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Transaction Services Newsletter

March 2012

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Securities Settlement Services – ready for take-off?

The draft Regulation on Central Securities Depositories (CSDs) has been published by the European Commission at last. The idea for a regulatory statute for CSDs was first floated in 2004, but was then parked because many of the objectives were perceived to be achievable through industry cooperation. It's not entirely clear what has changed since then: the primary policy objective has always been to create a single market in the post-trade airspace, and yet securities settlement is still configured along national lines. There are a number of reasons for that, which have a lot to do with differences in company law between member states, and with the wish of member state governments to protect their local CSD as a symbol of national prestige. It is perhaps unclear whether the new piece of legislation is going to change that; Target2-Securities (T2S) will probably have a bigger impact.

Jet-powered CSDs zoom all over Europe

The basic idea of the Regulation is to impose a uniform, EU-wide regulatory regime for CSDs. As with the EMIR legislation for CCPs, the centrepiece of the proposed Regulation is a set of rules about governance, oversight, risk management and passporting for CSDs. This should make it easier for CSDs to fly over the airspace of other countries, and, in theory, to compete with the local CSD for its business.

To support that idea, CSDs will be given rights of access to trade feeds from trading platforms and CCPs, and rights to participate in each other's systems; and issuers will be given the right to "choose" which CSD holds the root of title for their securities. Whether this last thing is easy to deliver remains debatable: company law rules many aspects of securities issuance and ownership, and CSDs rooted in one company law tradition will find it challenging to provide CSD-services to foreign corporates with very different needs.

Aircraft need to be passed as safe to ply the skies and CSDs will be no exception. As well as being given privileges, CSDs will be regulated in a manner which resembles the set of rules recently agreed for CCPs in the EMIR legislation. But CSDs will not be allowed to carry on (or own other legal entities which carry on) businesses which fall outside a narrowly-defined range of core CSD functions and a handful of ancillary services which are closely associated with the core business of a CSD.

UFO

European legislative aircraft design is a strange process. All sorts of oddments get bolted onto the outside, and the proposed CSDs Regulation is no exception. For market participants these other features are worth looking out for:

- **Scope.** Typically we think of CSDs as being the central systems for settling trades in equities and bonds. The European Commission is more ambitious. The proposed Regulation uses the term "securities" in the same sense as the Settlement Finality Directive, which means all financial instruments mentioned in section C of the Annex to MiFID – that is to say, including fund units, money market instruments, derivatives, and contracts for differences within its ambit. Many of these things do not have anyone who operates a "top-tier level" set of accounts or carries out "initial recording... in a book-entry system", but if (like us) you think it will

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be difficult to explain why a set of books which records the issuance of fund units or derivatives contracts is not one of these things, then there is a big question as to whether the operator of such books is a CSD caught by the provisions of the Regulation.

- **Dematerialisation and collateral.** To help settlement services remain light and airborne, securities (in the new, wide sense) traded on regulated markets will have to be issued exclusively in book-entry form after 1 January 2020. But the drive towards dematerialisation has a knock-on effect in the world of financial collateral. If securities are to be used in a financial collateral arrangement, they must be recorded in book-entry form in a CSD, with effect from the date the proposed Regulation comes into force. This might restrict the range of eligible financial collateral, since many securities which appear to be eligible now will not be book-entry securities or recorded at CSDs, and there is no deferred start for this particular provision.
- **T+2.** By 1 January 2015 the settlement period for all "securities" traded on regulated markets, MTFs and OTFs (the new type of regulated crossing network to be regulated under the new incarnation of MiFID) will have to be cut to T+2. Most European markets seem to work on T+3 at the moment – Germany being the main exception – so this could mean significant operational work for financial firms of all types.
- **Fails coverage.** If you do not board on time, that is if you do not settle on T+2, we will offload your luggage and you can pay a fine for delaying the flight. The proposed Regulation contains a set of rules requiring CSDs to pre-identify likely failed trades and take action to forestall fails and to implement deterrent measures to facilitate timely settlement. And the buy-in period for transferable securities, money-market instruments, fund units and emissions allowances is to be standardised at S+4.

