

CSDR - Regulatory Challenges and Opportunities

Abstract

I. Research background

Since the establishment of the European Union (EU), the member states have aspired to create a common market for goods, services and capital. The notion of creating a common market was first materialized in the 1999 Financial Services Action Plan, a five-year plan that aimed to build a single financial market, followed by the Lisbon Agenda in 2000, and Giovannini Reports, issued respectively in 2001 and 2003. It wasn't until 2004 that the Markets in Financial Instruments Directive led to the first harmonization of the financial markets, in particular the pre-trade segment, within the EU.

As for clearing and settlement, major associations such as the Federation of European Securities Exchanges jointly announced the Voluntary Code of Conduct for Clearing and Settlement in 2006 in an attempt to push for harmonization of the clearing and settlement systems in the EU.

Since 2006, the EU has also sought to introduce a series of fundamental reforms for post-trade operations through administrative and legislative initiatives, the most important of which are (1) the TARGET2-Securities clearing platform (hereafter referred to as T2S), launched by the European Central Bank, and (2) the Regulation on Improving Securities Settlement in the European Union and on Central Securities Depositories (CSDR) upon the request of the European Commission. Both have brought about profound changes to the post-trade market in Europe.

The legislation of the CSDR came to pass in July 2014 and entered into force in June 2015, governing the post-trade mechanisms and central securities depositories (CSDs) in Europe with an aim to eliminate all kinds of obstacles for cross-border transactions within Europe and to create a single capital market where CSDs of all member states can compete freely and fairly. Compared with other EU capital market regulations, the CSDR is mainly focused on the management of the post-trade market, and represents a major reform regarding the business scope of CSDs, settlement operations, provision of banking-type ancillary services by CSDs and connection with other market infrastructures.

1. Overview of legal reforms on central custody businesses in the EU

In the reasons of legislation of the CSDR, it was pointed out that CSDs play an important role in the EU securities system. While the settlement systems of individual member states were all rather developed, with good safety protection mechanisms and low operating costs, the risks and cost for cross-border settlement were quite high given a lack of common regulations and competition. To address the issue, the CSDR was formulated to achieve market harmonization and encourage competition.

The CSDR consists of 76 articles under six titles, namely (1) Subject Matter, Scope and Definitions; (2) Securities Settlement; (3) Central Securities Depositories; (4) Provision of Banking-type Ancillary Services for CSD Participants; (5) Sanctions; and (6) Delegation of Power, Implementing Power, Transitional, Amending and Final Provisions.

Regarding securities settlement, the CSDR stipulates the dematerialization of securities

in the EU, harmonization of settlement date to T+2, as well as common mechanisms for settlement fails. For CSDs, common supervisory and managerial standards and systems are specified, in conjunction with the deregulation of selection for issuers and competition among pre- and post-trade participants. For banking-type ancillary services, CSDs may choose to provide such services on their own or through a designated bank.

2. Major issues addressed by the CSDR

As far as securities settlement is concerned, in addition to the dematerialization of securities and harmonization of T+2 settlement date, the most substantial objective of the CSDR is to formulate common rules for settlement failures, which, according to the CSDR, shall include systems for automatic monitoring, regular reporting, penalties, buy-in, compensation for price differentials, cash compensation, loss compensation, public disclosure of failing participants and suspension of trading.

The CSDR requires CSDs to offer omnibus and segregate account options, depending on the needs of participants. The omnibus account option allows participants to hold the securities of their clients all in a single account, while the segregate option keeps the record and securities separately. Common standards are also set forth for the management of legal risks, operational risks, capital requirements and investment policy by CSDs.

Currently, the only member states that allow CSDs to provide banking-type ancillary services are Germany, Luxemburg, Belgium, Austria and Hungary. The banking-type ancillary services, as defined in the CSDR, include cash account provision, cash credit for reimbursement, forex transactions, securities lending and borrowing and cash processing. In order to balance risk management and operating efficiency, the CSDR specifies conditions under which CSDs are allowed to provide such services on their own, such as the acquisition of authorization as a credit institution, addition of capital surcharge and fulfillment of other requirements as stipulated in the CSDR.

