EUROPEAN CENTRAL BANK

EUROSYSTEM

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LEGAL COMMITTEE **RESTRICTED**

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LEGAL ASSESSMENT

0. EXECUTIVE SUMMARY

This legal assessment covers those legal aspects which are perceived to be most relevant for the development and functioning of TARGET2-Securities (T2S), based on the technical information contained in the T2S User Requirements (URD) and taking into account issues raised in public consultations or at meetings with T2S stakeholders. It focuses in particular on the following topics: legal basis, competition law aspects, substantive legal issues (e.g. accounts, finality, etc.), as well as regulatory requirements.

The assessment has been prepared by the Directorate General Legal Services of the ECB and has been reviewed by the Legal Committee (LEGCO) of the European System of Central Banks (ESCB). Substantive input has been received from the legal services of each ESCB national central bank (NCB) regarding the legal and regulatory situation in their Member State.

The following sets out the main conclusions of this assessment. However, additional legal work will be required for the next phases of the project, in order to reflect the increased detail to be expected and the potential evolution of the technical services.

– **Legal basis**

T2S is designed to be a purely technical platform providing specific services to central securities depositories (CSDs) for the settlement of securities transactions in central bank money, without entailing the creation of a new securities settlement system (SSS) or CSD.

Article 22 of the Statute of the European System of Central Banks and of the European Central Bank (the Statute) is the principal legal basis for the launch of the T2S platform as it allows the ECB and the NCBs to 'provide facilities' in order 'to ensure efficient and sound clearing and payment systems within the Community and with other countries'. This provision has a direct bearing on the Eurosystem's competence to launch and operate T2S, on account of the close and real connection between payment systems and securities clearing and settlement systems which, in the Eurosystem's case, is based on its operation of TARGET2-Cash since, by offering a real-time delivery versus payment (DvP) link between (cross-

system) securities settlement and cash settlement in (euro) central bank money on dedicated central bank cash accounts linked with real-time gross settlement (RTGS) accounts in TARGET2-Cash, T2S complements and is in effect an ancillary facility to the operation of TARGET2-Cash.

The Eurosystem's interest in securities clearing and settlement is also derived from its basic task to implement monetary policy under Article 105(2), first indent, of the Treaty establishing the European Community. As one of the main users of SSSs for the conduct of credit operations against adequate collateral, the Eurosystem considers the assessment and containment of their risks to be of the highest importance when accepting securities held with a CSD/SSS as collateral for such credit operations. To the extent that Article 17 of the Statute entitles the Eurosystem to 'open accounts for credit institutions … and other market participants' and to accept 'assets, including book entry securities, as collateral' for the purpose of conducting its operations, this Article provides a supplementary legal basis for the T2S settlement service for participating CSDs. In addition, having regard to Article 18.1 of the Statute, allowing the conduct of 'credit operations […] with lending being used on adequate collateral', to the extent that T2S supports the conduct of collateralised Eurosystem credit operations as part of the Eurosystem's performance of its basic monetary policy-related tasks, the establishment and operation of a facility providing services for the more effective conduct of Eurosystem credit operations and collateral management (through the efficient euro area-wide settlement of securities transactions in euro central bank money) fall within the Eurosystem's mandate.

Taking into account the technical set-up of T2S as currently envisaged, Articles 17, 18.1 and 22 of the Statute (in conjunction with Article 105(2) of the Treaty) provide a sound legal basis for the development and operation of T2S.

Article 105 of the Treaty and Article 2 of the Statute provide that the ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources ('open market economy principles'). The Eurosystem will ensure that conditions for access to T2S are objectively justified and reflect the character of 'public task' that befits the provision of central bank money, and the pricing will comply with the principles of not-for-profit cost recovery. In general, the Eurosystem's activities in the market will be conducted so as not to distort competition, unless and to the extent it may be strictly necessary for the fulfilment of its mandate.

The establishment of T2S fully complies with the open market economy principles, given that: (i) the establishment of T2S will promote technical and economic progress, (ii) this progress will be to the benefit of consumers, (iii) the establishment of a single technical platform to enable DvP settlement in central bank money is necessary, and (iv) T2S will contribute to transforming the existing local/domestic monopolies and will introduce potential competition between CSDs. In the same vein it is stressed that the relationship between the Eurosystem and CSDs will not raise concerns related to the open market economy principles, as the Eurosystem will continue to offer access to central bank money via the existing means, the CSDs would not be forced to use T2S, and the pricing and other conditions (e.g. access) for T2S services (both ancillary and core services) will not be discriminatory or abusive.

