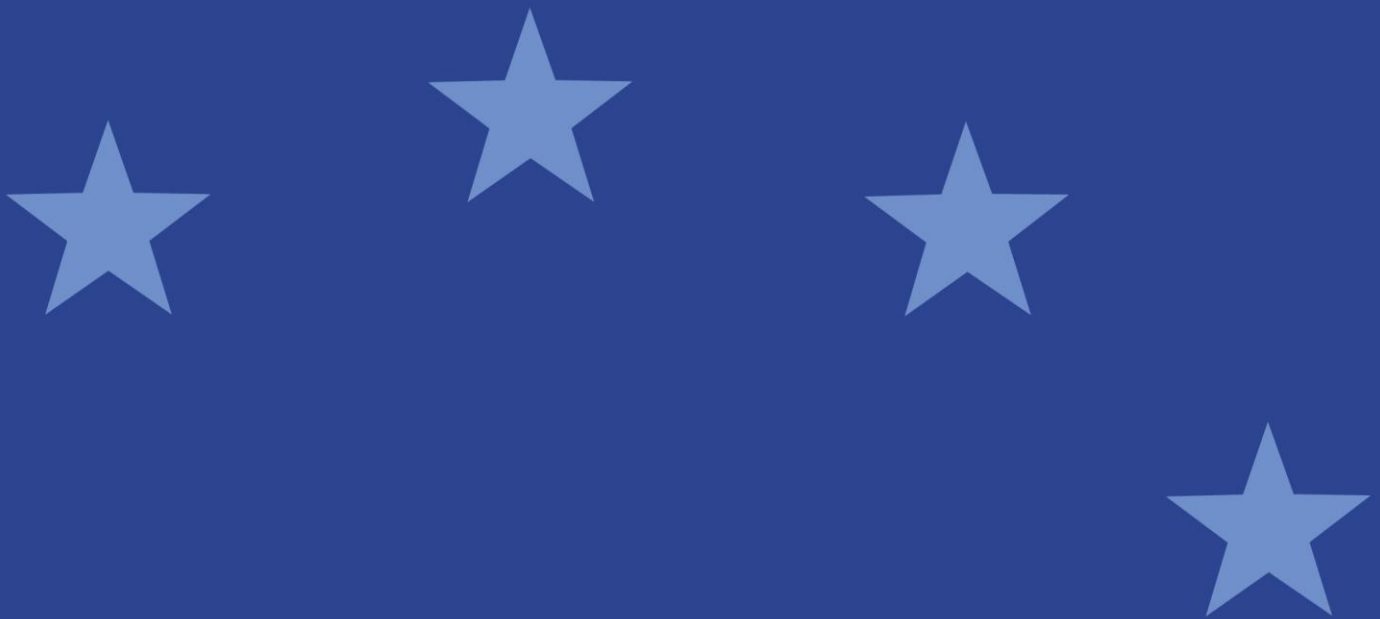




European Securities and
Markets Authority

Consultation Paper

Technical Advice under the CSD Regulation



Who should read this paper

All interested stakeholders are invited to respond to this consultation paper. In particular, responses are sought from CSDs, CSD participants, CCPs, market participants, and issuers.

Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex I. Comments are most helpful if they:

1. respond to the question stated;
2. indicate the specific question to which the comment relates;
3. contain a clear rationale; and
4. describe any alternatives ESMA should consider.

ESMA will consider all comments received by **19 February 2015**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations', using the [reply form](#).

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading [Legal Notice](#).

Who should read this paper

This document will be of interest to all stakeholders involved in the securities markets, in particular CSDs, CSD participants, CCPs, market participants, and issuers.



Table of Contents

1	Executive Summary	5
2	Penalties for settlement fails	11
2.1	Parameters for calculating the basic cash penalty	11
2.2	The increase or reduction of the basic amount of the penalty	17
2.3	Parameters for the calculation of cash penalties in the context of chains of interdependent transactions	19
3	Substantial Importance of a CSD	20
3.1	Introduction	20
3.2	Overview	21
3.3	Assessment of the ‘substantial importance’ of notary services	22
3.4	Assessment of the ‘substantial importance’ of central maintenance services	22
3.5	Assessment of the ‘substantial importance’ of settlement services	25
3.6	Market consolidation affecting host Member States	26
3.7	Additional considerations	28
3.8	Summary of the proposed indicators	29
	Annex I Summary of questions	32
	Annex II EC mandate on the level of penalties for settlement fails	33
	Annex III EC mandate on the substantial importance of a CSD	39

1 Executive Summary

Reasons for publication

1. On 7 March 2012 the European Commission (EC) proposed a Regulation 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 (CSDR). On 18 December 2013, the European Parliament and the Council of the European Union agreed the CSDR text. On 26 February 2014, the Permanent Representatives Committee, on behalf of the Council of the European Union, confirmed the agreement with the European Parliament. On 15 April 2014, CSDR was formally adopted by the European Parliament. On 16 July 2014 the European Parliament and the Council published the agreed text, ready for publication in the OJ. Finally, the CSDR was published in the OJ on 28 August 2014 and entered into force on 17 September 2014.
2. Additionally to the mandate to draft technical standards therein, on 23 June 2014 ESMA received a provisional request (mandate) from the EC to provide technical advice to assist the EC on the possible content of the delegated acts required by two CSDR provisions: penalties for settlement fails and the substantial importance of a CSD. On 2 October 2014, following the publication of the CSDR in the OJ and its entry into force, ESMA received the confirmation¹ from the EC that the respective mandates should no longer be considered as provisional but as final. ESMA is required to submit the technical advice to the EC by 18 June 2015, in tandem with the draft technical standards under CSDR.

Contents

3. This Consultation Paper covers the matters to be contained in the technical advice that ESMA intends to provide to the EC on penalties for settlement fails and on substantial importance, as further specified in the Annexes.
4. ESMA has prepared this Consultation Paper (CP) in order to consult interested parties for the purpose of producing its technical advice to the EC. Respondents to this consultation are encouraged to provide the relevant background information and qualitative and quantitative data on costs and benefits, as well as a concrete redrafting proposal, to support their arguments where alternative ways forward are called for.

On penalties for settlement fails

5. The CSDR introduces an obligation to settle instructions on the intended settlement date and provides for the application of a daily cash penalty to failed settlement

¹ http://www.esma.europa.eu/system/files/20141002_esma_-_csdr_mandates.pdf

instruction. In the DP, ESMA could not provide a detailed analysis in view of the early stage of the process. However, some stakeholders expressed their views in their answers. ESMA has analysed those contributions in order to prepare for this section of the CP.

6. It is important to note that the consultation on the cash penalty is divided on two consultations: one that relates to the penalty mechanism as it relates to the draft RTS, and this one that focuses on the parameters to set the level of the cash penalty as it relates to a technical advice.
7. The EC has asked ESMA to provide the former with technical advice on:
 - i. the parameters for calculating the cash penalty that a CSD will normally charge for settlement fails (i.e. the basic amount of a cash penalty);
 - ii. the circumstances that may justify an increase of the basic amount of the cash penalty and the parameters for the calculation of such an increase, whilst applicable under an automated system;
 - iii. the circumstances that may justify a reduction of the basic amount of the cash penalty and the parameters for the calculation of such a reduction whilst applicable under an automated system; and
 - iv. how to adapt the parameters for the calculation of cash penalties in the context of a chain of interdependent transactions and whether there are cases where this would not be possible (e.g. the chain would not be visible).

On the substantial importance of a CSD

8. One of the objectives of CSDR is to complete the internal market by also fostering an internal market for CSD services. To achieve this, Article 23 CSDR allows any EU-registered CSD to provide its services in any Member State of the Union (EU passport).
9. Article 24 CSDR provides for various cooperation measures between home and host Member States' competent authorities where a CSD provides its services cross-border. More specifically, Article 24(4) of CSDR provides that home and host competent authorities shall establish formal cooperation arrangements for the supervision of a CSD where the activities of such CSD have become "of substantial importance for the functioning of the securities markets and the protection of the investors" in the host Member State.
10. In order to implement this, Article 24(7) CSDR requires the EC to adopt delegated acts concerning measures for establishing the criteria under which the operations of a CSD in a host Member State could be considered "of substantial importance for the functioning of the securities markets and the protection of the investors" in the host Member State.

11. On this basis, the EC has asked ESMA to consider its own experience and from that of national authorities concerning the provision of CSD services and provide the EC with technical advice on:

- i. initial recording of securities in a book-entry system ('notary service');
- ii. providing and maintaining securities accounts at the top tier level ('central maintenance service'); and
- iii. operating a securities settlement system ('settlement service').

The EC has also asked ESMA to consider the three core services in the cases of:

- i. market consolidation affecting host Member States; and
- ii. branching into host Member States.

12. The EC provided ESMA with a number of principles and details on the above bullet-points, copied in the Annex and analysed under each appropriate section of this Consultation Paper.

