A new settlement regime

After CSDR entered legal force in 2014, Bob Santangelo of Broadridge explains that the regulation has and will continue to have a considerable impact on firms

The Central Securities Depository Regulation (CSDR) is one part of a far wider EU regulatory reform created in the aftermath of the 2008 financial crisis. It was implemented by the European Commission in efforts to strengthen the EU financial system.

CSDR, alongside the second Markets in Financial Instruments Directive (MiFID II), ensures that systemically important securities infrastructures are subject to common EU rules.

To that end, CSDR's aim is to improve the functioning and stability of financial markets in the EU by enhancing the legal and operational conditions for cross border settlement.

CSDR was published in the Official Journal of the EU in August 2014 and is gradually entering into force.

It applies across all EU central securities depositories (CSDs)—including the international CSDs, Euroclear and Clearstream—as well as market operators, in the context of all their market settlement operations.

The principal way that compliance with CSDR will be enforced is through authorisation of CSDs (by the home member state Competent Authority), a process which began in the first half of last year.

The European Commission is overseeing CSDR with the technical standards being defined by the European Securities and Markets Authority (ESMA) in cooperation with the European System of Central Banks (ESCB).

How responsibilities are mapped out

An overriding priority for CSDR is to harmonise the different rules applicable and establish a level playing field among European securities depositories.

Another imperative is to increase the safety of assets and improve the operational efficiency of securities settlement, leveraging enhanced infrastructure and more robust, consistent discipline measures that will encourage timely settlement.

The principal way European regulators aim to achieve this is by insisting that CSDs and ICSDs ascribe to a single set of rules that are consistent across the EU 27 markets.

With TARGET2-Securities (T2S) we have already seen the transition of settlement cycles to a T+2 settlement regime, and a move to dematerialisation, where an investor's physical share certificate is converted to an electronic format, that brings us to nearly 100 percent book entry form for securities.

Under CSDR, CSDs will additionally be bound by regulation to perform a daily reconciliation of securities balances, with support and data from market participants.

They are also required to maintain the segregation of client assets throughout the settlement and safekeeping process.

As such, CSDR aims to enforce a more rigorous process and calculation of cash penalties for any settlement fails. Reporting such fails will impact all participants in the transaction process and enforce buy-ins for participants' delivery fails. This is a significant change, as many markets have never applied such disciplines from a regulatory mandate.

Implications for market participants

The new regulations imposed by CSDR carry clear implications for the wider securities industry in Europe and will mandate changes in a number of the steps in the process lifecycle.

The goals of efficiency, consistency and risk reduction are all addressed by the CSDR requirement for T+2 settlement for all European CSDs.

Completing settlements for all on-exchange trades two days following their transaction date brings all CSDs on to a harmonised model for finalising the settlement cycle (this requirement was fulfilled when Spain migrated in September 2016).

Some of the biggest changes under CSDR have primary impacts beyond the CSDs themselves, to institutional market players and custodians. These changes involve the settlement process. Chief among these is a newly restyled settlement discipline regime, which targets timely and efficient settlement in two steps—through the introduction of cash penalties, and by implementing a mandatory buy-in procedure.

Cash penalties and mandatory buy-ins are components of a settlement discipline regime to address and prevent settlement failures, with the aim of encouraging the timely settlement of transactions by all participants (including indirect participants) at a CSD, monitoring settlement fails and providing regular reporting to the respective regulators.

This will apply as a single model across the EU. CSDs can also suspend customers that consistently fail to deliver securities or impose limitations on such customers.

Daily reconciliation is another area of focus. To ensure and validate the integrity of issues in the market, CSDs will be expected to take appropriate reconciliation measures, on a daily basis, that verify the number of securities making up an issue submitted to the CSD is equal to the sum of securities recorded on the securities accounts of the market participants.

This action will fall upon both the CSDs and market participants to complete, as participants will need to provide the CSD with all information required to ensure the integrity of an issue and work with the CSD to solve any reconciliation breaks.

CSDs will also be required to enable the full segregation of securities between participants, and between participants and their clients. They must offer both omnibus and individual client segregation. Requirements placed on CSDs are:

- Enable the segregation of securities for one participant from securities of another participant
- Enable a participant to segregate their securities from the securities of that participant's clients
- Enable a participant to hold in one securities account the securities of different clients of the participant (omnibus client segregation)
- Enable a participant to segregate the securities of any of the participant's clients (individual client segregation)

For market participants, the segregation requirement is to offer clients the choice between omnibus and individual client segregation, as well as advise costs and risks associated with each option.

How can the market prepare?

While many key deadlines for CSDR have passed, starting with its publication in the European Journal in August 2014, this is a continual process with key milestones still to come.

The next deadline approaches on 12 July 2019 where the first internalised settlement report is due to national competent authorities, and then the settlement discipline comes into force in 2020.

Further down the line, the CSDR's requirement for new issues to be represented in book-entry form will apply from 1 January 2023, and this is followed by a 1 January 2025 deadline for all transferable securities to be in book-entry form.

In order to prepare for these dates, steps need to be taken in order to meet requirements.

CSD/ICSDs, issuers, brokers, intermediaries and asset managers should set themselves clear self-assessment checklists.

For example, market participants will need to consider improving settlement processes to avoid daily late settlement penalties and mandatory buy-ins and consider how they will approach the various options for client securities segregation.

Ultimately, whether you are a CSD, broker, issuer, intermediary or asset manager, CSDR has had and will continue to have a considerable impact.

In order to mitigate risk and remain compliant, practices need to be reviewed. AST

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Bob Santangelo
President, international sales
Broadridge