Consequently, there are sound legal grounds for concluding that, in its currently envisaged form, T2S will comply with all relevant competition law requirements applicable to the Eurosystem.

– **Substantive law issues**

T2S is structured so as to maintain a legally decentralised structure for securities settlement based on individual (national) CSDs. Each CSD will continue to be legally responsible under its applicable laws for opening, maintaining and closing the securities accounts of its users in T2S and, where relevant, those of the clients of these users, in the case of account operators in direct holding systems. SSSs operated by the national CSDs will continue to be 'systems' within the meaning of and designated under the Settlement Finality Directive (SFD)[1]. The services provided by T2S will be developed in such a way as to enable CSDs to meet their obligations both as CSDs and as operators of SSSs in their respective markets in compliance with the applicable national laws and regulations.

- Location of accounts

Strong legal arguments support the conclusion that either substantive rules of law or the applicable rules (or a combination of both) point to the laws of the country in which the CSD

[1] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (OJ L 166, 11.6.1998, p. 45).

that has opened the securities accounts is located as the law governing the proprietary issues with regard to the settlement of (at least) domestic securities held with the CSD. The operational centralisation, in a country other than that where a CSD is located, of all securities accounts on a single technical platform, in which account data and changes to account balances resulting from the settlement process are to be recorded, is not generally seen as affecting the legal qualification of the securities account as being maintained in the country where the CSD is located. Legal clarification at EU level of persistent uncertainty about the relevance of the technical location of IT infrastructure, as opposed to the legal location of accounts, may allow the full benefits to be obtained by dismantling specific local legal records maintained purely for the purpose of avoiding such residual uncertainty. This will not affect the legal viability of T2S, but its degree of integration. Thus, the proprietary aspects relating to CSD settlements of securities are subject to the laws of the country in which the CSD that has opened the securities accounts is located. In any case, T2S will be developed in such a way as to maintain the technical capacity to cater for the requirements for ongoing support of a domestic register, where stipulated by national law or specific market needs.

– **Finality**

With respect to the finality of transfer orders, a conceptual approach similar to that of TARGET2 is envisaged (i.e. different systems would be linked by a common technical infrastructure to process transfer orders). The SFD, by way of its implementation in the laws of Member States, ensures the harmonised protection of transfer orders submitted to a system which has been designated by the competent national authorities and notified to the European Commission. Transfer orders processed in T2S will obtain adequate protection at the domestic level of the SSSs/CSDs under the relevant legal regime, with the rules of the system (within the meaning of the SFD) being defined by the SSS concerned (which, however, may have to be adapted to the harmonised T2S framework).

With respect to the finality of transfer of full title, as well as the establishment of rights in securities, securities accounts in T2S will, from a legal perspective, continue to be maintained by the relevant CSD. Thus T2S will ensure that the legal effects of a credit or debit in a particular CSD will continue to be determined by the same legal regime as they are currently. Finality (completion) of the transfer (or establishment) of rights in securities will be determined in accordance with the laws of the country in which the CSD that has opened the securities accounts is located.

The legal differences to which cross-border holdings and transfers of securities and the underlying CSD links are currently subject will continue to exist in a T2S environment. However, the possible legal repercussions and risks will be significantly reduced since the specific features of T2S ensure transfer order finality within the meaning of the SFD on both sides of a cross-CSD transaction and assure standardised simultaneous settlement in T2S on

the accounts of both CSDs involved, resulting in the legal exchange of cash and securities. Even in the absence of legal harmonisation of substantive law, T2S will increase the predictability and legal certainty of the completion of the legal transfer. The further harmonisation of certain legal regimes (conflict of laws and substantive law) could facilitate the operation of T2S, and enhance it from a legal point of view.

Since the SFD predates the introduction of night-time settlement (NTS) procedures, it does not provide for a scenario in which the calendar day of opening such proceedings ends during the run of a settlement cycle. There is a risk that certain applicable national laws that were drafted in accordance with the SFD may not protect a transfer of securities from the effects of the opening of insolvency proceedings, if a settlement is carried out after midnight. In order to remove this residual risk, in revising the SFD, the protection of transfer orders, and hence of the settlement process, will have to be aligned with the needs of an NTS process that does not follow the boundaries of calendar days.