3. Comparison with the systems in Taiwan

In Taiwan, the most prominent features of our settlement fail remedy system are (1) settlement by a substitute; and (2) shared responsibility. The automatic monitoring, regular reporting, penalties and buy-in, compensation, public disclosure and suspension systems are also in place in Taiwan.

In terms of CSD operations, book-entry processing, including the settlement, transfer, pledging and distribution of securities, is carried out in two phases in Taiwan. In phase one, investors are required to open a central custody account with a securities broker. In phase two, market participants, such as securities brokers, have to open a book-entry account with TDCC to become a CSD participant. Risk control requirements in general have covered all the potential risks a CSD in Taiwan may be exposed to.

In regard to banking service, TDCC is not allowed to provide banking-type ancillary services given a lack of authorization. That said, TDCC provides multiple cash flow services, including central custody, clearing and settlement of short-term bills, OTC securities clearing and settlement, on-shore and off-shore fund services, cross-border custody, DVP of foreign-currency bonds and bills via a third-party forex clearing platform.

The CSDR demands that, in case of a settlement fail, a clearing house or stock exchange

shall carry out a buy-in, similar to settlement by a substitute in Taiwan, if the transaction cannot be fully settled in four business days after the settlement date. Monetary penalties will be imposed on a daily basis between the settlement date and buy-in date, according to the CSDR. In Taiwan, brokers are required to designate a substitute for settlement, and in some cases the substitute is appointed by the stock exchange, but there's no daily penalty for brokers between the settlement and buy-in dates. This is main difference between the failure remedy systems in Taiwan and the EU.

European CSDs are required by the CSDR to provide omnibus and segregate account options for clients to choose from, whereas in Taiwan, TDCC only provides segregate accounts to participants.

Regarding risk management, the EU emphasizes the management of legal, operational and financial (including investment policy and capital requirements) risks for CSDs and requires competent authorities to formulate corresponding rules and regulations. In Taiwan, the supervision of CSD is incorporated in the Regulations Governing Centralized Securities Depository Enterprises, and TDCC has also formulated a handbook for processing abnormality, in addition to a BCP plan to prevent and tackle with contingencies. As far as legal risks are concerned, in Taiwan, there aren't any regulations in place for the conflict of jurisdictions, but as TDCC does not operate in a foreign territory, the legal risks should be very limited.

The CSDR grants all European CSDs the liberty to provide banking-type ancillary services provided they fulfill certain requirements. However, in Taiwan, current regulations do not allow a CSD to provide banking services without a banking license or equivalent qualifications, and there are no independent criteria that banks, or similar financial institutions can fulfill to apply for a CSD license. In other words, it is out of the question that banks and financial institutions can provide CSD services and vice versa, meaning the division of the two businesses is quite strict and clear in Taiwan.

II. Conclusion and recommendations

This study investigates the CSDR of the EU and compares the systems in Europe and Taiwan in an effort to identify potential challenges and opportunities for TDCC from the CSDR. After comparing the legal framework and actual practices in the EU and Taiwan, we came to the conclusion and recommendations as follows:

A. Conclusion

(i) The CSDR represents the last mile of integration and opening of the EU capital market

Building a common financial service market is a major step for full economic integration among EU member states. By promulgating the CSDR, the competent authorities hope to effectively reduce the costs and operational risks of cross-border settlement, and stimulate evolution of post-trade services, thereby improving the operating efficiency through the harmonization of securities settlement and central custody regulations of all member states, so that CSDs can compete with each other on equal terms. Overall, the CSDR marks the last mile of a common capital market within the EU, and it has indeed reshaped the playing field for European CSDs.

(ii) In order to create a level playing field for CSDs, the CSDR stipulates common standards

for processing settlement fails so that participants don't turn to CSDs that operate on more lenient rules after the launch of T2S.

By harmonizing the remedial rules for settlement failure, the CSDR ensures that participants can't go to a CSD that operates on more lenient rules for settlement after the launch of T2S so that all CSDs in Europe can compete in a fair environment. In Taiwan, the "settlement by a substitute" and "shared responsibility" mechanisms are put in place to ensure smooth settlement and market stability.

