Central Securities Depositories Regulation: The next systemic crisis waiting to happen?

Koen Vanderheyden* and Tim Reucroft**

Received (in revised form): 13th February, 2015

*DLA Piper UK, 106 Avenue Louise, 1050 Brussels, Belgium
E-mail: koen.vanderheyden@dlapiper.com
**Thomas Murray Advisory Services, Horatio House, 77–85 Fulham Palace Road, London, W6 8JA, UK
E-mail: treucroft@ids.thomasmurray.com

Koen Vanderheyden

Tim Reucroft

Journal of Securities Operations & Custody
Vol. 7 No. 3, pp. 242–252
© Henry Stewart Publications,
1753–1810

Koen Vanderheyden *is a partner at DLA Piper Belgium and Luxembourg, where he is a partner and head of the financial services regulatory practice. He focuses on advice to financial institutions and investment funds on financial market law and regulation, post trading capital markets infrastructure, settlement finality, financial collateral, clearing and settlement, payment services, derivatives and securities regulation and custody liability. He has assisted countries modernise their capital markets infrastructure benefiting from the experiences of consolidation, harmonisation and best market practices in the EU. He led cross-border studies and advised on the trading and post trading capital markets infrastructures for the European Commission and in Romania, Russia, Iraq and Qatar. In addition he advises on fund structuring, EMIR implementations and on a broad range of derivatives and structured synthetic products, and is the author of country opinions for ISDA, ICMA and ISLA. Previously he worked for PwC and PwC related law firms.*

Tim Reucroft *developed Thomas Murray's (TM's) central securities depository (CSD) risk assessment programme covering 130 CSDs globally. He then developed TM's central counterparty (CCP) risk assessments covering 30 of the top CCPs. Now he leads TM's Advisory Services, helping to modernise capital markets infrastructures in Russia, Ukraine, South Africa, Qatar, Dubai and Saudi Arabia. Much of his current work is driven by the mandatory requirements of EMIR and Dodd Frank for both institutional investors subject to mandatory clearing and third-country CCPs seeking ESMA recognition. Previously, he was a consultant with Capco and KPMG, Head of Derivative Operations at Salomon Brothers London and Head of Compliance at LIFFE. He holds degrees in natural sciences (Cambridge) and philosophy (London) and is a (lapsed) qualified accountant.*

Abstract

Central securities depositories (CSDs) are essential infrastructures within the securities market. Historically, they were natural monopolies serving many functions and providing many services, but now they are being regulated and their role closely defined, with some activities curtailed and then subjected to competition with the objective of forcing rationalisation and consolidation of the European post-trade landscape. The Central Securities Depositories Regulation EU (No. 909/2014) of the European Parliament and of the Council dated 23rd July, 2014 (CSDR) seeks to increase the safety and efficiency of securities settlement and settlement infrastructures. This paper will explore the likely impact of CSDR on the European landscape. The author's view is that, *instead of increasing safety and efficiency as CSDR is supposed to, the consequences will increase the systemic risk within the European capital markets. The question is whether CSDR will be able to solve more problems than it causes, and whether or not CSDR in fact may be the next systemic crisis waiting to happen.*

Keywords: CSDR, systemic risk, issuer CSD, settlement internalisers, settlement fails

WHY CSDR?

The main objectives of the Central Securities Depositories Regulation (CSDR) were provided in Section 6 of the European Union's (EU's) memo dated 16th April, 2014:[1]

- increase the safety of settlements, in particular for cross-border transactions, by ensuring that buyers and sellers receive their securities and money on time and without risks;
- increase the efficiency of settlements, in particular for cross-border transactions, by introducing a true internal market for the operations of national central securities depositories (CSDs); and
- increase the safety of CSDs by applying high prudential requirements in line with international standards.

These are admirable objectives, but the author believes that some of the (unintended) consequences of CSDR (along with TARGET2-Securities, T2S) may increase the level of systemic risk in the European capital markets.

WHAT IS A CSD UNDER CSDR?