In-flight entertainment

The big question for transaction service providers is how the Regulation, coupled with T2S, is going to change the business model of CSDs. If you are an in-scope CSD, the Regulation will restrict the types of business you can do and subject you to a new set of regulatory standards which are likely to be more onerous, one way or another, than anything in force in any given country today. On the other hand, the Regulation encourages "interoperability", which in practice means that CSDs will have a right to compete with custodians and other settlement agents to provide cross-border settlement services. Since T2S will take away the operational aspects of a CSD's core functions, CSDs examining their business strategy are likely to consider that the intermediary space is a better place to fly. That way they can exploit their special protected status as insolvency-proofed "designated settlement systems" and still have a business offering.

All this seems a long haul away from getting CSDs to compete with each other for business and/or to consolidate. What the final destination looks like as the new Regulation checks in to the European process of legislative security-screening is pretty unclear. What is reasonably certain is that there will be turbulence along the way.

Commission's proposed Regulation: http://ec.europa.eu/internal_market/financial-markets/docs/COM_2012_73_en.pdf

Payments – View from the Summit

In March each year experts from the field of payments gather on a mountain-top to survey the world around them. Or, rather, they gather at "International Payments Summit" in the Lancaster Hotel in London, which is much the same thing, except that it's easier to get to and the view is not so great. One topic under discussion this year was the likely shape of PSD2 – that is, the revamped Payment Services Directive – as people could see it beginning to heave itself over the horizon. Here are some of the mountaineers' predictions:

- **Leg-out transactions will be in.** Under the PSD as it now is, payments for which the payment service provider (PSP) of either payer or payee is situated outside the EEA are outside the scope of regulation. PSD2 may change that.
- **Scope of licensing.** Regulators have become concerned that non-bank providers of ancillary services (such as repositories of security information such as PIN numbers, or on-line payment facilitators) do not need a licence under the PSD but carry on activities which raise consumer-protection concerns. It's widely expected that the regulatory net will be cast still wider.
- **Regulatory pigeon-holes.** On the other hand, the divisions (and differences of regulatory approach, eg on matters such as segregation of funds and prudential supervision) between Payment Institutions, Electronic Money Institutions, and Credit Institutions look artificial as regards the oversight of payments businesses, so there may be a move towards harmonisation.

- **Liabilities.** Expect another shake-up of who bears the losses when there is screw-up in execution of a payment transaction. It is all going to be more complicated when you accept that a payment transaction could involve, in addition to the account providers at both ends of the transaction, a selection of licensed service providers who convert, transmit and manipulate data, originate and authenticate payment instructions, check balances, issue confirmations, arrange clearing and settlement and so forth. And there is also the question of who can charge what for providing these services....

More formally, London Economics has been awarded the European Commission's contract to review a range of specific issues on the PSD; they are

expected to report later this year (see http://ec.europa.eu/comm/dgs/internal_market/calls_en.htm).

If the experience of the first PSD is anything to go by, the policy-makers will use the opportunity provided by its overhaul to include a range of retail-banking reforms which have been difficult to fit into other parts of the legislative agenda. Keep those telescopes trained.

Market Developments
Securities Services

1. T2S

The European Central Bank has given an update on the T2S project.
http://www.ecb.int/paym/t2s/pdf/T2Sonline_11.pdf?6acb45e2c399fbf70a9645c8bd5c0662

2. LSE rules

The London Stock Exchange (LSE) has issued a Notice (N02/12) confirming the adoption of proposed rule amendments following a review of its settlement, clearing and corporate action rules. The confirmed rule amendments became effective on 1 February 2012.

LSE docs:
http://www.londonstockexchange.com/traders-and-brokers/rules-regulations/change-and-updates/stock-exchange-notices/2012/n0212.pdf

http://www.londonstockexchange.com/traders-and-brokers/rules-regulations/change-and-updates/stock-exchange-notices/2012/n0212_attach1.pdf

http://www.londonstockexchange.com/traders-and-brokers/rules-regulations/change-and-updates/stock-exchange-notices/2012/n0212_attach2.pdf

3. AIFMD consultations

Various bodies have been consulting on implementation of the Alternative Investment Fund Managers Directive, which will (among other things) affect the liability of depositaries acting for all varieties of non-UCITS funds targeting Europe for investors. What we're all waiting for though is the draft level 2 legislation, which will be made by the European Commission following the ESMA consultation carried out in Q3 of 2011.

