

CSD Regulation

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1. Introduction

The purpose of this document is to describe the **developments and demands arising from the upcoming application of European regulations on central securities depositories** (hereinafter, the “CSDs”) that may be of interest to IBERCLEAR participants and issuers. This regulation contains provisions that affect not only the CSDs, but also the participants in the corresponding systems, securities issuers, other market infrastructures, such as central counterparties and trading platforms, as well as the members of these infrastructures.

The **effective application** of these requirements depends on the date on which the corresponding CSD obtains the required authorisation in accordance with the corresponding regulations, with the exception of regulations on discipline in terms of settlement and internalised settlement, entry into force of which is independent on obtaining the aforementioned authorisation. IBERCLEAR is currently in the process of obtaining this authorisation.

The aforementioned European regulations are composed of the following **legislative 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 (EU) 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 (EU) 2017/389 of 11 November 2016 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council as regards 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 Delegated Regulation (EU) 2018/1229 of 25 May 2018 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline.

2. Items of interest

In accordance with the foregoing, the following are the new developments deriving from the European CSD regulations that may be of interest to IBERCLEAR participants and issuers. Following the description of each of the obligations established in the European standard, the actions that IBERCLEAR currently carries out or, where appropriate, intends to implement, to facilitate compliance with these obligations by participants and security issuers, whom IBERCLEAR will keep informed regarding possible progress or amendments in the explanations provided below, are indicated for each case.

2.1 Reconciliation

Article 37 of Regulation 909/2014 obliges 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 submitted to 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. In this regard, CSDs must carry out daily internal reconciliation measures, 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.

To this end, IBERCLEAR currently notifies its participants each day of the position and movements in securities accounts for each issue, using MT535/MT536 messages. Any participants that have direct connectivity with T2S may ask to receive this information directly from T2S.

Furthermore, participants are obliged to verify the information received from IBERCLEAR. In addition, in accordance with Article 16.2 of IBERCLEAR Regulations, when the participant detects a discrepancy in terms of the balances of securities held in its detail records, it must immediately inform IBERCLEAR.

To this end, IBERCLEAR has published an amendment of PR120 "Central Registry" in the ARCO System Procedures Manual.

2.1.2 Other reconciliation measures

In the event that entities other than participants are involved in the reconciliation of a specific securities issue, IBERCLEAR and these entities shall organise cooperation and information exchange measures. To this end, IBERCLEAR has established reconciliation measures, among others, issuers' agents, with link entities and with 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 remedied.

Suspension will be reported to all participants in an Informative Memo by IBERCLEAR.

In addition to the foregoing, if IBERCLEAR continues to have accounts open at 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.

Similarly, IBERCLEAR shall suspend the settlement if securities are entered on the System with the participation of an entity that acts as a link entity and such entity notifies IBERCLEAR of the suspension of the issue for settlement due to problems in the reconciliation related to the unjustified creation or cancellation of securities at the issuing CSD.

2.2 Book entries

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 shall be payable as of 1 January 1 2023 for negotiable securities issued after that date, and as of 1 January 2025 for all transferable securities.

This obligation is nothing new in the Spanish legal system. Currently, Article 6 of the Consolidated Text of the Securities Market Law requires that securities that are intended to be listed on an official secondary market or in a multilateral trading facility be represented by means of book entries.

2.3 Use of the LEI (Legal Entity Identifier)

Article 29.1 of Regulation 909/2014, which stipulates that depositories will maintain, for a period of ten years, all their records on the services and activities carried out, and Annex IV of Regulation 2017/394, entail the obligation for participants and issuers to have 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.**"* Furthermore, in the same document, in response to question 3, (f), ESMA expressly 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 terms, the objectives pursued with the measures are for settlement instructions to be notified at the earliest opportunity by the entities involved for them to be accepted (SF1) as soon as possible, for a match to be forthcoming as soon as possible in order to secure irrevocability (SF2), so that settlement instructions are finalised at their intended settlement date (hereinafter ISD), to enable the security to be actually transmitted (SF3).

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

Also, when settlement fails arise, CSDs must establish procedures for settlement of any operations not settled at the intended settlement date, including a penalty mechanism as an effective dissuatory factor for participants which cause settlement fails. It is worth noting that these penalties are not tariffs, but sanctions, applicable to the entities causing the damage, and to compensate the entities that have suffered harm. The penalty rates applicable to settlement fails are set out in the Annex to Regulation 2017/389.

The package of regulations for measures concerning settlement discipline will come into force on 13 September 2020.

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. To this end, IBERCLEAR has published Circular No. 1/2019, of 29 January on the "ARCO Settlement System

Users' Committee", the purpose of which is the creation of the ARCO Settlement System Users' Committee, which will be made up of representatives of issuers and participants in the ARCO System. 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 access of participants, 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 or traded on trading venues to be recorded in any CSD established in any Member State.

Documentation concerning the criteria and procedures for access of participants and issuers is posted on IBERCLEAR's website in the "Regulation and access" section, under "How to become a client".

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. To this end, IBERCLEAR's prices are posted on IBERCLEAR's website in the "Fees" section, under "How to become a client".

<http://www.iberclear.es/esp/Acceso/Tarifas>

2.6 Risk management

From the perspective of participants, the CSD's new risk management requisites focus on three aspects: (i) monitoring of failures, (ii) identification of major 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 respect to identification of the most important 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, that might affect the CSD; and (iii) their potential impact on other participants and 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, on an ongoing basis the CSDs must identify, monitor, and manage the operational risks that these participants face.

Likewise, CSDs must gather information about the clients of these participants that are classified as significant.

Article 38 of Regulation 909/2014 establishes a series 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 with the CSD, the securities of a participant from those of any other participant and, if applicable, from the CSD's own assets. Having said that, in the case of Spain this is not a new requirement, as it had already been imposed by Spanish Securities Market Law. With respect to segregation, IBERCLEAR is working on the publication of a document setting out the existing levels of protection, together with the costs associated with each one.

In turn, participants must follow suit. Given that the availability of segregated accounts has been required since the entry into force of Royal Decree 878/2015, the participants will have to publish a document that covers the different levels of protection together with the costs associated to each of the accounts offered to their customers.

The provisions of the Q&A document published by ESMA on 23 March 2018 are worth particular mention, in particular the response to question 5 a), which indicates: *"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."; as well as in response to the question 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 in the response to question 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 to their competent authority the volume and aggregate value of the transfer orders of securities settled outside the securities settlement systems.

These settlements fall outside the functions attributed to IBERCLEAR, as manager of the settlement system. IBERCLEAR does not perform any monitoring or control functions in relation to these settlements.

However, in the interest of any participants that might perform internalised settlements of IBERCLEAR securities using systems other than those established in the ARCO system, or on foreign securities held through custodians and settled on their own books, the implementing regulations describing the content and format of the reporting required under article 9 of Regulation 909/2014 are as follows:

- 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 aggregate 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

For any additional information, participants can direct their questions to the following address:
entidadesiberclear@grupobme.es

Issuers can direct their questions to the following address:
emisoresiberclear@grupobme.es.

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