Under CSDR, a CSD is an organisation whose core services consist of at least two of the following functions:

- settlement (mandatory);
- notary;
- account maintenance.

CSDs are allowed to provide ancillary services and establish delivery versus payment (DvP) links, while banking services will be supervised directly by the European Central Bank (ECB).

WHAT IS NOT A CSD?

Both registrars and transfer agents are necessarily excluded from being a CSD, as are settlement internalisers (which do settlement outside of a CSD and account maintenance where no notary is required if within the same nominee) and account operators (which do account maintenance and may be the notary). All settlements by settlement internalisers have to be reported to the local regulator and then onwards to the European Securities and Markets Authority (ESMA).

KEY POINTS IN CSDR

Settlement fails

The first stated objective refers to timely settlement. Already the settlement cycle has been moved to T+2 without much impact on the fail rate, which is an admirable achievement. Nevertheless, there are some intermediaries who manage their settlement book for negative fails, ie they do not mind participants failing to deliver to them, but they do not want to fail to deliver out. The reason for this is that, once the trade has been agreed, the buyer has a fixed price and, provided it is DvP settlement, will not pay for the securities until they are delivered. In the meantime, the cash is earning interest. Provided the buyer does not need the securities for a turnaround trade, voting or securities lending, if it is just buy and hold, they have effectively bought the securities and lent them back to the seller. The buyer might be quite happy with this situation; however, for a failing trade, if they needed the securities immediately, they would have to borrow them on the market. On the other hand, if a seller is delivering securities, they want to do this as quickly as possible and receive the cash to recycle elsewhere, indeed, their prime motive for the sale may have been to realise cash to meet a margin call. In such a situation a late settlement could put them into default and this is unacceptable. If the seller is late in delivering securities, there is likely to be a market claim against them for any dividends or other entitlements that they received in error (as the registered owner).

The seller usually has a good incentive to deliver on time. If they do not have the securities it might be because they have lent them out and the borrower has not returned them on time. If the seller is fined in such a scenario, would they pass the fine onto the borrower? Most likely, but then this acts as an impediment to securities lending and a dangerous impediment in a world of impending collateral shortages.

The buyer needs to be incentivised to deliver on time. You would not want a buyer in the market, failing to put up the cash and effectively borrowing from the seller for a day or two. When interest rates go up this may become commercially attractive, so settlement penalties need to be sufficient to deter such activity. Settlement fines punish buyers and sellers equally (unlike buy-ins that only punish the seller). CSDR requires CSDs to implement a penalty mechanism for fails that 'serves as an effective deterrent'. The intention of CSDR is to cover fails in all financial instruments. CSDR encourages fines to be credited to the non-failing participant as compensation; fines should not be a revenue source for the CSD concerned.[2] The CSD only recognises its participants, it does not have a contractual arrangement with the participant's clients. The CSD cannot impose fines on the end clients, only on its participants. There is no way to ensure that the participant passes on the fine to the end client as an effective deterrent (if it were the end client's fault).

On top of late settlement fines, ESMA considered imposing late matching fees. The assumption for imposing late matching fees would be that late matching only arises at the CSD; however, the moment of matching also depends on processes at the central counterparty (CCP) and/or trading venue. Early matching does not guarantee a high degree of settlement, other elements need to be fulfilled for a transaction to settle (ie available resources, non-hold status etc). It is doubtful whether the compulsory introduction of a late matching fee would have any benefits and ESMA therefore decided not to include this requirement in the draft Regulatory Technical Standards (RTS).[3] The draft RTS does provide that matching should be compulsory (with some exceptions). Also CSDs should offer matching possibilities continuously throughout the day and require their participants to use a minimum list of mandatory matching fields in order to facilitate settlement and future reporting requirements under the Securities Financing Transactions Regulation.[4] Other measures considered by ESMA in order to prevent settlement fails include standards on confirmation and allocation between investment firms and their clients, mandatory automation and the accommodation of straight-through processing (STP).[5]

The shortening of the settlement cycle and focus on timely settlement of transactions should force investment firms and their professional clients to use more efficient solutions; however, these often reside outside the mandate of the CSD and the matching utilities are often provided by third parties such as Omgeo. Unfortunately, CSDs and their participants have no power under CSDR to enforce measures such as STP and automation in the rest of the settlement chain. CSD participants can only encourage their clients to use automated processing, which they have been trying to do unsuccessfully for years. This is an area where the regulations could have helped rather than just imposing fines, ie treating the causes not the symptoms.