Next Steps

13. ESMA will consider the responses it receives to this Consultation Paper (CP), and will finalise the technical advice for submission to the EC by 18 June 2015.

14. ESMA will finalise the impact assessment regarding the proposed measures, which will be included in the Final Report to be submitted to the EC. One essential element in the development of technical advice is the analysis of the costs and benefits that the proposed measures would imply. The limited information available did not allow ESMA to produce a quantitative impact study for the purpose of this CP. The input from stakeholders will help ESMA in finalising the technical advice and the relevant impact assessment. Therefore, respondents to this consultation are encouraged to provide the relevant data to support their arguments or proposals.

15. ESMA is aware of the need to use consistent data at EU level for the calculation of the indicators for determining substantial importance. It may therefore be necessary to establish a mechanism for the collection, processing and aggregation of the data necessary for the calculation of the indicators. ESMA is currently analysing the most appropriate way to establish such a mechanism.



Acronyms and definitions used

CCP	Central counterparty
EC	European Commission
CP	Consultation Paper
CSD	Central Securities Depository
DA	Delegated act to be adopted by the EC
ESMA	European Securities and Markets Authority
ESMA Regulation	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC
ETF	Exchange-traded fund
EU	European Union
ITS	Implementing Technical Standards
MS	Member State
OJ	The Official Journal of the European Union
OTC	Over-the-counter
RTS	Regulatory Technical Standards

2 Penalties for Settlement Fails

16. In order to prepare for the technical advice, ESMA has analysed the penalty mechanisms that are currently in place in some markets at CSD and CCP level, in and out of the Union. Those models are all different and it is not possible to conclude whether one model is more efficient than the others. No single current approach was favoured and all mechanisms were used as a source of inspiration for the purpose of this technical advice.
17. In the mandate to ESMA, the Commission shares its view that the penalty should take into account the value of the transaction in order to be deterrent and proportionate and stresses that the parameters should be sufficiently simple to be applied via an automated system.
18. In the Discussion paper, there was no detailed analysis on the level of the cash penalty given that ESMA had no mandate yet. Nonetheless, stakeholders indicated their strong preference for a simple approach that would ease an automated implementation and limit associated costs.

2.1 Parameters for calculating the basic cash penalty

19. In its mandate the European Commission indicates some principles for ESMA to take into account when preparing the technical advice. The cash penalty should relate to the value of the transaction that fails to settle and the principle of neutrality concerning the securities holding models should apply. It means that a given securities holding model should not be significantly disadvantaged.
20. The Commission also notes the deterrent characteristic of the penalties that should lead to improve the levels of settlement efficiency, to the extent possible.
21. Finally, the cash penalty should be proportionate and take into consideration the specificities of the different asset types, the liquidity and category of transactions.
22. In this framework, in order to determine the relevant parameters, ESMA has analysed (1) the basis on which the penalty should be calculated and (2) the penalty formulae or rate that should be applied on that basis in order to calculate the penalties amount.
23. It is important to keep in mind that the approach for the calculation of the daily basic cash penalty relates to settlement instructions that fail to settle on ISD and apply both to fails due to lack of cash and lack of securities.

2.1.1 The basis for the cash penalty calculation

24. Depending on the transaction underlying the settlement instruction (e.g. repo, straight sale), the price indicated in the instruction may substantially vary from one instruction to the other for the same financial instruments. It could even be set to zero in the case of FOP instructions. Given that the penalty should have a deterrent effect, it would not be appropriate to consider the price set in the settlement instruction for the purpose of the penalties calculation.
25. For the purpose of harmonizing the approach across the Union, and in order to facilitate and simplify the calculation of penalties among CSD and their participants, the basis on which the penalty amount should be calculated, should be the same for an identical number of financial instruments which are failed to be delivered on a given ISD or thereafter. This implies that the variable component that takes into account the value of the transaction that fails to settle should be calibrated not on the price of the specific transaction that is failing, but on a reference price of the instrument involved. This reference price could be used for all calculations of penalties involving such instrument on a given day, across participants, and across CSDs.
26. Furthermore, the homogenization of the ad valorem component reflected above addresses the issue of FoP settlement instructions and non-market considerations, for instance in the context of cleared settlement instructions or, settlement instruction that does not bear an economic rationale by itself, and at the same time respects the proportionality and effectiveness of the penalty.
27. In order to determine the price to be used, it should be referred to the closing price of the regulated primary market for the relevant financial instrument. Alternatively, when such closing price would not be available, the price of the most liquid trading venue for the relevant instrument should be used. The price would reflect the market price and would be similar across CSDs. When none of these would be available, a pre-determined methodology to calculate the relevant price should be used referring as much as possible to criteria related to the markets data such as market prices available across trading venues or brokers.

Partial deliveries

28. In the proposed draft RTS, CSDs are required to offer the “partials” functionality to their participants. This measure aims at facilitating the settlement, even for a part, of the settlement instruction. Following that approach, when a receiving participant does not accept partials, the penalties applicable to the failing delivering participant should only apply to the missing financial instruments or the missing part of the cash. As the impossibility to partially deliver is due to the choice of the receiving participant, the delivering participant should not be penalised.
29. However, in situations where the partial delivery of financial instrument or cash is not accepted by the failing participant, the penalties should apply on the total amount of the

failing settlement instruction. This approach is justified by the fact that the receiving participant would have no responsibility in the delivery not taking place, even on a partial basis and may itself be subject to penalties for the full amount if it has entered into a subsequent transaction. Limiting the amount of the penalties to the missing part only would allow achieving higher settlement efficiency rates, which is the aim of the penalty regime.

Q1: What are your views on the proposed basis for the cash penalty calculation?

2.1.2 The penalty rate

30. Following the mandate received by the Commission, ESMA has considered the specificities of the different asset types, the liquidity and category of transactions when analysing the approach to be recommended.

The category of transactions

31. Most of the settlement instructions do not include information on the category of transaction it relates to. Indeed, the instruction does not indicate whether the underlying transaction is for instance a loan of financial instruments, part of a larger operation.

32. Furthermore, in the context of chains of fails, the transaction type may introduce a different penalty depending on the type of transactions and could create imbalances between the different parties in the chain limiting the mitigating effect of the redistribution of the penalties.

33. In view of the above, ESMA is of the view that the category of underlying transaction to which the settlement instruction relates should not lead to different penalty rates.

The asset type and liquidity of the financial instruments

34. The asset type of the financial instruments provides information on the settlement structure that is applicable and which may differ from one asset type to another. For instance, the settlement of ETF involves a different pre-settlement structure than the settlement of sovereign bonds or shares. It is therefore indeed important to analyse the asset type of the financial instruments in order to determine the penalty rate.

35. Liquidity is important as it will impact how special is the financial instrument and therefore the borrowing costs for such instruments. The less liquid is an instrument, the most difficult it will be to source it and the more expensive it will be to borrow it. It is therefore an important element for consideration in order to set the penalty rate.

36. As liquidity of a financial instrument may be complex to ascertain and can change rapidly depending on specific and contingent market conditions, considering the need to automate the system, it is not the liquidity of the specific financial instrument on the day of

the fail that should be considered, but rather the expected liquidity based on the asset type. This approach would be in line with the requirement of simplicity and of automation and would allow duly considering the liquidity of the relevant instruments. In particular, the penalty rate has been set in a manner that duly considers the liquidity of the instruments in the following manner: the penalty rates are higher for the most liquid instruments and lower for the instruments that are less liquid. In this manner, these rates would strongly incentivise the borrowing for instruments that have a liquid market and are easy to source (thus the fails can be prevented by borrowing the relevant instruments). However, for the less liquid instruments the penalty rate would be closer to the borrowing cost thus maintaining the deterrent effect, but not penalising excessively these types of instruments and maintaining the smooth functioning of the market.

The recommended approach

37. In order to determine the rate that should be applied for the penalties rate per asset type/liquidity, it is important to note that the penalty is not structured to compensate for the loss that a counterparty may suffer and that is part of the contractual arrangement between the counterparties. Therefore it is not designed to replicate exactly the loss incurred by the failed participant, or the gains achieved by the failing participant. The purpose of the penalties is to be sufficiently deterrent and to introduce the desired incentives to prevent and reduce settlement fails. It also is an add-on to any claim in compensation that the failed party may contractually have over the failing counterparty.
38. For the purpose of calibration, and so as to advise levels that are deterrent and proportionate, ESMA considered the effects of the penalty for participants in view of the costs and consequences of a failed trade.
39. Considering the effects of a failed trade, and assuming that the settlement will eventually be carried out, at a later date, as opposed to the trade being cancelled, ESMA considers appropriate for the purpose of the analysis to take as a framework the situation of securities financing transaction, where the failing participant borrows the security for the time the failing settlement persists. This framework is also consistent with a likely solution of the fail, which is for the failing participant to borrow the security for good delivery, thus incurring a cost. In order to calibrate a penalty that is both proportionate and deterrent and incentivize curing the fail, ESMA notes that the penalty should be set at a level that is consistent, and possibly higher, than the cost of borrowing the failed financial instruments.
40. Regarding the spreads for securities borrowing, their range varies according to the value either as collateral for financing purposes, in which case the securities are qualified as “general collateral”, with a spread of borrowing above money market rate (the party that borrows the money pays on top of money market rate a spread because he is doing the transaction for financing purpose), or because of their specific nature in which case the securities are qualified as “special” (because securities encounter a corporate action, a dividend, because they are sought by market participants).

