MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Circular to the Financial Services Industry on the Implementation of the Central Securities Depositaries Regulation (EU) N^{o} 909/2014

This Circular is being addressed to Central Securities Depositories ('CSDs') and market participants on trading venues, with the intention of providing an overview of the new requirements and amendments to the current regulatory framework in this area.

[1.0] General overview of the current local legal framework regulating Central Securities Depositories

CSDs in Malta are regulated under Part IV of the Financial Markets Act, Chapter 345 of the Laws of Malta, (the 'FMA' or the 'Act').

Part IV of the FMA is also supplemented by the following subsidiary legislations:

- Legal notice 360 of 2008 – Regulated Markets and Central Securities Depository (Fees) Regulations (S.L. 345.05)
- Legal notice 138 of 2009 – Central Securities Depository (Authorisation Requirements) Regulations (S.L. 345.12)
- Legal notice 139 of 2009 – Central Securities Depository (Control of Assets) Regulations (S.L. 345.13)
- Legal notice 380 of 2012 – Designated Financial Instruments Regulations (S.L. 345.14)

The coming into force of the Central Securities Depositories Regulation ('CSDR' or the 'Regulation') has necessitated certain amendments to our local legislation. These amendments are being explained below.

[2.0] New European rules to regulate settlement and CSDs

Following the 2008 financial crisis, the European Commission ('EC') was of the opinion that no financial product or market should remain without appropriate regulation and effective supervision. Amongst others, the EC expressed its intention to harmonise CSD practices amongst European Member States particularly given CSDs' vital role when processing securities settlement and when maintaining records of securities accounts and transactions.

These efforts started materialising on the 18 December 2013, where the European Parliament and the Council reached an important agreement on a regulation for more stability, efficiency and safety of settlement and CSDs.

Thereafter, on 26 February 2014, the Permanent Representatives Committee, on behalf of the Council of the European Union, confirmed the agreement with Parliament.

On 15 April 2014, Regulation (EU) N^{o} 909/2014 on improving securities settlement in the European Union and on Central Securities Depositories and amending directives 98/26/EC and 2014/65/EU and Regulation (EU) N^{o} 236/2012 (Central Securities Depositories Regulation) was adopted by the European Parliament, and subsequently adopted by the Council of the European Union on 23 July 2014.

The Regulation is considered an important development in European regulation because it enhances the safety and soundness of the financial system. Together with the Regulation on OTC derivatives, central counterparties and trade repositories ('EMIR') – Regulation (EU) No 648/2012 – that entered into force on 16 August 2012 and the Markets in Financial Instruments Directive ('MiFID') it will form a framework in which systemically important securities infrastructures (trading venues, central counterparties, trade repositories and central securities depositories) are subject to common rules on a European level.

The CSDR entered into force on 17 September 2014 and is directly applicable in all European Member States.

The Regulation is divided into 6 main titles as follows:-

Title I	Subject-matter, scope and definitions
Title II	Securities Settlement
Title III	Authorisation, supervision, requirements and access to CSDs
Title IV	Provision of banking-type ancillary services for CSD participants
Title V	Sanctions
Title VI	Delegation of power, implementing powers, transitional, amending and final provisions

The CSDR is accompanied by implementing measures coming in the form of technical standards as well as implementing acts. In this regard, the Regulation requires the European Securities and Markets Authority (ESMA), in close cooperation with the members of the European System of Central Banks, to prepare draft technical standards on the following matters:

- CSD Requirements – The authorisation, recognition, supervision of CSDs, organisational and prudential requirements for CSDs, access requirements (between a CSD and its participants, by issuers to CSDs, between CSDs, and between CSDs and other market infrastructures);
- Internalised Settlement Reporting Requirements – Covers securities transactions settled outside a securities settlement system; and
- Settlement Discipline Measures – Aiming at improving the settlement efficiency.

This circular will focus on the key parts of the CSDR framework and the impact of their requirements on CSDs. This circular should not be construed as professional legal advice. The industry is urged to read the Regulation as well as the above-mentioned implementing measures, and other technical advice to achieve a better understanding of the requirements laid-out therein.