Buy-ins

There is no real incentive for a buy-in. The buyer obtains the securities from a different seller and is compensated for any losses. The original seller is left with sorting out the problem and seeking compensation if its own failure was due to dependencies further up the chain; however, there has to be a mechanism to enforce settlement finality to avoid systemic risk and maintain the integrity of the market. Settlement fines do not achieve that, they do not deliver securities or cash, one needs a buy-in mechanism for that. Without an incentive, buy-ins are not commonly used to resolve settlement fails. The only party that has an incentive and is not concerned about holding onto the cash, because they always have back-to-back transactions, is the CCP. They have a strong incentive to exercise any buy-in facilities: it avoids using any guarantee funds.

A good reason why a trade might be failing, other than administrative reasons, is in respect of a stock lending transaction. This might have multiple settlement dependencies and is more likely to go wrong than a straightforward transaction; however, a lender is unlikely to force a buy-in on a borrower since it destroys their commercial relationship — it is not an arbitrary transaction with an anonymous third party. There are penalties built into the stock lending contract that the lender can exercise should they so wish — ie meaning there is no need for a buy-in mechanism.

Today, CSDs are typically not involved in the buy-in process, which, as recognised by CSDR, is primarily the responsibility of CCPs; however, CSDR imposes a mandatory buy-in process on any financial instrument that has not been delivered within four business days of the intended settlement date.[6] This period can be increased to seven days for illiquid securities. For over-the-counter (OTC) transactions that are not cleared by a CCP, the CSD will need to include the mandatory buy-in process in its internal rules as an obligation on its participants, but it is unclear how the CSD could enforce such a rule, if the CSD is not undertaking the buy-in process itself. The draft RTS developed by ESMA aims to harmonise the buy-in process and limit undue risks for the CSD by providing that the buy-in would be executed by auction or by a buy-in agent who could be appointed by the CSD or the receiving participant.[7]

Internal market for CSDs

Section 8 of the frequently asked questions on CSDR describes the expected benefits of CSDR as follows:

> 'In the short term, the CSD Regulation is likely to create more competition between CSDs, with expected benefits for the quality and price of cross-border services. In the medium to long term, the CSD market could become more consolidated and less fragmented. There could be less intermediation for cross-border holding of securities and CSD services, and cross-border settlement will become safer and cheaper. This would translate into lower costs for investors along the whole post trading chain.'[8]

The real objective, along with T2S, is to consolidate the number of CSDs operating in Europe. There are clearly too many and it is not efficient, either on a national or cross-border level. The problem is that the European regulators have only a single mechanism to force through this consolidation — ie via competition. There is no offering of a pan-European franchise to shortlisted incumbents resulting from a tender process, as is found in other utility/monopoly-based industries elsewhere in Europe, nor is there encouragement for larger players to acquire smaller candidates. There is just a free for all fight to the death, and some CSDs do not even see this coming, believing that they can just plug into T2S and survive. While this situation is bad enough, the consequences go much further. All single-market sub-custodians, as well as some of the regional providers, depend upon intermediating their client's access to the local CSD. If the local CSD is no longer there, their business has disappeared. They will be left with some asset servicing but this will move to the true pan-European players over time. Many smaller banks' securities business will be at risk. For example, Northern Trust has announced its T2S strategy: T2S indirect access via Euroclear and Deutsche Bank for asset servicing, ie just two agents — it no longer needs the 17 agent banks it used to use in Europe.[9] Maybe this is an intended consequence — after all, one of the real objectives is to move the business into the big banks that can afford to cover losses in a crisis — at least this way the taxpayer does not have to pick up the cost.