41. ESMA considered the possibility of linking the penalty rate to the prevailing market conditions for borrowing the security on the securities lending market, plus a mark-up to introduce the desired incentives. However, this approach was considered too complex to be implemented and maintained.
42. Indeed, prices are security specific. The above approach would introduce excessive granularity in the calculation of the penalty. Prices may also be very volatile which would introduce uncertainty in the determination of the penalty. Furthermore, prices are formed on OTC markets, and often not transparent, leading to difficulty for CSDs to ascertain them. Finally, the liquidity of the market may be discontinuous, with some instruments being liquid for some time and illiquid thereafter. As a result, the complexities introduced by this solution seem disproportionate and not adding significantly to the benefits of a simpler solution.
43. Considering the need to automate the penalty mechanism, a penalty rate in the form of a set table of values considering the asset class and liquidity, which are related but not the direct result of the cost of borrowing of each financial instrument, and which is simple to automate, delivers certainty to participants, and achieves the objectives of deterring settlement fails.
44. In this framework, ESMA has considered the specificities of different asset classes.

Equities

45. Equities should be the least problematic to source on the market, and therefore a higher penalty is needed to strongly disincentive unavailability of securities in a context where sourcing them is least disruptive to the market. Furthermore equities are most likely to be involved in long chains of fails, and a high penalty incentivizes participants to break the chains of fails and address the issue of limiting multiple buy-in.

Fixed Income

46. In defining penalties for government bonds, due consideration is given to the typical large size of these transactions and their importance for the financial system. Therefore it is advised that a smaller coefficient be applied to government bonds, which are normally large in size and involved in transactions which are extremely sensitive to even small price variations. A relatively small penalty should be sufficiently effective as a deterrent and an incentive to remediated failed chains.
47. For corporate bonds, the approach should be adapted from that proposed for government bonds as these instruments are usually less liquid than government bonds and transactions are smaller in size. The penalty should therefore be low but higher than for government bonds.

Other financial instruments



48. The approach on other financial instruments is motivated by the fact that these will often be OTC bilateral transactions, or relates to financial instruments such as ETF, DR which may be less liquid than the bonds instruments. Counterparties could face each other directly or have a less liquid market. In these cases a higher penalty than for fixed income should be enforced to ensure settlement discipline. However, the penalty should not be higher than for equities in view of the volume and size of the transaction on such financial instruments.
49. Fails due to the lack of cash should be subject to an equal rate for all transactions, given that the cause of the fail is always due to a lack of cash and this is independent from the type of transaction or financial instruments to be bought. Therefore the penalty should be particularly deterrent and not being related to unavailability of the instrument to be settled, but only to temporary lack of cash of a participant or one of its clients.
50. Similarly to the reasoning above on the lack of securities, the borrowing cost should be considered as a basis for the calculation of the penalty, as one of the remedy to avoid failing would be to borrow the missing cash. In the case of cash this borrowing cost is widely available in a transparent manner. Against this background, the most appropriate rate for fails to deliver cash should be the official discount rate for the relevant currency.
51. Most stakeholders that expressed a view in respect of the penalty rate call for a limited number of categories to support a cost effective implementation of the cash penalty system.
52. In order to propose the appropriate penalty rates ESMA has considered the above as well as the liquidity of the markets for the different asset types, the need to provide a strong incentive for the types of instruments that are more easy to source and for the others an incentive while preserving the smooth functioning of the markets. As a result, and in order to limit the number of categories of rates to apply for automation reasons, ESMA considers as appropriate the following levels for the calculation with regard to the penalty rates:

Asset Type	Size of transaction	Proposed daily flat penalty rate
Equities others	and Single fail size is modest compared to volumes, and in absolute terms	1.0bp

Government bonds	Very large transactions	0.25bp
corporate bonds	Size of transactions varies	0.5bp
Cash	Size is not a driver	Discount Rate per currency

53. In order to keep the levels relevant and effective and to allow for calibration and adaptation to changing market conditions and monitor the overall efficacy of the proposed measures, ESMA should be mandated to review the table of penalty rates on an ad hoc basis when market conditions are changing and provide an updated technical advice to the Commission.

54. For the sake of completeness, it is worth noting that ESMA also analysed an approach based on the TMPG applied for US treasuries at clearing level. Although, the model is designed to apply on trade consideration and not on mark-to-market value and lead to a zero penalty in case of low money market conditions, it was adapted, for the purpose of the analysis, to the circumstances of the penalty mechanism provided for by the Regulation. However, the approach was considered complex with results that would risk be less predictable.

Q2: What are your views on the proposed approach regarding the categories of financial instruments and the penalty rates? In particular, do you consider that these penalty rates could dis-incentivise trading in small caps? Please provide evidence to support your views.

2.2 The increase or reduction of the basic amount of the penalty

55. In view of the mandate granted by the Commission, ESMA has considered circumstances where the basic penalty should be either increased or decreased. In this respect, due consideration was given to the draft RTS on penalties and the Commission suggestion to take into consideration the chain of interdependent transactions.

56. The mechanism provided for in the RTS on penalties, allows the full amount of the collected penalty to be redistributed to the suffering participant. This approach allows mitigating the impact of the penalty in a chain of interdependent transactions. If a participant is in the middle of a chain, it will receive the same amount as that it would pay as a penalty. While incentivizing each intermediary in the chain to take action and cure the fail (as in this case it keeps the amount redistributed and is not charged with a penalty) this provides for a way to limit the negative effect the penalty because the amount received and paid are the same.
57. This approach also prevents negative impact on the risk profile of the CSD, trading venue or CCP and simplifies the implementation and management of the penalty mechanism as they only distribute what they collect.
58. A reduction or an increase of the penalties in different and various circumstances such as exceptional or repeated fails, would break the balance of the system described above and make more complex its implementation and management without bringing substantial additional benefits. Indeed, it is worth noting that, in view of the analysis of the current penalty systems that are applied, even though some do provide for a possible increase of the penalty, such increase is not applied and it was not considered efficient in order to further incentivize settlement discipline. Fails could result from different problems including technical difficulties.
59. For both the increase and decrease of the basic penalty amount, ESMA is of the view, as most stakeholders, that in a first stage the system should be simple and that therefore no decrease or increase should be used. In a second stage, depending on the outcome of the penalty mechanism on settlement efficiency, it may be necessary to review the approach. It could then be assessed whether applying a reduction or an increase of the basic penalty mechanism would support further enhancement of the settlement efficiency. A process should therefore be foreseen for revision of the approach at a later stage.
60. In their answer to the DP, some stakeholders have raised the issue of the financial instruments that cannot be settled for reasons that are independent from the participants or CSDs. In such situations, they consider unfair to be charged a penalty when they cannot take action in order to cure the settlement fail. ESMA understands that situation and proposes that in the limited circumstance where settlement cannot be performed for reasons that are independent from any of the participants or the CSD, the penalty would not be charged. In order to achieve that exception, it should be possible to reduce the amount of the penalty to zero. Examples of these occurrences may be a suspension of the instrument from trading and settlement due to reconciliation issues, specific corporate actions which imply the instrument no longer exists, or technical impossibilities at the CSD level. In order to prevent abuse, these exemptions should be approved by the Competent Authority, either through approval of the CSD procedures detailing in which specific cases penalties do not apply, or on a case by case basis.

Q3: What are your views on the proposed approach regarding the increase and reduction of the basic penalty amount?

2.3 Parameters for the calculation of cash penalties in the context of chains of interdependent transactions

61. In order to effectively reduce the number of failed instructions, and improve settlement efficiency in the Union, the focus of the penalty regime should be to disincentives the original fails, which are the root cause of the issue. This is best achieved by designing a penalty mechanism where penalties are paid by the failing party and are received by the non-failing party. Such a mechanism should be effective in targeting participants which fail to deliver the securities on ISD, and which should be fully subject to the penalty, but should also immunize participants that are failing because they are being failed in turn, because the penalty due would be offset by the penalty received.
62. Redistributing penalties for an amount equivalent to that collected achieves the objective of addressing the issue of chain of interdependent transactions, whether visible or not, as requested in the mandate.
63. For this reason, it is important that the balance between the amount collected and distributed as proposed in the RTS be maintained, and be similar across the different structures involved in the penalty mechanism. As a result the parameters for the calculation of the penalties should not be modified in order to address the situation of chains of interdependent transactions.