While the remedy systems for settlement fails in Taiwan and the EU are quite different, both have been able to ensure completion of settlement. The aforesaid two mechanisms have worked smoothly in Taiwan for years, so we'd say the system in Taiwan is just as effective as that in the EU. However, settlement fails of bond transactions by price negotiation at business premises are not covered by the remedy system in Taiwan. This means the trading parties can only ask for compensation on their own. The government should formulate relevant regulations with reference to the CSDR standards to further improve the settlement of financial instruments in Taiwan.

(iii) The requirement of the CSDR that CSDs should provide participants with two account options reflects the diversity in the European markets, and the efforts to remove regulatory obstacles of individual member states in order to create a level playing field for CSDs

As European CSDs operate on different account structures, the requirement of providing omnibus and segregate account options by all CSDs gives participants the flexibility they need to operate in a different EU country. By removing the regulatory obstacles, CSDs of all member states are able to compete freely.

Given indirect contractual obligations, book-entry processing in Taiwan is carried out in two phases. However, based on the operating guidelines of TDCC and the contracts TDCC enters into with participants during account opening, the relevant book-entry operations are completely undertaken by TDCC, so the characteristics of an omnibus and segregate account are to a degree fused in TDCC's account structure. TDCC will keep monitoring the implementation of the CSDR for the reference of future planning.

(iv) Organizational requirements of the CSDR are mainly based on the PFMI standards, which are legislated to ensure compliance by all member state CSDs

The Principles for Financial Market Infrastructures (PFMI), published by the International Organization of Securities Commissions (IOSCO) and Committee on Payment and Settlement Systems (CPSS) in 2012 outlined the regulatory principles for a variety of financial infrastructures. The recommendations of the PFMI were widely adopted by the CSDR with only a few minor changes of wording.

The PFMI is perceived by the EU as well as the international community as the minimum requirements for financial infrastructures. Against such a backdrop, the PFMI was incorporated into the CSDR to ensure all relevant institutions in Europe abide by the rules. In addition to the recommendations of the PFMI, the CSDR also specifies outsourcing and capital requirements for European CSDs to cover all aspects of the EU market.

In Taiwan, TDCC follows PFMI regulations on a voluntary basis as there are no binding laws that require compliance. TDCC should continue monitoring the implementation of

the CSDR in Europe to determine if legislating PFMI principles is necessary for the purposes of strengthening compliance results, reducing market risks and enhancing operating efficiency.

(v) Provision of banking services by a CSD is not the mainstream practice worldwide

It's not very common that a CSD provides banking-type ancillary services to participants, not in Europe or the world. Of the 28 member states of the EU, only five allow CSDs to provide banking services. As such, it is clear that provision of banking services by a CSD is not the mainstream practice in Europe.

During the deliberation of the CSDR in Europe, the competent authorities of all member states were divided on whether or not CSDs should be allowed to provide banking-type ancillary services. The European Commission also highlighted the importance of risk isolation in the draft of the CSDR, arguing that CSD and banking services should be provided by different entities to isolate potential risks.

The finalized CSDR is less stringent than the draft, but has nonetheless put restrictions on CSDs attempting to provide banking-type ancillary services. In addition to acquiring authorization as a credit institution, the CSDs are also required to put in extra capital in preparation for additional risks arising from banking services. As a result, it is obvious that the EU in principle is more inclined to restrict the provision of banking services by CSDs.

If a CSD insists on providing banking services as one entity, it will have to fulfill higher requirements than ordinary banks, and yet can only provide limited services. Other than the two ICSDs and some CSDs in Austria and Hungary that have been providing ancillary banking services, all CSDs across Europe that wish to provide ancillary banking services in the near future are more likely to do so by designating a third-party financial institution.

B. Suggestions and recommendations

(i) Keep monitoring the strategies and measures taken by European CSDs following the implementation of the CSDR and seek opportunities for cooperation

TDCC has in recent years proactively engaged in international events and exchanges with international CSDs. In 2015, TDCC hosted the 19th annual meeting of the Asia-Pacific Central Securities Depository Group (ACG19) to showcase system innovations and the positive image of Taiwan across the world. The event turned out to be a great success. Additionally, given the government's objective to achieve globalization of Taiwan's capital market and the New Southbound Policy, TDCC has signed memoranda of understanding (MOU) for cooperation and information exchange with 23 international CSDs to facilitate cooperation in general business, staff training, information exchange and cross-border operations, and to increase our presence in global events .