Open access

A CSD can apply to any other CSD to become a participant. It will be extremely interesting to see how this works in practice. There are a few CSDs that are vying to become the consolidator within Europe, for example, Euroclear, Clearstream, Monte Titoli and SIX SIS. The expectation is that they will become members of the smaller CSDs, take away their flows and then their issuers, finally offering an outsourced solution to a weakened CSD that is no longer commercially viable. The weaker CSD then has little option but to sell out — if it has any residual value. Thus the consolidation objective is achieved, but at the expense of the local market. The consolidating CSD does not even have to make an offer to acquire the target CSD. Just like T2S, it is nationalisation without compensation. The smaller CSDs should have sold out before incurring the expense of linking to T2S — after all, this just makes them a target to open access. So, what is Europe left with? Hopefully a minimum of two CSDs, maybe four or five. What has Europe created? An oligopoly that it has no means to control. How else has Europe tackled this issue? By franchises for a limited period subject to licence renewal and price caps. This works well in the electricity business, railways etc, so why not go down this route for the financial sector? Why was open access chosen?

Issuer CSDs

One consequence of CSDR, that is completely untested, is to encourage issuers to seek the most effective CSD in which to register their securities. It is accepted that, at this stage, it is unknown how this might play out. Certainly as the smaller CSDs begin to wobble, the larger issuers will look elsewhere — those with pan-European ambitions will seek a well-established CSD with good cross-border connections to their shareholders — which makes perfect sense. Unfortunately, it is the major issuers (the blue chips) that provide most of the flows for both the local CSD and their associated sub-custodians. Once this flow disappears, the local CSD is pretty much finished, the local sub-custodian bank's securities business has gone and the small and medium-sized enterprises (SMEs) in the market are left high and dry.

If one is going to create a single market for Europe that is open to competition, then this logic should apply to all participants (except of course central banks). Issuers are one such participant. The cost of raising capital can have a significant effect on a company's fortunes. Access to a deep liquid pool of capital is a clear objective to be supported. CSDR allows freedom of movement for issuers: they are free to pick which jurisdiction they want their securities to be lodged in. While CSDR accepts that there may be a need for adjustments to national laws to allow this to happen, it clearly supports such freedoms. But what are the intended consequences? The issuers most likely to migrate to another CSD are those in a smaller CSD but with pan-European ambitions. Take for instance the comparisons of Poland and Croatia as shown in Tables 1 and 2. The top ten CSDs in Croatia represent 93 per cent of the total market capitalisation — a significant risk if only a few of these were to migrate. If a foreign CSD were to target just the top four, that would be over 60 per cent of the market.

Table 1: Polish CSDs

Poland	*Market cap (%)*
PEKAO	7.93
PKOBP	7.56
PZU	7.10
BZWBK	6.29
PGE	5.97
PGNIG	4.44
KGHM	3.68
MBANK	3.56
PKNORLEN	3.54
INGBSK	3.08

Table 2: Croatian CSDs

Croatia	*Market cap (%)*
Interkapital vrijednosni papiri d.o.o.	21.55
Erste&Steiermarkische Bank d.d.	20.77
HITA vrijednosnice d.d.	11.14
Fima vrijednosnice d.o.o.	9.67
Zagrebačka banka d.d.	7.81
Agram brokeri d.d.	7.68
Privredna banka Zagreb d.d.	6.08
Raiffeisenbank Austria d.d.	4.50
Hypo Alpe-Adria-Bank d.d.	2.34
Antea brokeri d.o.o.	1.76

In a pre-CSDR and pre-T2S environment, it was quite difficult for an issuer to dual list. The exchange end was easy enough, but the dual listing on a foreign exchange meant that there had to be a link back to the home CSD, which was more problematic. CSD to CSD links are expensive and often do not have sufficient volume to justify the cost. The most active link is that between the Depository Trust & Clearing Corporation (DTCC) and Clearing and Depository Services (CDS) in Canada. The dual listing of South African securities is managed by the registrars who have to operate dual books. If the issuer wanted to decamp completely to a new exchange outside the home jurisdiction then it could move the whole company (as HSBC did) or live with the unnatural cross-border settlement of its securities from a foreign exchange to a domestic CSD (assuming that the legislation requires the company to use a CSD in its home jurisdiction). In a post-CSDR and post-T2S environment, the cross-border nature of the settlement is no longer a problem — this is what T2S is designed for. The issuer will find it much easier to migrate its listing and it would be an obvious choice to use the CSD most closely coupled with its new chosen exchange. The result is just a few vertical silos in Europe.