– **Regulatory requirements**

T2S will have to support the participating CSDs in complying in particular with the regulatory requirements of CSDs regarding outsourcing, anti-money laundering, data storage and audit requirements. However, it is acknowledged that additional regulatory, legal and supervisory requirements may apply and will have to be further assessed. Also, although T2S is designed to operate under the existing legislative and regulatory frameworks, the Eurosystem should support and encourage further harmonisation and convergence of regulatory requirements which are relevant to T2S, as this would further facilitate the environment in which T2S and CSDs using T2S services will operate.

Outsourcing

T2S is expected to provide a number of services to CSDs, so that an outsourcing relationship between a CSD and T2S will arise. As regards outsourcing requirements applicable to CSDs, the Eurosystem is aware that most of the CSDs will have to comply with specific or general hard-law and/or soft-law provisions when using the services to be provided by T2S. In many jurisdictions a distinction is made between the outsourcing by CSDs of operational functions that are considered critical, for which certain conditions or more stringent conditions than for non-critical functions apply, as opposed to the outsourcing of non-critical functions. In any event, T2S does not envisage the outsourcing of CSDs' core functions such as senior management responsibilities. The competent authorities of the Member States will have to assess whether the conditions for outsourcing will be met by CSDs. Given the nature of the services that T2S will provide, it is assumed that the contractual arrangements between T2S and CSDs will have to be drafted accordingly.

Anti-money laundering:

In a large number of Member States, anti-money laundering obligations apply to CSDs either by the inclusion of CSDs within the scope of national anti-money laundering legislation, or by the authorisation of a CSD as a credit institution. These obligations concern: customer due diligence (in particular, customer identification and the monitoring of transactions), record-keeping, and reporting of suspicious transactions. In order to comply with these requirements, CSDs must have in place appropriate internal procedures and systems. For many CSDs the most relevant requirements concern the reporting of suspicious transactions to the competent authorities, though for a number of CSDs, in particular those providing for direct connectivity of their customers, the requirements (including the storage of data) may go beyond this. In developing T2S, due care will have to be taken so that it will permit CSDs to continue to comply with applicable anti-money laundering provisions.

Data Storage

CSDs have requirements concerning the data they have to store, in particular regarding the duration of storage of transactions and the records to be made in securities accounts. There are a number of common features of the records which CSDs have to keep in almost all Member States, namely: the identification of the account holder, the financial instruments held, and the transactions relating to these holdings. However, these types of records may vary between Member States as regards the level of detail to be recorded; some CSDs are also required to keep records of additional information. The technical set-up of T2S will have to accommodate the possible need for access to relevant data by third parties, such as public authorities, regulators and auditors. Hence, the technical set-up of T2S will have to accommodate these data storage requirements.

Audit requirements

T2S will have to facilitate a CSD's compliance with the demands of auditors and regulators, where they act within their powers, to carry out audits of outsourced activities, or requests for information in relation to the services provided by T2S to a CSD.

Member States have rules on audits of CSDs, which are either contained in hard or soft law provisions (best practice), or a combination of both, and may entail the annual reports of the CSD being audited by an external auditor, or the outsourced functions being subject to the internal audit of the CSD. The technical set-up of T2S will have to pay due attention to these audit requirements.

With respect to the regulatory requirements identified above, subject to further analysis of the detailed requirements in each jurisdiction, and without prejudice to the powers of the competent authorities, T2S can be developed and operated so that the CSDs will receive the support of T2S and be able to comply with these regulatory requirements.

1. LEGALLY RELEVANT TECHNICAL ASPECTS OF T2S

T2S is a technical solution for the provision of efficient settlement services, but it will not itself constitute a system within the meaning of the SFD, and thus it will not have a finality regime in addition to the regimes applicable to CSDs[2] (though CSD rules may need to be adjusted to conform with T2S technical processes). Securities and dedicated cash accounts will be technically maintained and operated on the T2S platform, while they are legally maintained under the responsibility of the CSDs and NCBs, which are the account providers, with the accounts being opened in the books of the respective CSD. Under the technical scenario envisaged in the URD, CSDs will remain responsible for deciding which cross-CSD connections they will support within the T2S environment. For this technical platform to work effectively, database functionality will be needed. This will be limited to the basic function of compiling and electronically storing accounts-related data in a common technical location. CSDs will retain the legal responsibility for the records of their respective participants' accounts.