UK government:
http://www.hm-treasury.gov.uk/d/condoc_policy_options_implement_aifmd.pdf

ESMA:
http://www.esma.europa.eu/content/Discussion-paper-Key-concepts-Alternative-Investment-Fund-Managers-Directive-and-types-AIFM

FSA DP12/01:
http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/discussion/dp12-01.pdf

Payments and Cash Management

1. When did the client money cross the road?

What a riddle : the fact that the Lehman client money judgment split the UK Supreme Court 3-2 tells you that the UK Client Money Rules are in a state of disarray. Money in a "prop" account can be "client money" if the account-holder is using the "alternative" approach to client money segregation. What the implications and consequences of this are remain to be worked out.

Supreme Court Judgment (reference [2012] UKSC 6):
http://www.supremecourt.gov.uk/docs/UKSC_2010_0194_Judgment.pdf

Clifford Chance briefing:
http://www.cliffordchance.com/publicationviews/publications/2012/03/supreme_court_decisiononlehmanclientmone.html

2. FINRA and FATCA

The US Financial Industry Regulatory Authority (FINRA) has issued guidance on the need to verify emailed instructions to transmit or withdraw assets from customer accounts. The notice indicates that FINRA has received an increasing number of reports of incidents of customer funds being stolen as a result of instructions emailed to firms from customer email accounts that have been compromised. On the subject of customer accounts, the big US story is probably the developments relating to the Foreign Account Tax Compliance Act (FATCA): the Department of the Treasury and the Internal Revenue Service have proposed regulations implementing its information reporting and withholding tax provisions; and a joint statement was made by five EU member states indicating that they will adopt an intergovernmental approach to information exchange to address legal difficulties and compliance burdens that would otherwise arise for financial institutions affected by FATCA.

FINRA:
http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125462.pdf

US Dept of the Treasury statement on FATCA:
http://www.treasury.gov/press-center/press-releases/Pages/tg1412.aspx

Joint statement by France, Germany, Italy, Spain and the UK on FATCA:
http://www.hm-treasury.gov.uk/joint_intl_statement_fatca.htm

Clifford Chance FATCA briefing:
http://www.cliffordchance.com/publicationviews/publications/2012/02/fatca_the_new_regulationsandwhattheymea.html

3. Green about the gills

The long-awaited Green Paper from the European Commission on card-, electronic-, and mobile-payments has been issued. Described at International Payments Summit as a "serious document" this outlines the policy plans which the Commission has for these classes of payment. With traditional sources of banking revenue under threat, with competitors encroaching on income derived from payments processing, with Basel III altering the economics of clearing and cash management services, and with interchange fees doomed, banks are having to re-do their strategic planning. Although you might feel queasy reading the Green Paper, any new strategy needs to take account of likely shifts in regulatory policy.

Green Paper:
http://ec.europa.eu/atoz_en.htm

4. Payment Systems Access after the Crisis

There is an ongoing, unresolved spat going on over bust banks and payment systems. On the one hand, payment systems need to have tightly controlled conditions of access, which suggests that only robust banks can participate, and smaller banks should access indirectly. But big banks may be systemically important, which argues in favour of small banks having direct access. Payment services in the UK will have to be provided by "ring-fenced entities" when the split between retail/commercial banking and investment banking is completed following the Vickers Report. And it is believed that the toolkit for resolving failing banks should allow for the payment-systems-access function of a bank to be lifted out and transferred to another bank in a time of crisis. Reconciling all these policy objectives is a tough challenge. A selection of some recent thinking includes:

Bank of England speech:
http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech542.pdf

UK Government response to Vickers Report (paras 4.13-4.14):
http://www.hm-treasury.gov.uk/fin_stability_regreform_icb.htm

5. Detergent

More on money laundering from FATF and from the UK authorities. The FATF has revised its recommendations on international standards on combating money laundering and the financing of terrorism, prompting the UK Treasury to echo the FATF's conclusions and underline certain key messages. A debate is going on about credit transfers needing to have full payee information to complement the existing requirement to have full payer information accompany a transfer. And the UK's Joint Money Laundering Steering Group (JMLSG) has published the final amendments to its December 2007 Money Laundering Guidance.