Q4: What are your views on the proposed approach regarding the cash penalties in the context of chains of interdependent transactions?

3 Substantial Importance of a CSD

3.1 Introduction

64. Article 24(7) of Regulation (EU) No 909/2014 (CSDR) requires the European Commission (EC) to adopt delegated acts concerning measures for establishing the criteria under which the operations of a CSD in a host Member State could be considered “*of substantial importance for the functioning of the securities markets and the protection of the investors*” in that host Member State, in which case the competent authority of the home Member State and of the host Member State and the relevant authorities of the home Member State and of the host Member State shall establish cooperation arrangements for the supervision of the activities of that CSD in the host Member State.
65. On 2 October 2014 ESMA received a mandate to provide the EC with technical advice on this matter. The EC finds that the assessment of *substantial importance* needs to focus on the core CSD services (i.e. market infrastructure services) listed in Section A of the Annex to the CSDR (initial recording of securities in a book-entry system, central maintenance and settlement services, including securities and cash settlement provided by CSDs).
66. Therefore, the ancillary services listed in Sections B and C of that Annex that are not strictly speaking core market infrastructure services should not be considered beyond their complementary role to the core services to which they relate.
67. It is also the view of the EC that the assessment of the *substantial importance* should be done from the perspective of the host Member State and not from that of the CSD (i.e. a larger CSD may have limited non-substantial activities in a smaller Member State from the perspective of the CSD. Nevertheless, its service may be of *substantial importance* from the perspective of the host Member State).
68. ESMA’s technical advice aims at assisting the EC in formulating a delegated act on the criteria to assess the *substantial importance* of the CSD’s activities concerning the following three CSD core services and two related issues:
- (a) Initial recording of securities in a book-entry system ('notary service');
 - (b) Providing and maintaining securities accounts at the top tier level ('central maintenance service');
 - (c) Operating a securities settlement system ('settlement service').
69. In addition, these three core services need to be considered also in the following situations:
- (a) Market consolidation affecting host Member States; and
 - (b) Branching into host Member States.

3.2 Overview

70. As general principles, the number of indicators, the respective thresholds and the frequency for assessments should be defined in a way to: (i) capture CSDs of **substantial** importance with respect to core services offered to host Member States (ii) allow for a **practical and straightforward indicator based framework** to be regularly assessed by competent authorities (iii) **avoid an over-excessive number of cooperation arrangements** and ultimately **ensure an efficient and effective supervision/oversight** of CSDs/SSSs.
71. Each indicator is linked to a core service, on a standalone basis or in conjunction with an ancillary service. In the latter case, a sub-indicator is defined in connection to the core service.
72. Each main indicator is to be looked at separately. That is to say that if the result of the calculation in any of the main indicators is above the predefined threshold, this will indicate that the measured activity of a home CSD is substantially important in the host Member State. In addition, when a sub-indicator is defined, it is necessary that the result of the calculation for main indicator and the sub-indicator both exceed two predefined thresholds (in which case, the main indicator threshold has been decreased to leave room for the sub-indicator). On the other hand, a sub-indicator exceeding the predefined threshold does not on a standalone basis demonstrate substantial importance of a CSD in another Member State.
73. The determination of the thresholds is of utmost importance. The thresholds should be defined in a way as to solely capture CSDs of **substantial** importance for the host Member State. By doing so, the establishment of an over-excessive number of cooperative arrangements, potentially impacting the efficient and effective supervision/oversight of CSDs/SSSs should be avoided.
74. The competent authority of the host Member State should apply the indicators set out in this technical advice and assess substantial importance every year. This frequency is being proposed for practical reasons, given that the data required for the calculation of the indicators is quite extensive, involving aggregation at EU level.

Q5: Do you agree with the proposed frequency of one year for the assessment of the substantial importance of a CSD in another Member State?

3.3 Assessment of the 'substantial importance' of notary services

3.3.1 Scope of financial instruments to be included

75. ESMA has considered whether the assessment should cover all financial instruments issued by host Member State issuers, and concludes that all instruments where possible should be covered in order to include the full spectrum of issued securities.

76. ESMA has considered whether the assessment should capture the law that governs a financial instrument. Since issuers may opt to issue in a particular jurisdiction depending on their targeted investors and/or type of instruments, it does not seem appropriate to focus on instruments that are governed by a certain law, as this may not capture the full extent of the notary services by a host CSD in a home Member State.
77. In addition, since issuers may opt to issue securities in jurisdictions other than their principal place of incorporation, ESMA proposes the use of a criterion linked with the jurisdiction where the issuer is incorporated.

3.3.2 Criteria to assess the substantial importance of notary services

Notary Service – Issuers Perspective Main Indicator - proposed threshold: 15%

Numerator: Market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *securities issued by issuers* from the host Member State *initially recorded* in the CSD of the home Member State

Denominator: Total market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *securities issued by issuers* from the host Member State *initially recorded* in all CSDs established in the European Union

3.4 Assessment of the ‘substantial importance’ of central maintenance services

3.4.1 Scope of financial instruments to be included

78. Central maintenance services mirrors to a large extent the issuance services (i.e. a CSD responsible for the issuance of a given security is also normally responsible for the maintenance of the relevant securities accounts at the top tier level). The proposed criterion related to the notary function refers to the home jurisdiction of the issuer which has issued the security, whereas the criterion for the central maintenance function should refer to the home jurisdiction of the participant which holds the security at top tier level.

79. Therefore ESMA proposes that this criterion for the central maintenance service is assessed using data from the participant angle in order to get a more accurate representation.

80. It should also be noted that CSDs that use the direct holding model do not necessarily have participants that hold securities in the securities settlement system operated by the CSD. Therefore, we propose to refer also to other holders of securities accounts in the securities settlement system operated by the CSD of the home Member State.

3.4.2 Central maintenance versus maintenance

81. ESMA notes that the core service according to Annex A of Regulation (EU) No 909/2014 is providing and maintaining securities accounts at the top tier level, which describes the central maintenance service provided by Issuer CSDs. Nonetheless, it has also considered the possibility of capturing maintenance (maintaining securities accounts not at top tier level) in addition to central maintenance, in order to also capture the Investor CSD activity. This activity may not otherwise be fully captured under the indicators for the core services, as the settlement indicator would only capture this to the extent that securities are actively traded and settled.

3.4.3 Collateral management services

82. ESMA has considered whether, in addition to central maintenance services, it would be important to consider ancillary services that complement this service, such as collateral management services. A majority of the collateral management services would already be captured in the scope of the settlement services and therefore the substantial importance criteria for settlement services would reflect this. However, there would be instances where this service would not be covered by settlement service for example, where a pledge has been made. At the same time, collateral management services can also be provided by other entities than CSDs (such as custodians, investment firms, etc.). Therefore, ESMA proposes not to include collateral management services.

3.4.4 Criteria to assess the substantial importance of central maintenance services

1) Central Maintenance Main Indicator - proposed threshold: 15%

Numerator: Market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *securities centrally maintained* by the CSD of the home Member State *for participants and other holders of securities accounts* of the host Member State

Denominator: Total market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *securities centrally maintained* by all CSDs established in the European Union *for participants and other holders of securities accounts* of the host Member State

2) Maintenance Sub-indicator - proposed threshold: 10% (in conjunction with the Central Maintenance Main Indicator, which should be at least 5% in this case)

Numerator: Market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *securities* issued in a CSD established in the European Union, *non-centrally maintained* by the CSD of the home Member State *for participants other than CSDs, as well as for other holders of securities accounts* of the host Member State

Denominator: Total market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *securities non-centrally maintained* by all CSDs established in the European Union *for participants other than CSDs, as well as for other holders of securities accounts* of the host Member State

Either the threshold for the main indicator has to be reached (15%), or both the threshold for the main indicator (5%) and the sub-indicator (10%) have to be reached, for the home CSD to be considered of substantial importance in the host Member State.

3.5 Assessment of the ‘substantial importance’ of settlement services

3.5.1 Consideration of settlement services from the perspective of the Issuers

83. ESMA has considered whether the settlement services should be assessed from the perspective of the issuers. The settlement activities of a CSD from a home Member State may be of substantial importance for the functioning of the securities markets from another Member State if the CSD from the home Member State settles a significant amount of securities issued by issuers from the host Member State. In such a case if the settlement is not functioning smoothly or the CSD is not properly supervised, the confidence and the efficiency of the securities market of the host Member State would be at risk.
84. This indicator has the additional advantage of covering not only issuer CSD activities, but also investor CSD activities better than the participants’ perspective indicator mentioned below, because a CSD can be an investor CSD without necessarily having any relationship with participants from another Member State. This may happen when a CSD from a home Member State (investor CSD) has a link with a CSD from the

host Member State (issuer CSD). In this case, the investor CSD is not providing any settlement services to other participants in the SSS of the issuer CSD (the activity of the investor CSD is not covered by the participants' perspective indicator mentioned below); nevertheless, the investor CSD settles the securities issued by the issuer CSD.