Currently there are almost 40 CSDs of various sizes operating in the EU. In terms of the value of assets under custody, TDCC is comparable to a medium-sized CSD in Europe. The CSDR embraces free competition, so it's understandable that small- and medium-sized CSDs in Europe will face enormous competition pressure. In response, medium and small CSDs must figure out how to survive in an increasingly competitive environment.

TDCC should keep monitoring the development strategies, especially those adopted by medium-sized CSDs in Europe, and look for opportunities to work with foreign CSDs, either via mutual investment or formulation of a strategic alliance, to pave way for more globalized business operations.

(ii) TDCC can leverage its experience in full dematerialization of securities and proactively seek opportunities to transfer the know-how

Based on the planning of the CSDR, all securities circulated in the EU shall be dematerialized by 2025. Currently many European countries are in a crucial transition period of achieving full dematerialization.

Taiwan achieved full dematerialization of securities in 2011, thanks to the substantial contribution from TDCC. It is advised that TDCC should leverage the experience to create connections with European CSDs. By sharing the know-how with European counterparts, TDCC will have the chance to establish sustainable channels for future interactions.

(iii) TDCC should work with European and Southeast Asian (ASEAN) CSDs to broaden its cross-border business horizons

According to the CSDR, non-EU CSDs can also provide services in the EU territory, bringing in cross-nation competitions for the central custody industry. This presents an opportunity for TDCC to explore the possibilities of developing cross-border businesses in collaboration with the international or local CSDs in Europe to drive future development.

Notably, the ASEAN markets are also integrating at a rather fast pace as ASEAN member states seek closer business ties with each other. For instance, Singapore Exchange acquired a 20% stake in the Securities Clearing Corporation of the Philippines 20%, and Korean Securities Depository (KSD) licensed out its fund processing system to KSEI, the state CSD of Indonesia. TDCC has long maintained amicable relationships with ASEAN CSDs, and it should deepen the collaboration with ASEAN peers, and look for strategic partners to jointly explore new business opportunities in the ASEAN markets.

(iv) Providing ancillary services through banks is the better strategic option for TDCC at the moment, which is also in line with the mainstream practice in the EU

According to the CSDR, European CSDs may provide ancillary banking services in two approaches: the first is to acquire authorization as a credit institution, and meet the other requirements to be able to provide such services independently; the second is to designate a financial institution to provide such services on behalf of the CSD.

If TDCC decides to take the first approach to provide banking services, according to the regulations of the CSDR, it can only engage in cash account provision, cash credit for reimbursement, forex transactions, and cash processing. This means the scope of its banking business is limited, and TDCC will have to increase paid-in capital markedly and afford additional operating costs for limited benefits. More importantly, this is not in line with the mainstream practice in the EU.

TDCC does not have the qualification to engage in banking businesses. However, given diversification of its businesses, TDCC has collaborated with the central bank of Taiwan, international CSDs like Euroclear and Clearstream, as well as multiple local banks in

Taiwan. If it takes the second approach to provide banking services, it will be spared the trouble to increase the paid-in capital and won't need to pay additional operating costs. All it needs is to negotiate with collaborating banks to improve the operating efficiency of both sides. TDCC will play the role as the sole liaison between participants and banks. It is the participating banks that will undertake the credit and liquidity risks arising from the services. This is more in line with the mainstream practice in the EU and is a more sensible option for TDCC at the moment.

TDCC will stand by the commitment to serving the market by providing participants with efficient and safe post-trade services, such as registration, custody and book-entry processing, consequently helping participants reduce operating costs. Also, in light of a growing base of participants, TDCC plans to expand the book-entry services to cover more diversified financial instruments and international transactions in order to support deployment in the domestic market and facilitate alignment of participants with the global markets. The one-stop processing capabilities of TDCC is conducive to further integration of information and market innovation, thanks to its integrated, cross-field post-trade services. Moving forward, TDCC pledges to better fulfill its corporate social responsibilities and to build infrastructures that will allow the Taiwan's capital market to become more innovative, efficient and globally-compatible.