[2.1] Subject matter and scope

Title I of the Regulation lays out the subject matter and scope of the CSDR. The Regulation seeks to provide uniform requirements for the settlement of financial instruments in the Union and rules on the organisation and conduct of CSDs to promote safe, efficient and smooth settlement. The CSDR applies to the settlement of all financial instruments and activities of CSDs unless otherwise specified in the Regulation.

[2.2] Securities Settlement

One of the objectives of the CSDR is that of ensuring that settlement is carried out in a safer and more efficient manner across European Member States. Title II of the CSDR deals with securities settlement, which title is further divided into four chapters; chapter 1 deals with dematerialisation and immobilisation of securities, chapter 2 deals with settlement periods and chapter 3 and chapter 4 deal with settlement discipline and internalised settlement respectively.

[2.2.1] Dematerialisation and Immobilisation of Securities

Article 28 of the FMA currently states that the title to and rights in respect of designated financial instruments, may be held in a dematerialised or uncertificated form.

Article 3(1) of the CSDR requires that any issues of EU transferable securities which are admitted to trading or traded on trading venues be represented in book entry form as immobilisation or subsequent to a direct issuance in dematerialised form.

As a consequence of the implementation of the CSDR, Article 28 of FMA shall be deleted and in order for the FMA to be consistent with the Regulation, the phrase ‘uncertificated form’ is being replaced by the phrase ‘represented in book-entry form as

immobilisation' throughout. In addition, the definitions 'dematerialised form' and 'immobilisation' are being included in the Act.

[2.2.2] Settlement Periods

Prior to the entry into force of the CSDR, in the vast majority of European markets, including Malta, the settlement period for securities was the transaction date plus three business days, often referred to as T+3.

The European Commission set up the Harmonisation of Settlement Cycles Working Group in 2009. The group recommended harmonising securities settlement periods at a maximum of two business days after the trading day (T+2).

As a consequence the European Commission decided that moving to T+2 or a shorter period would be more beneficial to market participants. In this regard, Article 5 of the CSDR requires all transactions in transferable securities executed on trading venues to be settled on T+2.

The benefits envisaged for T+2 are as follows:

- The introduction of a common set of rules to harmonise 'settlement discipline' across the EU. The rules consist of measures to prevent settlement fails, and to address these fails when they occur.
- A shortened settlement period would reduce the additional margin and liquidity needs that can happen during times of economic volatility.
- T+2 helps reduce counterparty risk by moving trades more quickly to settlement, enabling capital available for reinvestment and reducing credit and counterparty exposure.

The settlement period T+2 became effective as of 1 January 2015, in time for the launch of Target2 Securities ('T2S') in June 2015.

[2.2.2.1] Target2 Securities (T2S)

T2S is a state-of-the-art settlement engine offering to the whole European market centralised delivery-versus-payment (DvP) settlement in central bank money. It is operated by the Eurosystem on a cost-recovery basis, to the benefit of all users. T2S will only perform settlement and will be a service offered to CSDs and is therefore not a CSD in itself. The CSDs will be the only parties involved in a contractual relation with the Eurosystem and will remain responsible for the legal and business relations with their clients. They will continue to maintain their customers' accounts and to perform all activities pertaining to the rest of the post-trading value chain.

[2.2.3] Settlement Disciplines

A key component of the CSDR is the harmonisation of settlement discipline across Europe. These consist of a common set of measures which European CSDs will have to adopt in order to prevent and address settlement failures.

A number of principles relating to settlement discipline are already set out in a very detailed Article 7. Nevertheless, ESMA has on 1st February 2016 issued a final report in relation to the regulatory technical standards on settlement discipline under the CSDR, which report has been submitted to the European Commission for endorsement.

The European Commission is now in the process of endorsing the regulatory technical standard provided in the report, followed by a non-objection period of the European Parliament and Council. These rules will then enter into force two years after their publication in the Official Journal of the European Union. This will give enough time to relevant stakeholders to implement the changes needed to comply with the CSDR.

[2.2.4] Settlement Internalisers

Article 9 of the CSDR requires settlement internalisers to report to their Competent Authorities on a quarterly basis the aggregated volume and value of all securities transactions which they settle outside of CSDs.