3.5.2 Consideration of settlement services from the perspective of participants to a CSD

85. ESMA has considered whether the settlement services should be assessed from the perspective of the participants in a securities settlement system operated by a CSD. It is ESMA's view that this approach would allow for the investor CSD activity to be captured and would therefore provide an accurate representation of whether the activity is substantially important.

86. To the extent that a CSD does not have the necessary information on the indirect provision of settlement services (i.e. to indirect participants or to the end investors) and that it would be problematic to compute such a calculation, participants of the host Member State would be an adequate proxy for investors and should help ensure there is consideration of the protection of investors in the host Member State.

3.5.3 Criteria to assess the substantial importance of the settlement services

1. Settlement Service – Issuers' Perspective Main Indicator - proposed threshold: 15%

Numerator: Value of the *DVP settlement instructions* plus the market value of the *FOP settlement instructions* (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, the nominal value of the *FOP settlement instructions settled* by the CSD of the home Member State in relation to transactions in *securities issued by issuers from the host Member State*

Denominator: Total value of the *DVP settlement instructions* plus the total market value of the *FOP settlement instructions* (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, the nominal value of the *FOP settlement instructions settled* by all CSDs established in the European Union in relation to transactions in *securities issued by issuers from the host Member State*

2. Settlement Service – Participants' Perspective Main Indicator - proposed threshold: 15%

Numerator: Market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *settlement instructions settled* by the CSD of the home Member State *from participants as well as for other holders of securities accounts of the host Member State*

Denominator: Total market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *settlement instructions settled* by all CSDs established in the European Union *from participants as well as for other holders of securities accounts of the host Member State*

3.6 Market consolidation affecting host Member States

3.6.1 Reflections on how to apply/adapt the criteria above for assessing the substantial importance where a host Member State no longer has a 'local' CSD

87. In the event where a host Member State's "local" CSD is subject to market consolidation (e.g. through mergers, takeovers, or other types of business transfers), the respective core CSD services will be provided by one or more CSDs of (an) other country/countries. This would result in two scenarios:

- a) The core services of the local CSD are predominantly taken over by one (or a limited number of) other CSD(s) (e.g. through a merger, take-over). In this case the criteria for assessing substantial importance for the core services would duly show that the other CSD(s) has/have become of substantial importance for the functioning of the securities markets and the protection of the investors in that host Member State (i.e. where the "local" CSD was established). Indeed the host Member State will substantially rely on the activities of such CSD(s) and thus a cooperation arrangement between the home and host Member State competent authorities is warranted.
- b) The core services of the local CSD are transferred to a large number of other CSD(s) or custodians (e.g. activities are partly or fully transferred by respective participants/issuers to a high number of other CSDs or custodians because e.g. of increased competition). In this case the criteria for assessing substantial importance for the core services may not (at least for an individual CSD) exceed the suggested thresholds, as each of these CSDs would not necessarily be of substantial importance for the functioning of the securities markets and the protection of the investors in that host Member State. In this situation, the activities, and thus the risks for the host securities markets and investors, would not be concentrated in a specific CSD but spread among a large number of CSDs or custodians. The host securities markets would thus not substantially rely on a specific CSD and alternative CSDs would be available should one of the CSDs/custodians stop offering services in that host Member State. In such cases, the information exchange foreseen in the CSDR would

provide the host authorities with adequate information on the activities of the respective CSDs in the host Member State and specific cooperation arrangements are not warranted. Therefore no specific criteria would be required.

3.6.2 Criteria to assess substantial importance in the event of market consolidation

88. ESMA concludes that no criterion is necessary to assess substantial importance in the event of market consolidation. The proposed criteria to assess substantial importance of notary services, central maintenance services and settlement services are sufficient as they will take into account any major market consolidations in the host Member State and would capture any need to have dedicated co-operation arrangement with another competent authority.

3.6.3 Establishing branches into host Member States - Reflections on how to apply/adapt the criteria above for assessing the substantial importance in the context of branching

89. Whilst establishing a branch in a host Member State and having a physical presence indicates the willingness of developing in a certain market, the activity of the CSD in a host Member State may not necessarily be of substantial importance, despite the fact that a branch is established. There is no guarantee that having a branch will lead to significant activity. As a consequence, the establishment of a branch should not be a standalone separate criterion in demonstrating substantial importance. In the event that the branch does generate significant activity of a CSD in the host Member State and it is substantially important, this will be adequately captured under one (or more) of the indicators relating to the core services.

90. ESMA concludes that no additional criteria are necessary to assess substantial importance in the context of the establishment of branches. The proposed criteria to assess substantial importance of notary services, central maintenance services and settlement services would adequately capture the need for the competent authorities to have co-operation arrangements, if the activity of a CSD does become of substantial importance.

3.7 Additional considerations

91. This section has the aim to draw the attention on certain aspects which have been taken into account when defining the criteria for the measurement of the substantial importance of a CSD for a host Member State.

3.7.1 Specialisation of a CSD in a specific type of financial instrument and/or in a specific type of securities transaction

92. In case a CSD concentrates its activities on a specific type of financial instrument and/or specific type of securities transaction, the CSD may be of importance for this

specific type of financial instrument and/or type of securities transaction at European Union level as well as at national level.

93. However, the fact that a CSD may be of importance for a specific type of financial instrument and/or type of securities transaction with respect to the securities markets or investors of the host Member State would not automatically mean that the CSD is of substantial importance for securities markets or investors of the host Member State in general. For instance in case a CSD is specialised in the initial recording, central maintenance and/or settlement of one specific type of financial instrument and/or type of securities transaction but this type of financial instrument [and/or type of securities transaction] only represents a minor part of the initial recording, central maintenance or settlement activity of that host Member State, the CSD should not be considered as substantially important for the securities market and/or investors of the host Member State.
94. Having this in mind, and considering the need to ensure a practical and efficient framework in line with the general principles described in section 1, it is proposed to evaluate the substantial importance of a CSD with respect to the functioning of the securities markets and protection of the investors of a host Member State on a global basis and thus not to split the above indicators per type of instrument or per type of transaction. Such a split would indeed significantly multiply the number of indicators that would need to be collected and regularly assessed by competent authorities and lead to a complex and unmanageable process.

3.7.2 Scope of the securities markets

95. ESMA notes that certain of the considered services are not exclusively provided by CSDs but also by other entities and that for certain types of financial instruments and/or types of securities transactions, the entire services are, to a large extent, provided by other entities than CSDs. This has an impact on measuring the substantial importance of a CSD with respect to a specific securities market and has as consequence that the reference to securities market as proposed in the indicators does not represent the entire securities market of the European Union (i.e. the denominator does not represent the total activity in the securities market of a Member State). This is particularly the case for the settlement related indicators due to settlement internalisation.
96. Despite the above limitations, it is of the utmost importance that the indicators suggested in this Technical Advice appropriately balance the need to keep the framework simple and manageable. In this respect, ESMA considers that the proposed indicators will allow for an appropriate assessment of the substantial



importance of the CSDs established in the European Union with respect to the securities market and investors of a specific host Member State.

3.8 Summary of the proposed indicators

97. The criteria by which the operations of a CSD in a host Member State could be considered of substantial importance for the functioning of the securities markets and the protection of the investors in that host Member State are:

Notary Service

1) Issuers Perspective Main Indicator – proposed threshold: 15%

Numerator: Market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *securities issued by issuers* from the host Member State *initially recorded* in the CSD of the home Member State

Denominator: Total market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *securities issued by issuers* from the host Member State *initially recorded* in all CSDs established in the European Union

Central Maintenance Service

2) Central Maintenance Main Indicator - proposed threshold: 15%

Numerator: Market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *securities centrally maintained* by the CSD of the home Member State *for participants and other holders of securities accounts* of the host Member State

Denominator: Total market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *securities centrally maintained* by all CSDs established in the European Union *for participants and other holders of securities accounts* of the host Member State

3) Maintenance Sub-indicator - proposed threshold: 10% (in conjunction with the Central Maintenance Main Indicator, which should be at least 5% in this case)

Numerator: Market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *securities issued* in a CSD established in the European

Union, *non-centrally maintained* by the CSD of the home Member State *for participants other than CSDs, as well as for other holders of securities accounts* of the host Member State

Denominator: Total market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *securities non-centrally maintained* by all CSDs established in the European Union *for participants other than CSDs, as well as for other holders of securities accounts* of the host Member State

Either the threshold for the main indicator has to be reached (15%), or both the threshold for the main indicator (5%) and the sub-indicator (10%) have to be reached, for the home CSD to be considered of substantial importance in the host Member State.

