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Typology of CSD links

The aim of this paper is to present the different types of existing link arrangements between central securities depositories (CSDs) with a view to define a clear typology in the upcoming CSD regulation (Commission Proposal (2012)73).

A link is a contractual arrangement that enables securities issued in one CSD (typically referred to as Issuer CSD) to be made available through the books of another CSD (referred to as Investor CSD), thus allowing the Investor CSD to offer services on these "foreign" securities to its own customers.

From a functional perspective, CSD links take the form of an omnibus account opened by the Investor CSD with the Issuer CSD and require the establishment of an IT interface for the transmission of instructions or receipt of reports between Issuer and Investor CSD. The role of the Investor CSD is thus very similar to the one of a local custodian bank that keeps an account in a CSD and services the related securities.

From a regulatory perspective however, CSD links are treated differently from the relation of a local custodian bank to a CSD as they are subject to specific rules to ensure the safe and sound processing of cross-CSD transactions.[1]

Having good and legally enforceable definitions of "links" is important in at least three respects:

- For guaranteeing settlement finality for transactions processed through the link;
- For determining rights of access from one CSD to another and also with other infrastructures (transaction feeds from trading venues or CCPs);
- For determining the appropriate authorisation process and supervisory framework.

Given that the perspective is different in all three cases, it is not straightforward to find definitions for CSD links that are suitable for all purposes.

[1] See for instance CPSS-IOSCO: Principles for FMIs, Principle 20 on FMI links.

1. Settlement Finality

The Settlement Finality Directive (SFD, 98/26/EC) does not define CSD links but contains a definition of **"interoperable systems"** in its article 2, which is aimed to extend the protection of the SFD to linked systems (whether CCP or CSD links). The definition of interoperable systems is very general, referring to *"two or more systems whose system operators have entered into an arrangement with one another that involves cross-system execution of transfer orders".*
In practice, there is no official list of existing interoperable systems and it is up to national regulators to determine whether systems are to be considered interoperable or not for the purpose of the SFD.

While, in the case of CCPs, all links are to be considered as "interoperable", given the need to collateralise inter-CCP credit exposures, in the case of CSDs, links can take different forms and most links do not give rise to credit risk and simply allow for a DvP or FoP[2] transfer. The problem with the definition of interoperable systems contained in the SFD is that it does not reflect these differences and leaves some discretion for interpretation by national authorities.

The definition of "interoperable systems" contained in the SFD is therefore not appropriate for most provisions of the CSD regulation and should only be used when dealing with issues related to the protection under the SFD.

2. Access

The 2007 Code of Conduct, Access and Interoperability Guideline provides for the following definitions of links:

- "**Standard access**" involves one CSD opening an account in another CSD;
- "**Customised access**" involves one CSD opening an account in another CSD, where the receiving (issuer) CSD is requested to develop special functions for the requesting (investor) CSD;
- "**Interoperability**" means advanced forms of relationships where a CSD is not generally connecting to existing standard service offerings of the other CSD but where both CSDs agree to establish mutual solutions.

Both standard and customised access refer to a CSD opening an account with another CSD, without necessarily implying a reciprocal relation (unilateral link). The reason for differentiating "standard" and "customised" links in the context of access provisions is because the latter is a conditional (rather than an absolute) right. While standard CSD access is based on the same terms and conditions as any other standard participant in the receiving CSD, customised access implies some specific functions

[2] DvP: Delivery versus Payment. FoP: Free of Payment.

(such as specific reporting or communication standards) which come in addition to the standard terms and conditions applying to the other participants. Customisation is in principle requested by and primarily benefits the requesting CSD, thus the requesting CSD can be expected to compensate the receiving CSD for the customisation.