ESMA has, on the 28 September 2015, published technical standards establishing requirements on how to report internalised settlements to national regulators to allow proper risk monitoring. These requirements do not however apply to CSDs themselves since the definition of a settlement internaliser is an institution which executes transfer orders on behalf of clients or on its own account other than through a CSD.

[2.3] Central Securities Depositories under the CSDR

As aforementioned, Title III of the Regulation deals with the authorisation and supervision of CSDs, as well as with the requirements of CSDs and the access to CSDs. For the purpose of this circular, we shall focus on the main changes brought about by the coming into force of the CSDR.

[2.3.1] Designation of Competent Authority

Pursuant to Article 11(1) of the CSDR, each Member State is required to designate the competent authority responsible for carrying out the duties for the authorisation and supervision of CSDs established in its territory and shall inform ESMA thereof. With the introduction of a new Article 24A in the FMA, the Malta Financial Services Authority shall be the designated competent authority in Malta.

[2.3.2] Provision of Services in another Member State

The CSDR allows for a CSD, which is established and authorised within an EU Member State, to provide the services referred to in the Annex to the Regulation, within the territory of the Union, including through the setting up of a branch. Such CSD is subject to the procedure laid down in Article 23 of the Regulation. Mainly, the CSD wishing to provide services within the territory of another Member State shall provide the necessary information[1] to the competent authority of the home member state. The home Member State shall then communicate that information to the competent authority of the host Member State. The CSD may start providing its services in the host Member State, upon the host Member State acknowledging receipt of the communication from the competent authority of the home Member State; or, after three months from the date of transmission of the communication to the competent authority of the host Member State.

Further to the above, the CSDR also allows third-country CSDs to provide services within the territory of the European Union. Prior to providing the services referred to in points (1) and (2) of Section A of the Annex, the CSD shall obtain recognition from ESMA in accordance with Article 25 of the CSDR.

Passporting of services provided by a CSD has to be in line with the requirements of the Regulation nevertheless, Article 24 of the FMA is being amended to include three provisos to cater for the following situations:

i. CSD authorised in Malta wishing to provide its services within the territory of another EU Member State;

ii. CSD authorised in an EU Member State wishing to provide its services within the territory of Malta;

iii. CSD authorised within a third-country wishing to provide its services within the territory of Malta.

[2.3.3] Organisational Requirements for CSDs

CSDs are required to have robust governance arrangements which include a clear organisational structure and should have a management body of which at least one third, but not less than two, of its members are independent. Furthermore, a CSD shall establish user committees for each securities settlement system it operates which shall be composed of representatives of issuers and of participants in such securities settlement

[1] A CSD wishing to provide services within the territory of another Member State shall communicate to the competent authority of the home member state: the Member State in which it intends to operate; the services which it intends to provide; the currency that it intends to process; if it intends to establish a branch, the organisational structure of the branch; where relevant, the measures that the CSD intends to take to allows its users to comply with the national law referred to in Article 49(1).

system. Records on the services and activities shall be maintained for a period of at least ten years.

[2.3.4] Capital Requirements

Amongst the prudential requirements contained in section 4, Chapter II, Title III the CSDR requires that capital together with retained earnings and reserves of a CSD, shall be proportional to the risks stemming from the activities of the CSD. The capital requirements under Article 47 apply to all CSDs whereas the requirements under Articles 54 and 59 apply exclusively to CSDs offering banking-type ancillary services listed in Section C of the annex to the CSDR or credit institutions designated by the CSD to offer such banking-type ancillary services.

[2.4] Provision of banking-type ancillary services for CSD participants

The Regulation makes a distinction between core services and ancillary services. The latter are further divided between non-banking type ancillary services of CSDs (which do not entail credit or liquidity risks) and banking-type ancillary services. The list of services which can be offered by CSDs is contained in the annex to the Regulation.

Title IV of the CSDR sets out the detailed requirements for the provision of banking type ancillary services for CSD participants. In effect these provisions deliver a legal framework to govern the provision of commercial bank money settlement by CSDs to their participants. A CSD shall not itself provide any banking-type ancillary services unless it has obtained an additional authorisation to provide such services. The banking-type ancillary services are listed in Section C of the annex to the CSDR. The application for authorisation to provide banking-type ancillary services shall contain a programme of operations setting out the banking-type ancillary services envisaged, the structural organisation of the relations between the CSD and the designated credit institutions where applicable and how that CSD intends to meet the prudential requirements laid down in the CSDR.