Based on the available information in the URD, and subject to further clarification of the scope of the project, the services that T2S will offer to CSDs in relation to its various components are as follows:

- T2S interface component:
  CSDs will be able to make use of the T2S interface to send/receive inbound and outbound messages and files to/from T2S.

- T2S life cycle management and matching component:
  The T2S lifecycle management and matching component (LCMM) will cover the lifecycle of the settlement and maintenance instructions. It includes instruction validation, matching, eligibility, instruction maintenance, and status management.

- T2S settlement component:
  The T2S settlement component will include *inter alia* the settlement process, the settlement optimisation process, the real-time gross settlement process, and the cross-CSD settlement process.

- Static data management and access:

[2] The term 'CSD' is used in this paper as defined in the Glossary of the draft URD: an entity, which holds and administers securities and enables securities transactions to be processed by book entry. Securities can be held in a physical but immobilised or dematerialised form (i.e. such that they exist only as electronic records). In addition to safekeeping and administration of securities, a CSD may incorporate clearing and settlement functions. There is no harmonised definition of 'CSD' and 'SSS' at EU level, so that the different concepts applied in the Member States have to be taken into account. Moreover, from a technical point of view, in some Member States T2S will provide services to the respective Securities Settlement System (SSS). An SSS is not usually a legal entity, so that the operator of the SSS, which is usually a CSD, is likely be the contractual counterparty of T2S.

Static data management will include the whole set of functions provided by T2S for the management of reference data related to the following:

- T2S actors (e.g. CSDs, NCBs, T2S parties, payment banks)
- Securities
- Securities accounts
- Cash accounts
- Configuration rules and parameters

- Archiving function in T2S:
  T2S will maintain a settlement-related central archive for its own purposes. T2S will archive transactions and static data. T2S will archive settlement transactions three months after the day of their final status (e.g. settled, cancelled etc.).

- Interfaces and connectivity services

Furthermore, the following principles will be applied:

– T2S will not entail the creation of a new CSD or SSS,
– T2S will not take on the management or control functions of CSDs,
– T2S will not have a legal relationship with customers, who will continue to open accounts with CSDs under objective and non-discriminatory conditions,
– T2S will be operated on the basis of full cost recovery, and
– Participation in T2S will be non-mandatory.

2. LEGAL BASIS

2.1 Article 22 of the Statute as a legal basis for T2S

Under the heading of 'Clearing and payment systems', Article 22 of the Statute allows the ECB and the NCBs to 'provide facilities' in order 'to ensure efficient and sound clearing and payment systems within the Community and with other countries'. This Article is the principal legal basis for the launch of the T2S platform.

In particular, Article 22 does not limit the power of the Eurosystem to provide facilities for payment systems of a particular design, nor does the wording to 'provide facilities' in order 'to ensure efficient and sound clearing and payment systems' require a facility to be part of a payment system. Payment systems can be designed to provide for contingent payment instructions by participants, e.g. instructions to carry out a cash transfer only on condition that simultaneous corresponding book-entries are made in the securities accounts of the participants.

It is argued that there is a close and real interconnection between payment systems (for which the Eurosystem's competence is undisputed)[3] and securities clearing and settlement systems, especially in the context of real-time DvP settlement in central bank money. T2S supports the Eurosystem's operation of TARGET2-Cash, which has primarily been designed for the processing of large-value euro payments[4]. By offering a real-time DvP link between cross-system securities settlement and cash settlement in (euro) central bank money on dedicated central bank cash accounts linked with RTGS accounts in TARGET2-Cash, T2S complements and facilitates the operation of TARGET2-Cash. In accordance with the 'T2S on T2' concept, as adopted by the Governing Council of the ECB, T2S dedicated cash accounts are funded exclusively through TARGET2-Cash, meaning that, at the start of each settlement day, the account balances on all cash accounts in T2S are zero, that liquidity is to be provided through T2S dedicated transit accounts in TARGET2-Cash and that, at the end of the settlement day, all liquidity on T2S dedicated cash accounts is to be automatically transferred back to the RTGS accounts of the payment banks with their respective central banks.