In summary, from an access & interoperability perspective:

<table>
<tr><td>Standard access</td><td rowspan="2">unilateral or bilateral</td><td>Right</td></tr>
<tr><td>Customised access</td><td>Conditional right</td></tr>
<tr><td>Interoperability</td><td>reciprocal</td><td>Advanced form of bilateral or multilateral negotiation</td></tr>
</table>

Concretely, many if not most CSD links today involve the adoption of a separate agreement between the linked CSDs in addition to the standard terms and conditions of the receiving CSD, which apply to all participants of that CSD. Such an additional agreement, is typically based on the ECSDA model agreement template (see http://www.ecsda.eu/site/reports.html) and refers to the receiving CSD's general terms and conditions while holding a number of individually negotiated annexes on service level (e.g. corporate actions, opening days/hours, custody services, qualifying securities, securities account and cash account static data, invoicing, communication formats and contingency procedures).

Based on the Code of Conduct definition, it seems that such links could fall under the definition of "customised access", because some of the provisions included in the link agreement (such as requiring the use of ISO 15022 message or of customised reporting) can in some cases differ from the standards in use for ordinary participants.

However, the provisions contained in the link agreement do not increase risk and in fact often reduce operational risk by providing for more automation in communication procedures. The difference between standard and customised links is thus not relevant from a risk perspective. All these links boil down to one CSD opening an account with another CSD without giving rise to any credit or liquidity risk. This is why regulators today oversee them in a similar way.

In the context of the CSD regulation, the definitions from the Code of Conduct that distinguish between standard access, customised access and interoperability between CSDs are therefore relevant for the access provisions but are neither suitable for provisions related to the protection under the SFD nor for authorisation and supervisory purposes.

3. Authorisation and supervision

CPSS-IOSCO defines links as "a set of contractual and operational arrangements between two or more FMIs that connect the FMIs directly or through an intermediary" (*CPSS-IOSCO Principles for financial market infrastructures*, April 2012).

From a supervisory point of view, regulators and overseers tend to distinguish between "standard links" and more complex link arrangements involving a high degree of interdependence between the linked (I)CSDs and thus also more complex risk exposures. An example for such a link is the "bridge" between the two ICSDs. The existence of customised reports or other functions is not relevant *per se* from a risk point of view. Hence, links resulting from customised access rules are – from a supervisory perspective – just "standard links".

From a supervisory perspective:

Standard links	Account opening, no risk transfer (with or without customised functions). *This includes links resulting from standard and customised access.*	Notification by the CSD to the regulator in most cases
Complex link arrangements resulting in the transfer of risks among the linked CSDs	Reciprocal arrangement resulting in liquidity and/or credit risk exposures among the linked CSDs. *This includes interoperability access.*	Special supervisory arrangement in place

Furthermore, supervisory authorities also tend to distinguish between:

Direct links	(standard)	An account opened by a CSD (the Investor CSD) in the books of another CSD (the Issuer CSD) in order to facilitate the transfer of securities from participants in the issuer CSD to participants in the investor CSD[3].
	operated link	A direct link between two CSDs where a third party, typically a custodian bank, operates the account in the issuer CSD on behalf of the investor CSD[1].
Indirect links	(standard)	A link between two CSDs through a non-CSD intermediary[1].
	relayed link	A contractual and technical arrangement that allows Issuer and Investor CSDs to hold and transfer securities through an account with a third CSD (a "middle CSD"), which acts as an intermediary[1].

In the case of operated and indirect links, i.e. whenever an intermediary is involved between the linked CSDs, the CPSS-IOSCO Principles recommend that the investor CSD should *"measure, monitor, and manage the additional risks (including custody, credit, legal, and operational risks) arising from the use of the intermediary".*

From an authorisation and supervision point of view a distinction between two types of links is relevant. Standard links that constitute a mere account opening (with or without customisation) do not involve any transfer of risk and should be notified to competent authorities. More complex link arrangements (including interoperable links) result in more complex risk exposures and should be subject to pre-authorisation by competent authorities.

