dealing with a foreign CSD that benefits from derogation offering services in the host member state?

The derogation clause also raises questions around the ability of CSDs to compete equally in the cross-border consolidation process. While a CSD providing banking services may acquire another CSD, the reverse would not be possible, as Art. 16, paragraph 4 would prevent a CSD from acquiring another CSD that is also a bank.

AGC members believe that any inclusion of derogation powers in the proposed Regulation must be justified with clear evidence from CSDs that it is necessary in order to prevent detrimental impacts to market participants, and that the resulting risks and level playing field issues can be managed.

Members believe that the proposed requirement set out in Art. 52, paragraph 3, for a specific authorization in the case a CSD intends to settle the cash leg of at least parts of its SSS is reasonable. However, the opportunity for a regulatory/supervisory body to require a minimum of two cash settlement banks should be tightly circumscribed to ensure that the result does not increase risk or operational costs, as having two functioning settlement banks is comparatively complex to implement.

The rationale for the difference in treatment between banks that are within a CSD group versus those that are not, as addressed by Art. 52, paragraph 5, is not convincing. In the absence of a more convincing rationale, AGC members believe that there should be a level playing field, so that restrictions on banks within the group of a CSD should be lifted.

The AGC generally welcomes the proposal that enhanced prudential requirements will be applicable to all banks offering cash settlement bank services (see Art. 57). Members believe that in the event a bank, as a single legal entity, provides to a single client both CSD-related cash settlement bank services and more general banking services (including credit facilities) there should be an appropriate regulatory structure to ensure that the specific regulatory requirements for the cash settlement bank cash accounts are distinct from the regulatory requirements for other cash accounts.

Question 5 Who should own a CSD?

The AGC declines to express specific preferences with respect to the ownership structure of a CSD. However, Members stress that the ownership structure of an authorized CSD should not give rise to conflicts of interest with the proposed Reg CSD's provisions on governance/management arrangements (including user committees), transparency, participant access, and risk management.

Question 6 How interoperable do we want CSDs to be?

Finding a balanced answer is indeed a key factor, affecting both the level of systemic risk in this sector as well as overall efficiency. Reg CSD naturally does not answer this question, and we principally agree with the approach to allow market forces to shape the level of

interoperability based on the existence of a level playing field and risks being mitigated as part of a sufficient regulatory framework. Members' answer would naturally differ depending on, for example, whether derogation will be allowed or not.

Typically, the question around interoperability is posed from the perspective of how to make CSDs more interoperable. This is driven by a number of considerations:

- CSDs wishing to interoperate through T2S as a shared platform could potentially make certain activities less costly than today
- Many CSDs wishing to expand their revenue opportunities are developing access to cross-border markets

There are, however, certain downsides to this development:

- Anecdotal evidence from CSDs suggests significant upfront investments and extensive time-to-market (over a year)
- Inability of CSDs focused on standardized, large scale processing to cater to individual client requirements, which may render such links of limited use to institutional investors
- Appearance of multiple access points with increased costs if all CSDs offer cross-border services (noting that cross-border (outbound) flows of local participants may not justify the investments)
- Additional operating and business risk is necessarily introduced to CSDs expanding into this activity

Members recommend clarification as to whether there should be a limit on the extent to which CSDs enter into interoperability arrangements and what framework is needed to manage the transitional period effectively. These clarifications could be achieved in the following way:

- Article 49 (2) could be strengthened to require that the cost for building and operating such links should not be socialized to users accessing the CSD only for its settlement and safekeeping services as an issuer-CSD
- Article 50 (3) could be strengthened to require ESMA to analyze the operational aspects of present links in order to develop a guidance framework for authorities concerning how to arrive at a decision to approve a link, or not. We note that many formats, reporting standards and service levels differ widely, and a successful delivery of T2S will require activities outside the T2S platform to follow

some common principles. As such, it would be advisable to support the harmonisation efforts of T2S by requiring some compliance standards around approval of interoperable links on T2S

Question 7 **Is securities lending an issue?**

Securities lending, together with collateral management and repo markets, are activities that should be encouraged. They allow market participants to manage risk and to optimize the use of scarce resources (both cash and collateral). They help increase settlement success rates and generally contribute to the efficiency and liquidity of markets.