Settlement Service

4) Settlement Service – Issuers’ Perspective Main Indicator - proposed threshold: 15%

Numerator: Value of the *DVP settlement instructions* plus the market value of the *FOP settlement instructions* (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, the nominal value of the *FOP settlement instructions settled* by the CSD of the home Member State in relation to transactions in *securities issued by issuers from the host Member State*

Denominator: Total value of the *DVP settlement instructions* plus the total market value of the *FOP settlement instructions* (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, the nominal value of the *FOP settlement instructions settled* by all CSDs established in the European Union in relation to transactions in *securities issued by issuers from the host Member State*

5) Settlement Service – Participants’ Perspective Main Indicator - proposed threshold: 15%

Numerator: Market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *settlement instructions settled* by the CSD of the home Member State *from participants as well as for other holders of securities accounts of the host Member State*

Denominator: Total market value (based on the closing price of the trading venue where the securities were first admitted to trading or the most relevant market in terms of liquidity) or, if not available, nominal value of *settlement instructions settled* by all CSDs established in the European Union *from participants as well as for other holders of securities accounts of the host Member State*



Q6: What are your views on the proposed indicators?

Q7: What are your views on the proposed thresholds?

Q8: Do you believe that the proposed indicators and thresholds are relevant in the case of government bonds? If not, please provide details and arguments.

Annex I – Summary of questions

- Q1: What are your views on the proposed basis for the cash penalty calculation?**
- Q2: What are your views on the proposed approach regarding the categories of financial instruments and the penalty rates? In particular, do you consider that these penalty rates could dis-incentivise trading in small caps? Please provide evidence to support your views.**
- Q3: What are your views on the proposed approach regarding the increase and reduction of the basic penalty amount?**
- Q4: What are your views on the proposed approach regarding the cash penalties in the context of chains of interdependent transactions?**
- Q5: Do you agree with the proposed frequency of one year for the assessment of the substantial importance of a CSD in another Member State?**
- Q6: What are your views on the proposed indicators?**
- Q7: What are your views on the proposed thresholds?**
- Q8: Do you believe that the proposed indicators and thresholds are relevant in the case of government bonds? If not, please provide details and arguments.**



Annex II - EC mandate regarding technical advice on the level of penalties for settlement fails

PROVISIONAL² REQUEST TO ESMA FOR TECHNICAL ADVICE ON POSSIBLE DELEGATED ACTS CONCERNING CERTAIN SETTLEMENT DISCIPLINE MEASURES

With this mandate, the Commission seeks ESMA's technical advice on possible delegated acts concerning the Regulation on improving securities settlement in the European Union and on central securities depositories (CSDs) ('CSDR' or the "**legislative act**"). These delegated acts should be adopted in accordance with Article 290 of the Treaty on the Functioning of the European Union (TFEU).

The provisional nature of the present mandate stems from the fact that the CSDR has not yet entered into force. However, the Council (at the meeting of COREPER on 24 February) and the European Parliament (by a vote in the Plenary Session on 25 April) have approved the CSDR text. Currently, CSDR is subject to legal revision and translation prior to its publication in the EU Official Journal.

The Commission reserves the right to revise and/or supplement this formal mandate. The technical advice received on the basis of this mandate should not prejudice the Commission's final decision.

The mandate follows the Regulation of the European Parliament and the Council establishing a European Securities and Markets Authority (the "**ESMA Regulation**"),³ the Communication from the Commission to the European Parliament and the Council – Implementation of Article 290 of the Treaty on the Functioning of the European Union (the "**290 Communication**"),⁴ and the Framework Agreement on Relations between the European Parliament and the European Commission (the "**Framework Agreement**").⁵

According to Articles 7(13) of CSDR, the Commission shall adopt delegated acts to specify the parameters for the calculation of cash penalties to be imposed by CSDs for settlement fails.

The European Parliament and the Council shall be duly informed about this mandate.

In accordance with the Declaration 39 on Article 290 TFEU, annexed to the Final Act of the Intergovernmental Conference which adopted the Treaty of Lisbon, signed on 13 December 2007, and in accordance with the established practice within the European Securities Committee,⁶ the Commission will continue, as appropriate, to consult experts appointed by the Member States in the preparation of possible delegated acts in the financial services area.

In accordance with point 15 of the Framework Agreement, the Commission will provide full information and documentation on its meetings with experts appointed by the Member States within the framework

² On 2 October 2014, following the publication of the CSDR in the OJ and its entry into force, ESMA received the confirmation from the EC that this mandate should no longer be considered as provisional but as final. (http://www.esma.europa.eu/system/files/20141002_esma_-_csdr_mandates.pdf)

³ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), OJ L 331, 84 15.12.2010.

⁴ Communication of 9.12.2009. COM (2009) 673 final.

⁵ OJ L304/47, 20.11.2010, p. 47-62.

⁶ Commission's Decision of 6.6.2001 establishing the European Securities Committee, OJ L191, 17.7.2001, p.45-46.

of its work on the preparation and implementation of Union legislation, including soft law and delegated acts. Upon request by the Parliament, the Commission may also invite Parliament's experts to attend those meetings.

The powers of the Commission to adopt delegated acts are subject to Article 68 of CSDR. As soon as the Commission adopts a possible delegated act, the Commission will notify it simultaneously to the European Parliament and the Council.

1. Context

1.1 Scope

One of the objectives of CSDR is to improve settlement efficiency in the Union. To achieve this objective, Article 7 of CSDR provides for a set of strict measures to address settlement fails. In particular, any participant to a securities settlement system operated by a CSD, party to a transaction, that fails to deliver the relevant financial instruments on the agreed settlement date will be subject to cash penalties that will be collected by CSDs and a buy-in procedure whereby those securities shall be bought and delivered in a timely manner to the receiving counterparty. While most of technical details of the operation of the settlement discipline measures will be further specified in the future regulatory technical standards, Article 7(13) of CSDR requires the Commission to adopt a delegated act to specify the parameters for the calculation of a deterrent and proportionate level of cash penalties for settlement fails. This provision states also that the level of cash penalties should take into account the asset type, liquidity of the financial instruments and the type of the transactions concerned and should ensure a high degree of settlement discipline and a smooth functioning of the financial markets concerned.

This mandate focuses on the technical aspects of a delegated act on cash penalties. In providing its advice, ESMA should build upon its own experience and upon that of national authorities concerning settlement discipline measures already in place.

1.2 Principles that ESMA should take into account

ESMA is invited to take account of the following principles:

- It should respect the requirements of the ESMA Regulation, and, to the extent that ESMA takes over the tasks of CESR in accordance with Art 8(1)(l) of the ESMA Regulation, take account of the principles set out in the Lamfalussy Report⁷ and those mentioned in the Stockholm Resolution of 23 March 2001⁸.
- The principle of proportionality: the technical advice should not go beyond what is necessary to achieve the objective of the delegated act set out in the legislative act.
- While preparing its advice, ESMA should seek coherence within the regulatory framework of the Union.

⁷ Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, chaired by M. Lamfalussy, Brussels, 15 February 2001. (http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf)

⁸ Results of the Council of Economics and Finance Ministers, 22 March 2001, Stockholm Securities legislation, (<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/01/105&format=HTML&aged=0&language=EN&guiLanguage=en>).

- In accordance with the ESMA Regulation, ESMA should not feel confined in its reflection to elements that it considers should be addressed by the delegated act but, if it finds it appropriate, it may indicate guidelines and recommendations that it believes should accompany the delegated act to better ensure its effectiveness.
- ESMA determines its own working methods depending on the content of the various aspects dealt with. Nevertheless, horizontal questions should be dealt with in such a way as to ensure coherence between different standards of work being carried out by the various expert groups.
- In accordance with the ESMA Regulation, ESMA is invited to widely consult market participants in an open and transparent manner. ESMA should provide advice which takes account of different opinions expressed by the market participants during their consultation. ESMA's technical advice should include a feedback statement on the consultation justifying its choices vis-à-vis the main arguments raised during the consultation.
- ESMA is invited to support its advice by providing a cost-benefit analysis of all the options considered and proposed.
- The technical advice should contain sufficient and detailed explanations for the assessment done, and be presented in an easily understandable language respecting current legal terminology at European level.
- ESMA should provide comprehensive technical analysis on the subject matters described below covered by the delegated powers and included in the relevant provision of the legislative act, in the corresponding recitals as well as in the relevant Commission's request included in this mandate.
- The technical advice given by ESMA to the Commission should not take the form of a legal text. However, ESMA should provide the Commission with an "articulated" text which means a clear and structured text, accompanied by sufficient and detailed explanations for the advice given, and which is presented in an easily understandable language respecting current terminology in the Union.
- ESMA should address to the Commission any question it might have concerning the clarification on the text of the legislative act, which it considers of relevance to the preparation of its technical advice.

2 Procedure

The Commission is requesting the technical advice of ESMA in view of the preparation of a delegated act to be adopted pursuant to the legislative act and in particular regarding the questions referred to in section 3 of this formal mandate.