[3] ECB Glossary, see http://www.ecb.int/home/glossary/html/glossd.en.html

4. Conclusion: Finding definitions that work for all purposes

The draft CSD regulation issued by the European Commission on 1 March 2012 defines three types of links between CSDs:

Standard link access	"whereby a CSD is connected to another CSD as any other participant to the securities settlement system operated by the latter"	→ close to the Code of Conduct definition
Customised link access	"whereby a CSD provides specific services to another CSD distinct from the services provided to other participants to its securities settlement system"	→ close to the Code of Conduct definition
Interoperability links	"whereby the securities settlement systems operated by CSDs become interoperable as defined in point (o) of Article 2 of Directive 98/26/EC"	→ different from the Code of Conduct definition, refers to the SFD definition which is not precise and gives a lot of room for interpretation as far as CSDs are concerned

There are two problems with the definitions being proposed by the EU Commission:

1. The proposed definitions work for the access and interoperability provisions (art.48 to art.50), but are less appropriate/relevant for determining the applicable authorisation regime (art.17(1)d, art.45). Whether a link entails customised functions or reports is not relevant *per se* from a supervisory point of view. Whether a CSD link should be notified to regulators or whether it should require pre-authorisation by competent authorities should depend on the risks involved.

2. The definition of interoperable links/interoperability is too vague (SFD "cross-system execution of transfer orders") and would leave too much room for interpretation if applied in the context of the new EU authorisation/supervision regime. There is no such problem for CCPs, since all inter-CCP links can qualify as interoperable (see section 1 of this paper).
ECSDA believes that, as far as CSDs are concerned, a more precise definition could be helpful to avoid any ambiguities and to ensure a consistent implementation, for instance:

"Interoperable link means a set of reciprocal contractual and technical arrangements between two or more CSDs that aim to provide facilities for delivery versus payment settlement between the linked CSDs' participants and that result in a transfer of risk from one CSD to the other."

Such a definition summarises the main characteristics of interoperable links as described in the 2007 Code of Conduct Access and Interoperability Guideline and would reflect the importance of risk considerations as suggested above. It would cover the "bridge" between the two ICSDs as well as potentially other such links in the future.

<u>A solution to the problems outlined above could be to distinguish in the definitions of the CSD regulation between two types of links only:</u>

(1) Standard links (with or without customisation) that do not involve a transfer of risk and;

(2) More complex links such as interoperable links that do involve a transfer of liquidity and credit risk.

- **Such a distinction would be appropriate from an authorisation and supervision perspective: while standard links should be notified to competent authorities, more complex, interoperable links should be subject to pre-authorisation.**
- **In addition, a distinction between standard and customised *access* could be achieved directly in the relevant access provisions of the CSD regulation (art.48-50) without formally distinguishing between standard and customised links.**
- **A reference to the SFD definition of "interoperable system" should be used solely in the context of SFD protection that is required for both standard and interoperable links.**

<u>As a minimum, if the CSD regulation maintains a distinction between three types of links in needs to be ensured that:</u>

- **standard and customised links** are treated in a similar way from an authorisation and supervisory point of view (notification to the competent authorities);
- **interoperable links**, based on a new and more precise definition, would have to undergo the authorisation process foreseen in article 17(1), given their more complex nature and the potential impact on the risk profile of the linked CSDs.

Annex – Background on CSD links

To access securities in a non-domestic jurisdiction, investors and their agents have two options:
(1) To use a custodian bank that participates directly or indirectly in the payment and securities settlement systems of the country of the non-domestic issuer; or
(2) To use the access that may be offered by that investor's local CSD through links which that CSD has with another CSD acting for the non-domestic issuer.

This second option requires the domestic CSD of the investor (the 'Investor CSD') to have a link with the non-domestic CSD of the issuer (the 'Issuer CSD'). Settlement taking place across such CSD link is often referred to as "cross-system" or "cross-border" settlement.