In a very abstract sense, both securities lending and collateral management have to deal with the challenge of addressing adequately the rights and the interests of securities lenders as well as securities borrowers – the collateral givers and the collateral takers.

CSDs, as operators of SSSs, provide the core market infrastructure that should allow securities lending and collateral management to take place in a secure, safe and efficient environment.

With respect to Reg CSD, the following issues can be identified:

- Risks encountered by CSDs when they provide specific securities lending and collateral management services, rather than generic settlement services;
- Restrictions imposed by CSDs on the provision of securities lending and collateral management services by third parties; and
- Advantages granted by regulatory bodies to CSDs in the provision of securities lending and collateral management services.

As previously mentioned, the AGC believes that CSDs should be limited strictly to the provision of agency services, including with respect to securities lending and collateral management. In addition, the AGC is a strong proponent of open access rights, and of a level playing field. Those elements ensure that market participants can freely elect their preferred provider(s).

Question 8 **Should we constrain rehypothecation and is account segregation really necessary?**

The AGC would like to draw attention to the work of the AFME Post Trade Settlement Committee Task Force on CSD Account Structure. This group released on 19 March 2012 the paper "CSD Account Structure: Issues and Proposals" that covers the topic of account segregation in considerable detail.

Question 9 And a final question - what have we missed?

9.1 To be considered a CSD, and to fall under the obligations of the Reg CSD, a legal entity has to (a) operate an SSS, and (b) perform one other core service ('notary service' and 'central maintenance service').

The AGC principally agrees with the Commission's approach to defining a CSD. The current definition, however, seems to cause a number of inconsistencies and hence increase legal uncertainty.

One source of uncertainty with respect to the scope of application of Reg CSD is that it uses a very broad definition of an SSS. In order to avoid a result that an SSS is anything that *operates as* an SSS (i.e. including even SSSs that are not "designated" under the Settlement Finality Directive), members suggest consistently referencing the need to be designated as an SSS under the Settlement Finality Directive in order to be considered an SSS. Otherwise, the definition of a CSD becomes broad and unpredictable.

The definition of a CSD is especially important because Art. 16, paragraph 2 says that SSSs can be operated only by CSDs. This effectively prohibits entities that are not CSDs -- and that do not fall within the Reg CSD definition of a CSD -- from providing services that could fall under a broad definition of an SSS. This would be very problematic and would create inconsistencies with international standards[3].

It is unclear whether the Commission considers an SSS to be simply a legal framework per a designation under the SFD -- or something more. For example, Art. 30 provides access rights for participants in an SSS, while Art. 48 et seq. provide access rights to CSDs. There is lack of clarity around whether the different terminology such as CSDs, SSS (CPSS-IOSCO, or SFD) and operators of SSS entail different practical or legal implications. For example ESMA's recent discussion paper dated 16 February 2012 (draft technical standards for the European Regulation on OTC derivative transactions, central counterparties and trade repositories on the EMIR implementation) discusses how to hold collateral for centrally-cleared transactions and distinguishes the following options for depositing collateral: i) "operators" of an EU securities

[3] For example, the CPSS-IOSCO Principles for financial market infrastructures clearly differentiates between CSDs (Page 8: "in many countries, a CSD also operates a securities settlement system but unless otherwise specified, this report adopts a narrower definition of CSD that does not include securities settlement functions) and SSS ("A securities settlement system enables securities to be transferred and settled by book entry according to a set of predetermined multilateral rules. Such systems allow transfers of securities either free of payment or against payment. When transfer is against payment, many systems provide delivery versus payment (DvP), where delivery of the security occurs if and only if payment occurs. In this report, CSDs and CCPs are treated as separate types of FMIs. As noted above, in many countries, CSDs also operate an SSS.").

settlement system, i.e. not the SSS directly hence potentially referring to a CSD; ii) a European central securities depository; and iii) "operators" of a third country security settlement system or central securities depository. This sort of ambiguity produces uncertainty around relevant actors and their rights and obligations, which should be avoided.