This mandate takes into account the ESMA Regulation, the 290 Communication and the Framework Agreement.

The Commission reserves the right to revise and/or supplement this formal mandate. The technical advice received on the basis of this mandate will not prejudice the Commission's final decision.

In accordance with established practice, the Commission may continue to consult experts appointed by the Member States in the preparation of the delegated acts relating to the legislative act and will keep ESMA informed of progress made.

The Commission has duly informed the European Parliament and the Council about this mandate. As soon as the Commission adopts the relevant delegated act, it will notify it simultaneously to the European Parliament and the Council.

3. Mandate for technical advice

3.1 Preliminary remarks

Article 7(2) provides that CSDs should put in place a penalty mechanism which serves as an effective deterrent for participants that cause settlement fails. Such a penalty mechanism does not apply to failing participants which are CCPs and should include cash penalties that should be calculated on a daily basis for each business day following the settlement fail until the actual settlement date or any other factor terminating the transaction.

It is the view of the Commission services that only a cash penalty with a variable component (ad valorem penalty) that takes into account the value(s) of the transaction(s) that fail to be settled will be able to achieve the required deterrence and proportionality of the penalty⁹. The Commission services consider that the application of cash penalties should be subject to parameters that are simple enough to be applied via an automated system, given the high volumes of settlement instructions. However, CSDs should also be able to increase or decrease the cash penalty that they would normally charge (basic amount) in order to take account of the actual behaviour of non-compliant participants (e.g. repeated non-compliant behaviour).

3.2 Content of the technical advice

ESMA is invited to provide technical advice to assist the Commission in formulating a delegated act on cash penalties, and more specifically on the following aspects:

- (a) the parameters for calculating the cash penalty that a CSD will normally charge for settlement fails (i.e. the basic amount of a cash penalty);
- (b) the circumstances that may justify an increase of the basic amount of the cash penalty and the parameters for the calculation of such an increase, whilst applicable under an automated system;
- (c) the circumstances that may justify a reduction of the basic amount of the cash penalty and the parameters for the calculation of such a reduction whilst applicable under an automated system; and
- (d) how to adapt the parameters for the calculation of cash penalties in the context of a chain of interdependent transactions and whether there are cases where this would not be possible (e.g. the chain would not be visible).

3.2.1 *The parameters for the calculation of the basic amount of a cash penalty*

⁹ A fixed cash penalty may be either too small for a high value transaction or too big for a small value transaction

- ESMA is invited to reflect on the parameters for the calculation of the basic amount of cash penalties that CSDs will charge by taking into account the following policy principles:
 - The variable component of a cash penalty should relate to the value(s) of the transaction(s) that fail to settle;
 - The principle that CSDR is neutral as regards the existing securities holding models (the parameters of the calculation of the basic amount of the cash penalty should not put at a significant disadvantage a given securities holding model);
 - The cash penalty should be deterrent to ensure a high degree of settlement efficiency (improve to the extent possible the existing levels of settlement efficiency);
 - The cash penalty should be proportionate and take into account the specificities of different asset types, the degree of liquidity, and the types of transactions concerned.

3.2.2. The circumstances that justify an increase of the basic amount

- In order to ensure a high degree of deterrence, the cash penalty needs to be increased in situations where the basic amount proves to be insufficient to change the non-compliant behaviour of a CSD participant. ESMA is invited to reflect on:
 - The circumstances in which an increase of the basic amount of the cash penalty is justified (e.g. repeated non-compliant behaviour; continuous underperformance of a CSD participant with regard to settlement discipline; refusal to cooperate by a CSD participant with a view to improving settlement discipline);
 - The parameters of the calculation of an increase of the basic amount of a cash penalty by taking into account the principles of deterrence and proportionality.

3.2.3. The circumstances that justify a reduction of the basic amount

- In order to guarantee the proportionality of the cash penalty, the cash penalty needs to take account of the circumstances that may mitigate the non-compliant behaviour of a market participant. ESMA is invited to reflect on:
 - The circumstances in which a reduction of the basic amount of the cash penalty is justified.
 - The parameters of the calculation of a reduction of the basic amount of a cash penalty by taking into account the principles of deterrence and proportionality.

3.2.4. Chain of interdependent transactions

- ESMA is invited to reflect on how to adapt the parameters for calculating/allocating the payment of the basic amount of cash penalties in the context of a chain of



interdependent transactions. In this regard, ESMA should consider cases where chains of interdependent transactions are not visible.

4. Indicative timetable

This mandate takes into consideration that ESMA requires sufficient time to prepare its technical advice and that the Commission needs to adopt the delegated acts according to Article 290 of the TFEU. The powers of the Commission to adopt delegated acts are subject to Article 68 of the legislative act which allows the European Parliament and the Council to object to a delegated act within a period of 3 months, extendible by 3 further months. The delegated act will only enter into force if neither European Parliament nor the Council has objected on expiry of that period or if both institutions have informed the Commission of their intention not to raise objections.

The deadline set to ESMA to deliver the technical advice is nine months after the entry into force of CSDR.



Annex III – EC mandate regarding technical advice on the substantial importance of a CSD

PROVISIONAL¹⁰ REQUEST TO ESMA FOR TECHNICAL ADVICE ON POSSIBLE DELEGATED ACTS CONCERNING CERTAIN ASPECTS RELATED TO THE COOPERATION OF COMPETENT AUTHORITIES IN THE SUPERVISION OF CSDs

With this mandate, the Commission seeks ESMA's technical advice on possible delegated acts concerning the Regulation on improving securities settlement in the European Union and on central securities depositories (CSDs) ('CSDR' or the "**legislative act**"). These delegated acts should be adopted in accordance with Article 290 of the Treaty on the Functioning of the European Union (TFEU).

The provisional nature of the present mandate stems from the fact that the CSDR has not yet entered into force. However, the Council (at the meeting of COREPER on 24 February) and the European Parliament (by a vote in the Plenary Session on 25 April) have approved the CSDR text. Currently, CSDR is subject to legal revision and translation prior to its publication in the EU Official Journal.

The Commission reserves the right to revise and/or supplement this formal mandate. The technical advice received on the basis of this mandate should not prejudice the Commission's final decision.

The mandate follows the Regulation of the European Parliament and the Council establishing a European Securities and Markets Authority (the "**ESMA Regulation**"),¹¹ the Communication from the Commission to the European Parliament and the Council – Implementation of Article 290 of the Treaty on the Functioning of the European Union (the "**290 Communication**"),¹² and the Framework Agreement on Relations between the European Parliament and the European Commission (the "**Framework Agreement**").¹³

According to Article 24(7) of CSDR, the Commission shall adopt delegated acts concerning measures to establish the criteria under which the operations of a CSD in a host Member State could be considered of *substantial importance* for the functioning of the securities markets and the protection of the investors in that host Member State.

The European Parliament and the Council shall be duly informed about this mandate.

In accordance with the Declaration 39 on Article 290 TFEU, annexed to the Final Act of the Intergovernmental Conference which adopted the Treaty of Lisbon, signed on 13 December 2007, and in accordance with the established practice within the European Securities Committee,¹⁴ the Commission will continue, as appropriate, to consult experts appointed by the Member States in the preparation of possible delegated acts in the financial services area.

¹⁰ On 2 October 2014, following the publication of the CSDR in the OJ and its entry into force, ESMA received the confirmation from the EC that this mandate should no longer be considered as provisional but as final. (http://www.esma.europa.eu/system/files/20141002_esma_-_csdr_mandates.pdf)

¹¹ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), OJ L 331, 84 15.12.2010.

¹² Communication of 9.12.2009. COM (2009) 673 final.

¹³ OJ L304/47, 20.11.2010, p. 47-62.

¹⁴ Commission's Decision of 6.6.2001 establishing the European Securities Committee, OJ L191, 17.7.2001, p.45-46.

In accordance with point 15 of the Framework Agreement, the Commission will provide full information and documentation on its meetings with experts appointed by the Member States within the framework of its work on the preparation and implementation of Union legislation, including soft law and delegated acts. Upon request by the Parliament, the Commission may also invite Parliament's experts to attend those meetings.

The powers of the Commission to adopt delegated acts are subject to Article 68 of CSDR. As soon as the Commission adopts a possible delegated act, the Commission will notify it simultaneously to the European Parliament and the Council.

1. Context

1.1 Scope

One of the objectives of CSDR is to create an internal market for CSD services. To achieve this objective, Article 23 of CSDR allows any CSD duly authorized under the CSDR rules to provide its services in any Member State of the Union (passport rights). Article 24 of CSDR provides for various cooperation measures between home and host Member States' competent authorities where a CSD provides its services cross-border. More specifically, Article 24(4) of CSDR provides that home and host competent authorities shall establish formal cooperation arrangements for the supervision of a CSD where the activities of such CSD have become "of substantial importance for the functioning of the securities markets and the protection of the investors" in the host Member State.