Links allow CSDs to offer their customers a single point of access for multiple markets. The Investor CSD will act as intermediary, similar to a custodian bank.

Practicalities of CSD links

A link is a contractual arrangement that enables securities in one CSD to be made available through the books of another CSD. A link takes the form of an omnibus account held by the Investor CSD with the Issuer CSD and requires the establishment of an IT interface for the transmission of instructions between the Issuer and Investor CSD.

In effect the Investor CSD becomes a participant (or "customer") in the Issuer CSD. This participation may be a "direct link", whereby the Investor CSD opens a direct account (like any other participant) with the Issuer CSD and operates the account itself. Or it can take the form of an "operated direct link" whereby a third party such as a custodian bank operates the direct account with the Issuer CSD on behalf of the Investor CSD. In the case of "indirect links", whereby an Investor CSD accesses an Issuer CSD through a third party – e.g. a custodian bank - who maintains an account in its own name, the establishment of an IT interface for the transmission of instructions between the Issuer and Investor CSD is typically not required.

Links can be:

- Free of Payment (FoP) or Delivering versus Payment (DvP);
- Unilateral or bilateral (most are unilateral);
- Relayed (where at least three CSDs are linked including an intermediary CSD);
- Fully interoperable (which only applies to the Bridge between Euroclear Bank and Clearstream Luxembourg for Eurobonds which can be held and settled in both systems with full interoperability between them).

For securities issued into a single Issuer CSD (primarily equities, investment funds, government debt and corporate debt), all that is required to deliver choice of settlement location is standard unilateral access of another (Investor) CSD to the Issuer CSD. In that case, the Investor CSD is acting as a standard participant in the Issuer CSD and is subject to the same contracts and pricing as any other CSD customers.

CSD Interoperability means an advanced form of relationship where a CSD is not generally connecting to existing standard service offerings of another CSD but where mutual and reciprocal solutions have been established. The Code of Conduct Access and Interoperability Guideline of 2007 provides more details on the different categories of horizontal links, including the difference between standard access and interoperability,

In the case of CSDs, interoperability is not a requirement to deliver choice of settlement provider. This is a difference with the CCP area where interoperability is required to offer choice of clearing location. Indeed, should a CCP open a standard account with another CCP, this would mean that the first CCP becomes a general clearing member of the second CCP and there is no choice of clearing location.

Risks related to CSD links

The ESCB/CESR recommendation 19 is used by regulators to assess the risk and appropriate mitigation measures in CSD links. This recommendation requires “CSDs that establish links to settle cross-system trades should design and operate such links so that they effectively reduce the risks associated with cross-system settlements (...) should evaluate and mitigate the potential sources of risk that can arise from the linked CSDs and from the link itself”.

A CSD wanting to establish a link needs to assess the financial soundness and operational reliability of the CSD with which intends to establish a link. It also needs to assess the legal risks as links will generally involve multiple jurisdictions. Links also need to deal adequately with issues related to settlement finality and DVP. For CSD links that involve extensions of credit, appropriate measures for credit and liquidity management have to be foreseen.

A CSD that opens a new link will inform its national regulator that will ensure that the risks are adequately managed. Existing links will be subject to periodic review by the CSD’s national regulator and links used for monetary policy operations are formally assessed by the Eurosystem.

Further information

A full description of CSD links can be found in an ECSDA paper published in 2006 in preparation of the introduction of Target2:
http://www.ecsda.eu/site/uploads/tx_doclibrary/2006_10_Report_cross_border_links.pdf

In addition a full description of access rights can be found in the Access and interoperability Guidelines of the Code of Conduct agreed in 2007: http://ec.europa.eu/internal_market/financial-markets/docs/code/guideline_en.pdf

The European Central Bank publishes a list of CSD links that are assessed against the ESCB user standards and can therefore be used for collateralisation of Eurosystem monetary policy operations:
http://www.ecb.de/paym/coll/coll/ssslinks/html/index.en.html

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