The original thinking was to draw a distinction between an issuer CSD and an investor CSD. In most European markets, being an issuer CSD is fairly passive — a CSD with the indirect account holding model does not have any direct contact with the issuer — if it lists on the local exchange, it lodges in the local CSD. An investor CSD can link to an issuer CSD in T2S, thereby settling securities of that issuer on behalf of its local investors, which is critical for cross-border settlement. This dichotomy is therefore enshrined in T2S but hardly gets a mention in CSDR.

WEAKNESSES IN CSDR

The author believes that, instead of mitigating systemic risks, which was the initial purpose of CSDR, it introduces additional systemic risks for the following reasons.

CSDR encourages internalisation

Late settlement fines and buy-in requirements are only applicable to CSDs, not to settlement internalisers. This could lead to a migration of business away from CSDs and an increase in internalisation on the books of intermediaries, which are not subject to CSDR. Taking into account the fact that systemic internalisers are not protected by the Settlement Finality Directive and the measures set out in CSDR to manage settlement fails are limited to CSDs only, such a shift to internalisation would substantially increase systemic risks.

There is no portability

The European Market Infrastructure Regulation (EMIR) requires a CCP to offer portability to end users, which can only be achieved by individual segregation (one could port an omnibus account, but by the time everybody has agreed to move to the same secondary provider, it would be too late). The scenario is as follows: a clearing member goes into default. The end clients with individual segregation plus a secondary clearing broker can port their positions and collateral within a few days and it is business as usual. This minimises the disruption (systemic risk) of a clearing member's default, which is extremely commendable; however, the client is with a new clearing broker in turbulent times (assuming the default has a knock-on effect). The new clearing broker calls the client margin on their ported derivative positions, and the client says: 'Fine, I'll sell securities to raise the cash'. The client uses the same clearing broker for derivatives and securities, but, while the derivative positions have moved to a new clearing broker at the CCP, the securities positions are stuck in the CSD that has frozen the account of the defaulting participant. The client can sell the securities but the account is blocked for settlement so they cannot get the cash out. The client fails to meet its margin call and is put in default. Repeat as above several times and there is now a market meltdown. As illustrated, there is an inconsistency between EMIR and CSDR that introduces systemic risk.

Limitation on banking-type ancillary services

To cope with T2S, CSDs have been told they must compete with custodian banks if they want to survive. CSDR prevents them from doing this by limiting the banking services they can offer. CSDs were always going to find it difficult to transition from a membership-based organisation to a client-focused one and not being able to offer the necessary banking services will make this impossible. The argument for limiting their banking services is that CSDs should be risk-minimising vehicles — not taking a commercial risk for a commercial return — ie the role of banks with big balance sheets. This logic depends upon the CSDs being natural monopolies, something that now has been removed, but they are still prevented from taking commercial risk as this would be systemic, which is correct, but limiting their banking activities introduces a different kind of systemic risk: the potential failure of CSDs commercially.