We suggest defining rights and obligations of CSDs for the purpose of this Regulation. This definition and the scope of Reg CSD will have an impact on other regulatory initiatives such as EMIR, MiFID and others and for that reason should use terms consistently.

Based on the commentary above, the AGC suggests the following amendments:

Reg CSD *Article 2*	***AGC drafting suggestion*** *Article 2*
1. For the purposes of this Regulation, the following definitions apply:	*1. For the purposes of this Regulation, the following definitions apply:*
(3) 'securities settlement system' means a system under the first and second indents of point (a) of Article 2 of Directive 98/26/EC whose business consists of the execution of transfer orders as defined in the second indent of point (i) of Article 2 of Directive 98/26/EC;	*(3) 'securities settlement system' means a system under the first, ~~and~~ second and third indents of point (a) of Article 2 of Directive 98/26/EC whose business consists of the execution of transfer orders as defined in the second indent of point (i) of Article 2 of Directive 98/26/EC;*

and:

Reg CSD	***AGC Drafting suggestion***
ANNEX *List of Services* *Section A* *Core services of central securities depositories* *1. Initial recording of securities in a book-entry system ('notary service');* *2. Maintaining securities accounts at the top tier level ('central maintenance service');* *3. Operating a securities settlement system ('settlement service').*	*ANNEX* *List of Services* *Section A* *Core services of central securities depositories* *1. Initial recording of securities in a book-entry system ('notary service');* *2. Maintaining securities accounts at the top tier level ('central maintenance service');* *3. Operating a securities settlement system as designated under the Settlement Finality Directive (98/26/EC) ('settlement service').*

9.2 CSD liability: protecting participants from CSD negligence, failures or default

The Reg CSD proposal is silent on the responsibilities and degree of liability that a CSD sustains in the event that its acts, omissions, operational failures or default result in loss or damage to holdings or to the settlement activity of participants. Criteria for liability and restitution requirements for losses or damages attributable to a CSD's negligence or failure to deliver should be transparent, risk-based, consistent with applicable laws and subject to oversight by the competent authority. Under the current proposal, market participants will have free access to multiple CSDs in different member States and this should not result in exposure to differing liability regimes as they apply to CSDs. Clearly defined and harmonized liability standards will be important to legal certainty and to clear delimitations in respect of other liability regimes, such as those resulting from the AIFMD, UCITS V, and the Securities Law Directive. The CSD Regulation should establish a minimum harmonized liability regime and clear guidelines and disclosure requirements in this regard.

At a minimum the harmonized liability regime should cover situations such as:

- reconciliation errors with registrars and/or issuers

- theft of securities (either physical or electronic)
- failure of the CSD's systems during which time participant lose use of their securities or funds
- failure within the CSD's central counterparty functionality, if applicable
- CSD errors, omissions or fraud impacting settlement, safekeeping and asset servicing activities
- CSD insolvency / default
- Force majeur events

CSD should disclose to their Participants information as to the type of loss/ damage protection, and related risks, that exists. Participants should also be able to understand what financial limits might be imposed on the amount of liability. Participants should also be able to understand what financial limits may be imposed on the amount of liability assumed by the CSD, whether liability extends to indirect or consequential losses, what service guaranties exist, and what rules and regulations govern the liability regime of the CSD.

9.3 Consistency of CSDR with broader regulatory landscape

Reg CSD is meant to complete the regulatory framework for securities market infrastructures, alongside MiFID and EMIR. The AGC therefore stresses that Reg CSD should achieve consistency with related sectoral legislation, with particular focus on uniformity of defined terms and the relationship between Reg CSD and the law and regulation covering issuers and issuer agents.

* * * *

The Association appreciates the opportunity to provide you with comments at this stage in your consideration of proposed Reg CSD. Members stand ready to provide supplemental comment as appropriate.

Sincerely yours,

Dan W. Schneider
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Counsel to the Association