FATF:
http://www.fatf-gafi.org/dataoecd/49/29/49684543.pdf

JMLSG:
http://www.jmlsg.org.uk/news/further-amendments-to-2007-guidance-20-december-2011

HMT commentary:
http://www.hmtreasury.gov.uk/d/financial_sector_advisory_mar2012.pdf

6. SEPA Regulation

Payments regulation never stops. The text of the SEPA Regulation was agreed at the end of February. Discussions are now going on in the industry about what it means for operations and for client documentation. And then there is the "big BIC" debate: once the Regulation comes into force, clients who quote an IBAN will be able to rely on their bank to find the relevant BIC and they can't be charged a fee for this. The European Payments Council's January newsletter contains a few articles on the Regulation.

SEPA Regulation text (17 February edition – official version still awaited):
http://register.consilium.europa.eu/pdf/en/11/pe00/pe00076.en11.pdf

EPC newsletter:
http://www.europeanpaymentscouncil.eu/newsletter.cfm

Commentary by France, Czech Republic, Austria and Estonia on the BIC problem:
http://register.consilium.europa.eu/pdf/en/12/st06/st06574-ad01.en12.pdf

See also the Clifford Chance commentary:
http://www.cliffordchance.com/publicationviews/publications/2012/02/the_sepa_regulationtheclockisticking.html

7. Personal and confidential

The European Commission's proposal for overhaul of the data protection regime was issued on 25 January. It's going to be a Regulation now. Read all about it in Clifford Chance's comment paper.

Legislative proposal:
http://ec.europa.eu/justice/newsroom/dataprotection/news/120125_en.htm

http://www.cliffordchance.com/publicationviews/publications/2012/03/the_new_world_ofeudataprotectionregulation.html

Clearing

1. You read it here first

In an earlier edition we suggested that the proposed merger between Deutsche Börse and NYSE Euronext might raise difficult questions with regard to clearing. As it turns out, this aspect of the combined offering was one of the residual issues which troubled the competition regulators, leading to the blocking of the deal.

DG Competition press release:
http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/94&format=HTML&aged=0&language=EN&guiLanguage=en

2. You didn't clear it here first

As you know, agreement was reached in February on EMIR - the legislation which will compel dealers in, and some users of, OTC derivatives to put clearing arrangements in place, and regulate CCPs. The legislation will require all European CCPs, not just those that clear OTC derivatives, to have "segregation and portability" machinery which enables a client using the services of a clearing member to transfer their portfolio of cleared transactions to another clearing member if their first-choice clearer goes bust. Like everyone else, we are waiting for the official publication of EMIR to get the definitive text.

EU Commissioner Barnier statement:
http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/12/90&format=HTML&aged=0&language=EN&guiLanguage=en

3. Big issue, little consultation

Given the ambitious timetable for getting its secondary legislation in place, ESMA issued a mini-consultation on what it will have to do under EMIR. In practice this gives little away on ESMA's policy thinking.

ESMA consultation:
http://www.esma.europa.eu/consultation/Consultation-Draft-Technical-Standards-Regulation-OTC-Derivatives-CCPs-and-Trade-Reposi

4. Unclear to some

ESMA is not working alone. The European supervisory agencies have also issued a spate of consultations on issues related to clearing (uncleared trades and CCP capital), IOSCO came out with recommendations on how mandatory clearing regimes should be structured, and the Bank for International Settlements has also issued a working paper on the amount of collateral needed to support mandatory clearing.

ESAs:
http://eba.europa.eu/cebs/media/aboutus/News%20and%20Communications/JC-DP-2012-01-ver1--Draft-discussion-paper-on-RTS-on-Article-6-3-EMIR-.pdf

EBA paper on CCP capital:
http://eba.europa.eu/cebs/media/aboutus/News%20and%20Communications/EBA-DP-2012-01--Draft-discussion-paper-on-RTS-on-Article-12-3-EMIR-.pdf

IOSCO:
https://www.iosco.org/library/pubdocs/pdf/IOSCOPD374.pdf

BIS working paper:
http://www.bis.org/publ/work373.pdf

5. UK CCPs

The FSA has issued final guidance to UK CCPs on counterparty risk management issues such as margin and default funding. And LCH. Clearnet obtained regulatory approval in the UK for its foreign exchange clearing service.

FSA document:
http://www.fsa.gov.uk/static/pubs/guidance/fg12-03.pdf

LCH press release:
http://www.lchclearnet.com/media_centre/press_releases/2012-03-13.asp

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