CSDs that want to provide commercial bank money settlement services have two options: either they hold a banking licence, or they offer money services via third-party settlement banks. A banking licence would bring with it banking supervision and all the associated risk management requirements. Also, of course, it would shift supervision from securities regulators to the central banks. CSDR introduces a significant limitation on the provision of such ancillary banking services by CSDs, by creating a new status of limited-purpose bank for all CSD commercial bank money settlements. Those CSDs that currently hold a banking licence (such as Euroclear Bank, Clearstream Bank Luxembourg and Clearstream Bank Frankfurt) will have to comply fully with these provisions and will have to apply for authorisation under CSDR.[10] Those CSDs that do not have a banking licence (most CSDs in Europe) will only be allowed to use third-party settlement banks that comply with the limited-purpose banking provisions of Title IV of CSDR.[11] This goes to the heart of settlement: what should it be? Should there be settlement finality of the securities and cash legs simultaneously, or should securities settlement be split from cash settlement by pushing out the cash into the banking system? The problem is that, in either of the above options, CSDR imposes very tight restrictions on the banking business that limited-purpose banks can undertake, as well as a very intensive supervisory regime. There is an exception to these limitations but it only applies where a third-party credit institution (ie not the CSD itself) is providing credit for settlements that are less than 1 per cent of the value of a CSD's total annual transactions, and do not exceed €2.5bn per year. The author believes that only the EU's very smallest CSDs will be able to benefit from this exemption (if they survive).

CSDs providing commercial bank money settlement services of a value greater than the limitation set down in the exemption through the services of third-party settlement banks probably will have to restructure their services. This is because, under CSDR's requirements, those third-party banks, which are all full-service banks, 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, so such commercial bank services provided by CSDs can be expected either to be restructured or discontinued entirely. Another consequence of the very tight restrictions on ancillary 'banking' services is that this will limit CSDs' ability to develop additional services to their customers to compensate for their declining settlement revenue due to T2S.

Segregation

Article 38 of CSDR requires CSDs to keep records that enable a participant to segregate the securities of any of their clients if and when required by that participant. Article 38(5) places the obligation on CSD participants to offer their clients at least the choice between omnibus segregation and individual client segregation and to have informed them of the costs and risks associated with each option. CSDs and participants have to publicly disclose the levels of protection and costs associated with the levels of segregation that they provide.[12] A specific exemption is granted for direct holding markets.

CSDs in indirect holding markets and their participants should consider carefully how they can best comply with these requirements, taking into account that the indirect holding models were set up to support omnibus accounts and introducing individual client segregation in an omnibus model might create more problems than it solves. It is clear that individual client segregation increases asset protection by reducing the risk of fraud and the risk of dispossession or blocking of securities in the case of insolvency of an intermediary. The protection against fraud, dispossession and insolvency of intermediaries will still remain limited, however, since individual segregation does not change the fact that, in an indirect holding model, securities are recorded on securities accounts opened by intermediaries with higher tier intermediaries in their name. The effects of individual segregation are not recognised in all jurisdictions and, even if they are recognised, this does not prevent the blocking of securities accounts in an insolvency situation.

Individual segregation also increases transparency, allowing securities holder identification at the CSD level by authorities, regulators, issuers and for tax processing. This facilitates corporate action processing, and allows relief at source without tax reclaims and differentiation between taxable and exempt transactions. On the other hand, introducing individual client segregation in an indirect holding model eliminates all the advantages of indirect holding models (as opposed to direct holding models). End-investor information and changes of investor information need to be passed through the intermediary chain, and trades need to be allocated to individual securities accounts at the CSD and processed and reconciled across multiple accounts. Matching needs to be performed across multiple segregated accounts. Since, in an indirect holding model, securities are still recorded on omnibus securities accounts opened by intermediaries with higher tier intermediaries in their name, this adds a substantial level of complexity, risk and cost, which, in most cases, will outweigh the limited asset protection and transparency benefits of individual client segregation in an indirect holding model. Moreover, the requirement to allocate trades to individual securities accounts at the CSD reduces the netting benefits of CCPs and hinders securities lending and borrowing on a single omnibus account at the CSD.

DOES CSDR CORRELATE TO T2S?

The objectives of both CSDR and T2S are certainly consistent with one another. T2S is a European securities settlement engine aiming to offer centralised (DvP) settlement in central bank funds across all European securities markets. CSDs from across Europe will be joining in a series of 'waves' from June 2015 to February 2017. So, while CSDR establishes the rules for CSDs at the European level, it will (hopefully) ease the progression of T2S across Europe and help it to achieve its objectives. But the aim of each is to reduce the number of CSDs in Europe in a haphazard manner — subject to the vagaries of competition. If every participant requested individual segregation via CSDR, the wholesale model of T2S would be broken. So, why is it still supported?