Simultaneous bookings on central bank cash accounts (the T2S dedicated cash accounts) and CSD securities accounts (their participants' accounts) through a single technical platform are an easy, highly effective and secure settlement method for facilitating linked cash and securities settlement. Further, the application of DvP mechanisms, whereby securities are only delivered against a simultaneous transfer of funds, means that transactions involving securities generally entail a cash payment. The settlement of both legs of the transaction needs to be subject to the same safeguards if asymmetries with systemic implications are to be avoided.[5] In view of the above it is concluded that T2S complements and is in effect a facility ancillary to the operation of TARGET2-Cash. It follows that Article 22 of the Statute empowers the Eurosystem to establish and operate a technical platform ('facility') whereby such DvP bookings are carried out, since such technical facility promotes the smooth operation of payments systems.[6]

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[3] The Eurosystem's competence in respect of payment systems is linked to (i) the implementation of monetary policy operations through payment systems, of which central banks are the focal point, and (ii) the wide-ranging implications of payment system failures for the stability of the financial system; see Carel van den Berg, The making of the Statute of the European System of Central Banks: An Application of Checks and Balances, Dutch University Press, Amsterdam 2005, p. 349, citing René Smits, The European Central Bank: Institutional Aspects, Kluwer, 1997, p. 297.

[4] In fact, many large-value payments involve a corresponding securities leg, without prejudice to the proprietary effects of the respective book-entries on securities accounts (transfer of ownership, e.g. for the purpose of a repurchase transaction, or a pledge).

[5] European Central Bank, Monthly Bulletin, April 2002, p. 52.

[6] This view has not been challenged even by commentators who are otherwise critical of the Eurosystem's role and powers in connection with SSSs and their regulation (see, for instance, Peter Mülbert, 'The legal Competence of the ECB for Target2-Securities', Report to the Financial Services Panel of the European Parliament's Economic and Monetary Affairs Committee, 2006, p. 21 at p. 28; A. von Bogdandy and J. Bast, 'Scope and limits of ECB powers in the fields of securities settlement. An analysis in view of the proposed "TARGET2-securities system"', Euredia 2006/3-4, p. 365 at p. 396).

A final point to be made is that the integration of dedicated central bank cash accounts and securities accounts within a single technical environment through T2S (and the facilitation of the provision of central bank money for settlement purposes by the Eurosystem that this entails) can contribute to increased financial stability (because of the real-time DvP settlement in central bank money and the use of state of the art technology with the highest contingency standards),[7] especially in times of crisis, helping to mitigate the operational or legal risks inherent in the use of commercial bank money for the settlement of DvP securities transactions (notably, cross-border and cross-system transactions). To the extent that the promotion of T2S services to participating CSDs contributes to the preservation of financial stability, the Eurosystem's interest in the proper functioning of securities clearing and settlement systems appears warranted and legitimates its launch of T2S.[8]

2.2 Article 105(2), first indent, of the Treaty and Articles 17 and 18.1 of the Statute as a legal basis for T2S

In addition, to Article 22 of the Statute as the principal legal basis for the launch of the T2S platform, the Eurosystem's competence in the area of securities clearing and settlement is also derived from its basic task of implementing monetary policy under Article 105(2), first indent, of the Treaty. The Eurosystem has a legitimate concern about disturbances to payment and securities settlement systems as well as to the money markets, both of which are relied upon as vehicles for the execution and transmission of monetary policy[9] and their malfunctioning could threaten the smooth implementation and execution of statutorily collateralised monetary policy operations. As one of the main users of SSSs in the conduct of credit operations against adequate collateral, it is only natural that the Eurosystem should attach the highest importance to the assessment and containment of their risks when accepting securities held with a CSD/SSS as collateral for such credit operations.