Article 24(7) of CSDR requires the Commission to adopt delegated acts concerning measures for establishing the criteria under which the operations of a CSD in a host Member State could be considered "of substantial importance for the functioning of the securities markets and the protection of the investors" in the host Member State.

This mandate focuses on the technical aspects concerning the assessment of *substantial importance* within the meaning of the legislative act. In providing its advice, ESMA should build upon its own experience and from that of national authorities concerning the provision of CSD services.

1.2 Principles that ESMA should take into account

ESMA is invited to take account of the following principles:

- It should respect the requirements of the ESMA Regulation, and, to the extent that ESMA takes over the tasks of CESR in accordance with Art 8(1)(l) of the ESMA Regulation, take account of the principles set out in the Lamfalussy Report¹⁵ and those mentioned in the Stockholm Resolution of 23 March 2001¹⁶.
- The principle of proportionality: the technical advice should not go beyond what is necessary to achieve the objective of the delegated act set out in the legislative act.

¹⁵ Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, chaired by M. Lamfalussy, Brussels, 15 February 2001. (http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf)

¹⁶ Results of the Council of Economics and Finance Ministers, 22 March 2001, Stockholm Securities legislation, (<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/01/105&format=HTML&aged=0&language=EN&quiLanguae=en>).

- While preparing its advice, ESMA should seek coherence within the regulatory framework of the Union.
- In accordance with the ESMA Regulation, ESMA should not feel confined in its reflection to elements that it considers should be addressed by the delegated act but, if it finds it appropriate, it may indicate guidelines and recommendations that it believes should accompany the delegated act to better ensure its effectiveness.
- ESMA determines its own working methods depending on the content of the various aspects dealt with. Nevertheless, horizontal questions should be dealt with in such a way as to ensure coherence between different standards of work being carried out by the various expert groups.
- In accordance with the ESMA Regulation, ESMA is invited to widely consult market participants in an open and transparent manner. ESMA should provide advice which takes account of different opinions expressed by the market participants during their consultation. ESMA's technical advice should include a feedback statement on the consultation justifying its choices vis-à-vis the main arguments raised during the consultation.
- ESMA is invited to support its advice by providing a cost-benefit analysis of all the options proposed.
- The technical advice should contain sufficient and detailed explanations for the assessment done, and be presented in an easily understandable language respecting current legal terminology at European level.
- ESMA should provide comprehensive technical analysis on the subject matters described below covered by the delegated powers included in the relevant provision of the legislative act, in the corresponding recitals as well as in the relevant Commission's request included in this mandate.
- The technical advice given by ESMA to the Commission should not take the form of a legal text. However, ESMA should provide the Commission with an "articulated" text which means a clear and structured text, accompanied by sufficient and detailed explanations for the advice given, and which is presented in an easily understandable language respecting current terminology in the Union.
- ESMA should address to the Commission any question it might have concerning the clarification on the text of the legislative act, which it considers of relevance to the preparation of its technical advice.

2 Procedure

The Commission is requesting the technical advice of ESMA in view of the preparation of a delegated act to be adopted pursuant to the legislative act and in particular regarding the questions referred to in section 3 of this formal mandate.

This mandate takes into account the ESMA Regulation, the 290 Communication and the Framework Agreement.



The Commission reserves the right to revise and/or supplement this formal mandate. The technical advice received on the basis of this mandate will not prejudice the Commission's final decision.

In accordance with established practice, the Commission may continue to consult experts appointed by the Member States in the preparation of the delegated acts relating to the legislative act and will keep ESMA informed of progress made.

The Commission has duly informed the European Parliament and the Council about this mandate. As soon as the Commission adopts the relevant delegated act, it will notify it simultaneously to the European Parliament and the Council.

3. Scope of the technical advice

3.1 Preliminary remarks

The objective of Article 24(4) is to enhance cooperation between home and host competent authorities where the activities of a CSD in the host Member State become of *substantial importance* for a proper functioning of the financial system in that Member State.

It is the view of the Commission services that the assessment of *substantial importance* needs to focus on the core CSD services (i.e. market infrastructure services) listed in Section A of the Annex to the CSDR (initial recording of securities in a book-entry system, central maintenance and settlement services, including securities and cash settlement provided by CSDs). Therefore, the ancillary services listed in Sections B and C of that Annex that are not strictly speaking core market infrastructure services should not be considered beyond their complementary role to the core services to which they relate.

It is also the view of the Commission services that the assessment of the *substantial importance* should be done from the perspective of the host Member State and not from that of the CSD (i.e. a big CSD may have limited non-substantial activities in a small Member State from the perspective of the CSD. Nevertheless, its service may be of *substantial importance* for the host Member State). Proceeding otherwise would seriously compromise the goal of CSDR to allow a greater involvement of host Member States in the supervision of CSDs that affect substantially their markets.

3.2 Content of the technical advice

ESMA is invited to provide technical advice to assist the Commission in formulating a delegated act on the criteria to assess the *substantial importance* of the CSD's activities concerning the following three CSD core services and two related issues:

- (a) Initial recording of securities in a book-entry system ('notary service');
- (b) Providing and maintaining securities accounts at the top tier level ('central maintenance service');
- (c) Operating a securities settlement system ('settlement service');

In addition, the three core services need to be considered in the following situations:

- (a) Market consolidation affecting host Member States; and

(b) Branching into host Member States.

3.2.1 Assessment of the 'substantial importance' of notary services

ESMA is invited to examine the notary services provided by a CSD to issuers established in the host Member State. In particular, ESMA is invited to reflect on:

- Whether the assessment should:
 - cover all financial instruments issued for host Member State issuers; or
 - should be limited according to, for instance:
 - the law that governs those financial instruments (e.g. only consider financial instruments that are governed by the laws of the host Member States);
 - the type of financial instruments (e.g. for certain instruments such as shares, the involvement of host Member States is critical from the perspective of corporate or securities law).
- The appropriate methods of calculation and thresholds to capture the *substantial importance* by taking into account that such thresholds should relate to the markets of the host Member States concerned.

3.2.2 Assessment of the 'substantial importance' of central maintenance services

Central maintenance services mirror to a large extent the issuance services (i.e. a CSD responsible for the issuance of a given security is also normally responsible for the maintenance of the relevant securities accounts at the top tier level). Therefore, the technical advice is expected to cover *mutatis mutandi* the issues referred to in the previous subsection, even though in certain cases the CSDs may not provide the notary service themselves.

3.2.3 Assessment of the 'substantial importance' of settlement services

ESMA is invited to reflect on whether:

- The settlement services need to be assessed:
 - only from the perspective of the issuers (i.e. the *substantial importance* test takes into account only settlement services related to the financial instruments issued and/or centrally maintained by a CSD on behalf of the issuers established in a host Member State); or
- should also be assessed from the perspective of the participants to a securities settlement system operated by a CSD and/or of the participants to trading venues in a host Member State (i.e. the 'substantial importance' test takes also into account the settlement services provided to financial institutions from the host Member State).
- For the first aspect of the point above, the technical advice should cover *mutatis mutandi* the issues referred to in subsection 3.2.1.

- For the second aspect of the point above, ESMA is invited to reflect on the principles (i.e. methods of calculation and thresholds) for assessing the *substantial importance* of a CSD for a host Member State from the perspective of the participants from that host Member State to a securities settlement system from a different Member State, and/or of the participants to trading venues in the host Member State for which the CSD in a different Member State provides settlement services either directly or indirectly.

3.2.4 *Market consolidation affecting host Member States*

Currently, there is at least one CSD in each Member State. In the medium/long term, the CSD market may consolidate as a result of increased competition, mergers, takeover, or any other form of business transfer. ESMA is invited to reflect on how to apply/adapt the criteria developed for assessing the *substantial importance* where a host Member State has no longer a 'local' CSD (in particular if the activity of a CSD in a host Member State is taken over by more than one CSD where neither of them individually meet the criteria for *substantial importance*).

3.2.5 *Branching into host Member States*

The physical presence through a branch is a strong indication of the importance for the host Member State of the activities of a CSD in that Member State. ESMA is invited to reflect on how to apply/adapt the criteria developed for assessing the *substantial importance* in the context of branching.

4. Indicative timetable

This mandate takes into consideration that ESMA requires sufficient time to prepare its technical advice and that the Commission needs to adopt the delegated acts according to Article 290 of the TFEU. The powers of the Commission to adopt delegated acts are subject to Article 68 of the legislative act which allows the European Parliament and the Council to object to a delegated act within a period of 3 months, extendible by 3 further months. The delegated act will only enter into force if neither European Parliament nor the Council has objected on expiry of that period or if both institutions have informed the Commission of their intention not to raise objections.

The deadline set to ESMA to deliver the technical advice is nine months after the entry into force of CSDR.