[3.0] Changes in Local Legislation

The CSDR brought about a number of changes to both the FMA as well as the related subsidiary legislations, which changes are being highlighted below:

[3.1] Changes to the Financial Markets Act

[3.1.1] Right of Appeal

A new Article 27A is being included to deal with all the instances in which a CSD has a right of appeal before the Financial Services Tribunal. Prior to the amendments, a CSD had a right of appeal when an application for authorisation has been refused (Article 25) and when authorisation has been revoked (Article 27). Further to these two instances, a

CSD shall now also have a right of appeal where no decision is taken, within six months of its submission, in respect of an application for authorisation which contains all the information required under the provisions in force.

[3.1.2] Functions of a Central Securities Depository

Prior to the amendments, Article 26 of the FMA included a non-exhaustive list of functions. This article is being amended and the functions of a CSD shall include the services listed in the Annex to the CSDR. As its core services, a CSD shall operate a securities settlement system and shall in addition also provide at least one of the following services: initial recording of securities in a book-entry system or provision and maintenance of securities accounts at the top tier level.

[3.2] Changes to Subsidiary Legislation

[3.2.1] Revocations

Legal notice 138 of 2009 [S.L 345.12 Central Securities Depository (Authorisation Requirements) Regulations] and legal notice 380 of 2012 [S.L 345.14 Designated Financial Instruments (Revocation) Regulations] are being revoked. Please refer to Annex I.

[3.2.2] New Subsidiary Legislation dealing with Administrative Penalties and Sanctions

A new Legal Notice under the FMA shall deal with the penalties, which can be imposed by the MFSA by notice and without recourse to a court hearing, in the event when a person contravenes or fails to comply with the provisions of the Act or the Regulation. The penalties are as follows:-

a) a public statement which indicates the person responsible for the infringement and the nature of the infringement;

b) an order requiring the person responsible for the infringement to cease the conduct and to desist from a repetition of that conduct;

c) withdrawal of authorisation;

d) a temporary, or for repeated serious infringements, a permanent ban against any member of the institution's management body or any other natural person, who is held responsible, from exercising management functions in the institution;

e) maximum administrative pecuniary sanctions of at least twice the amounts of the profit gained as a result of an infringement where those amounts can be determined;

f) in respect of a natural person, maximum administrative pecuniary sanctions of five million Euro (€5,000,000);

g) in the case of legal person, maximum administrative pecuniary sanctions of twenty million Euro (€20,000,000) or up to 10% of the total annual turnover of the legal person according to the last available accounts approved by the management body; where the legal person is a parent undertaking or a subsidiary of the parent undertaking which has to prepare consolidated financial accounts according to Directive 2013/34/EU, the relevant total annual turnover shall be the total annual turnover or the corresponding type of income according to the relevant Accounting Directives according to the last available consolidated accounts approved by the management body of the ultimate parent undertaking."

In view of the above, Article 39A, which entailed an administrative penalty which may not exceed one hundred and fifty thousand euro (€150,000) in case of an infringement, is no longer applicable to Part IV of the FMA which deals with CSDs.

Contacts

Should you have any queries on the CSDR, please do not hesitate to contact: Mr Edward Grech, Senior Manager, Securities and Markets Supervision Unit (EGrech@mfsa.com.mt), Mr Nathan Fenech Analyst, Securities and Markets Supervision Unit (NFenech@mfsa.com.mt) or Dr Anneliese Saliba Analyst, Securities and Markets Supervision Unit (ASaliba@mfsa.com.mt).

Communications Unit
Malta Financial Services Authority
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Annex I

Subsidiary Legislation being revoked

I. Legal notice 138 of 2009 – Central Securities Depository (Authorisation Requirements) Regulations (S.L. 345.12)

SL345.12.pdf

II. Legal notice 380 of 2012 – Designated Financial Instruments Regulations (S.L. 345.14)

SL345.14.pdf