Articles 17 and 18.1 of the Statute are also relevant for determining the legal basis for the Eurosystem's launch of T2S. Article 17 allows the ECB and the NCBs to open accounts for 'credit institutions, public entities and other market participants and accept assets, including book-entry securities as collateral', 'in order to conduct their operations'; while Article 18

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7 Referring to the risk of contagion that the close association between payment systems and SSSs entails for the soundness of the former, the BIS has recently remarked that 'the potential for such spillovers is likely to have increased in recent years because of the increased importance of secured lending as money market instruments, the increased use of securities collateral to control risks and increase liquidity in payment systems through collateralised intraday credit lines, and the rapid growth of securities settlement volumes'; see Bank for International Settlements, Cross-border Securities Settlement, Basel, 1995, p. 6; see also, Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) Recommendations for securities settlement systems, Introduction.

8 A Eurosystem competence to provide joint cash and securities settlement-related facilities might also be read into Article 22 of the Statute on the basis of the Community law doctrine of 'implied powers' which, in its wider formulation, accepts that 'where an article of the EEC Treaty … confers a specific task on the Commission it must be accepted, if that provision is not to be rendered wholly ineffective, that it confers on the Commission necessarily and per se the powers which are indispensable in order to carry out that task'; Joined Cases 281, 283, 284, 285 and 287/85 Germany v Commission [1987] ECR 3203. In view of the above assessment of the relevance of Article 22 to establishing a legal basis for the involvement of the Eurosystem in the launch of T2S, this point need not be examined further.

9 See Bank for International Settlements, (above, note 9), p. 7.

recognises the Eurosystem's competence to determine the conditions under which it is willing to carry out its monetary policy operations and payment transactions based on intraday liquidity including, in particular, collateralised credit operations. To the extent that Article 17 entitles the Eurosystem to 'open accounts for credit institutions … and other market participants' and to accept 'assets, including book entry securities as collateral' for the purpose of conducting its operations, it could be argued that it provides a legal basis for the provision of the T2S settlement service to participating CSDs,[10] not least because the term 'assets' is fairly wide and *prima facie* appears to cover *any* method of transferring securities.[11] Article 18.1 of the Statute is similarly relevant for deciding whether or not the Eurosystem has a competence to launch T2S. A cursory examination of the provision reveals that its scope covers the lending and borrowing of 'marketable instruments' and, perhaps more importantly for present purposes, the conduct of 'credit operations…with lending being based on adequate collateral'. While Article 18 does not explicitly state that the Eurosystem has the power to set up a technical facility for the purpose of promoting the secure and efficient functioning of SSSs, a commentator has cogently observed that 'the ESCB/Eurosystem has a vital interest in the efficient and secure functioning of SSSs since, otherwise, its ability to pursue monetary policies by lending against collateral transactions will be severely hampered. It is also recalled that since its inception, the Eurosystem has (uncontested) been setting up and providing structures to support the (cross-border) use of collateral for credit operations purposes. Therefore, Articles 18.1 in conjunction with Article 17 could plausibly be interpreted to mean that, *a fortiori*, the ESCB/Eurosystem is empowered to set up the technical (IT-) infrastructure required for the purpose of effectively operating lending against collateral transactions'.[12]

It follows that, to the extent that T2S can support the conduct of collateralised Eurosystem credit operations, as part of the Eurosystem's performance of its basic monetary policy-related tasks, the establishment and operation of a facility providing services to promote the more effective conduct of the Eurosystem's credit operations and collateral management (through the efficient euro area-wide settlement of securities transactions in euro central bank money) falls within the mandate of the ECB and the NCBs, notwithstanding that such operations are currently conducted without such a platform, though less effectively and securely.

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10 See Marco Lamandini, 'The ECB and Target2-Securities: questions on the legal basis', Report to the Financial Services Panel of the European Parliament's Economic and Monetary Affairs Committee, 2006, p. 16; cf. Peter Mülbert, 'The legal Competence of the ECB for Target2-Securities', Report to the Financial Services Panel of the European Parliament's Economic and Monetary Affairs Committee, 2006, note 9 at p. 25, who takes the view that because, in its capacity as the manager and operator of T2S, the Eurosystem is not acting autonomously (as Article 17 of the Statute requires), but instead acting on behalf of the CSDs, Article 17 cannot legitimately be invoked as a legal basis for T2S.

11 See René Smits and Georg Gruber in 'Von der Gröben and Schwarze', Commentary on Article 22 ESCB Statute, paragraphs 7-8.