CONCLUSION

As real-life experience has shown, CSDs in the EU came through the financial crisis unscathed. The reason for this is a combination of their risk-minimising profile, the full collateralisation of credit exposures and a strong legal protection of settlement finality and financial collateral. As key systemic institutions that perform the vital post-trade process of securities settlement, CSDs are subject to the oversight of central banks, which can take whatever measures necessary to mitigate and avoid systemic risk, based on assessments against soft-law legal instruments such as the Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions (CPSS-IOSCO) *Principles for Financial Market Infrastructures*[13]. The advantage of such a soft-law approach is that it is principles-based, does not inhibit the evolution of market practices and technological change, and adapts to all market circumstances and situations by focusing on results, instead of imposing a list of hard-law limitations and restrictions, which by definition will never be able to accommodate all situations, market circumstances and technical evolutions, as is the case under CSDR. So, why change what proved to be working perfectly during the invaluable learning experience of the financial crisis? The decision of the European Commission to harmonise CSD practices and improve the safety and efficiency of transaction settlement will probably cause more problems than it solves. The use of competition as the only lever for policy implementation and the obsession with competing with the USA will in fact result in Europe being less competitive, both domestically and internationally. The European emerging markets being nurtured by the European Bank for Reconstruction and Development (EBRD) will be decimated as their capital markets evaporate. The tight restrictions and the intensive supervisory regime imposed on CSDs will lead to a migration of business away from CSDs and an increase in internalisation on the books of intermediaries, which are not protected by the settlement finality directive and CSDR. Smaller and local CSDs will become commercially at risk and eventually will disappear, which will lead to the disappearance of single-market sub-custodians and regional providers. Add to this the inconsistencies with EMIR and misperception in respect of individual client segregation and one ends up with increased systemic risk instead of increased safety and efficiency. CSDR is another example that the current hard-law approach of the European Commission does not work. What the financial sector needs is protection against risk, increased safety and efficiency instead of imposing restrictions and fines — ie treat the causes not the symptoms.

References

(1) European Union, Memo, Regulation on securities settlement and on Central Securities Depositories in the EU ('CSD Regulation') — Frequently asked Questions, Section 6, 16th April 2014.

(2) Article 7(2) of 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; Articles 8.1 and 10.1 of Annex I — Draft RTS on Settlement Discipline, in Annex 9 to European Securities and Markets Authority (ESMA) (2014) Consultation Paper: 'Technical Standards under the CSD Regulation', ESMA/2014/1563, 18th December (further referred to as 'Draft RTS on Settlement Discipline').

(3) ESMA, ref. 2 above, section 2.3, subsection 23.

(4) European Commission (2014) 'Proposal for a Regulation of the European Parliament and of the Council on

Reporting and Transparency of Securities Financing Transactions', COM/2014/040 final, 2014/0017 (COD), 29th January 2014.

(5) Draft RTS on Settlement Discipline, ref. 2 above, Article 3.

(6) CSDR, ref. 2 above, Article 7(3).

(7) Draft RTS on Settlement Discipline, ref. 2 above, Article 11.3.

(8) Regulation on Securities Settlement and Central Securities Depositories in the EU ('CSD Regulation') (2014) Frequently asked questions, 16th April, available at: http://europa.eu/rapid/press-release_MEMO-14-312_en.htm?locale=en (accessed 17th March, 2015).

(9) Northern Trust Press Release, 'Northern Trust Announces Target2 Securities Strategy', 25th September 2014, available at https://www.northerntrust.com/about-us/news/press-release?c=50124e486681b73c5ba4547b93eaca08 (accessed 17th March, 2015).

(10) CSDR, ref. 2 above, Article 54(2) (a).

(11) *Ibid.*, Article 54(2) (b).

(12) *Ibid.*, Article 38(6).

(13) Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions (CPSS-IOSCO), Principles for Financial Market Infrastructures, April 2012.