12 Peter Mülbert, 'The legal Competence of the ECB for Target2-Securities', Report to the Financial Services Panel of the European Parliament's Economic and Monetary Affairs Committee, 2006, note 9 at p. 25. Marco Lamandini, 'The ECB and Target2-Securities: questions on the legal basis', Report to the Financial Services Panel of the European Parliament's Economic and Monetary Affairs Committee, 2006, note 14, pp. 15-16) also takes the view that Article 18 of the Statute is relevant for deciding on the existence (or otherwise) of a legal basis for the ECB's tasks in this field, without nevertheless substantiating that view.

3. COMPETITION ASPECTS

3.1. Compliance with the principles of an open market economy

The ECB considers that the specific provisions of the Treaty on competition law (Articles 81 – 87) do not, as such, apply to Eurosystem central bank activities in their performance of the tasks assigned to them in the Treaty. However, Article 105 of the Treaty and Article 2 of the Statute provide that the Eurosystem central banks must act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources ('open market economy principles'). Neither the Treaty nor the existing case law provide a definition of compliance with the open market economy principles. The ECB considers that compliance with these principles means that the Eurosystem should assess each method of carrying out a public task according to the effects of that method on the market, and while the application of the general principles of competition should not mean that the carrying out of the Eurosystem's public tasks should be compromised, for example in the event of adverse effects on certain market parties, but that the Eurosystem should, as far as possible and consistent with the carrying out of its public tasks, refrain from following legislative or administrative policies that would unduly restrict competition. As with other Community institutions and bodies, the Eurosystem has wide discretion in performing its public tasks, but this discretion is subject to review by the Court of Justice[13]. Consequently, given the requirements of necessity and proportionality in carrying out its tasks, the Eurosystem's (public) activities must not constitute such an interference with market activities as would unduly restrict competition in the market or the freedom of individual undertakings to pursue their market activities.

For T2S, the conditions for access will be objectively justified and reflect the character of a 'public task' that befits the provision of central bank money, and its pricing will comply with the principles of not-for-profit cost recovery and, in general, the Eurosystem's activities in the market will be conducted so as not to distort competition unless and to the extent it may be strictly necessary for the pursuance of its public mandate. In this respect, the Court of Justice decisions on the rules in Articles 81 and 82 of the Treaty will be applied analogously, as they can, in general terms, be deemed to reflect the general principles of an open market economy. It is considered that an action that would not be prohibited under the competition rules should not be considered as potentially distorting competition. For this reason, the following section analyses T2S in light of the specific competition rules in order to determine the scope of the Eurosystem's duty to act in line with the open market economy principles.

[13] The ECJCourt exercises its jurisdiction in such a way that "'where the evaluation of a complex economic situation is involved, the administration enjoys a wide measure of discretion. In reviewing the legality of the exercise of such discretion, the court must confine itself to examining whether it contains a manifest error or constitutes a misuse of power of whether the authority did not clearly exceed the bounds of its discretion".'; Case 136/77 *A.* Racke v Hauptzollamt Mainz [1978] ECR 1245. The ECJ specified that inIn such cases the Court has specified that the discretion "'does not apply exclusively to the nature and scope of the measures to be taken, but also to some extent to the finding of the basic facts".'; Case 138/79 *SA Roquette Frères* v *Council* [1980] ECR 3333. See also Case C-122/94 Commission v Council [1996] ECR I-881.

3.2. Assessment of T2S in light of specific competition rules

3.2.1. The Eurosystem's internal allocation of functions

The basic legal framework for T2S is expected to be set out in an ECB Guideline, which is a binding legal act addressed to the Eurosystem central banks. It may be supplemented by complementary arrangements, the content of which would be determined by the Guideline.

As explained above, the specific competition rules of the Treaty are used as interpretative guidance for the purpose of analysing T2S in the light of the open market economy principles. Thus, the following paragraphs set out the reasons why, *inter alia*, the establishment of T2S and the offering of the T2S services to CSDs[14] do not contain restrictions which infringe open market economy principles:

i) The establishment of T2S promotes technical and economic progress:

Competition policy has the aim of integrating national markets into a unified market. Indeed, 'without efficient cross-border clearing and settlement arrangements in the EU, the ability and willingness of participants to trade in EU securities will be sub-optimal, the liquidity of financial markets will be adversely affected and the cost of capital will be higher than need be'. In the light of this, the services offered by T2S with respect to securities and cash accounts that are legally maintained by different entities (CSDs and NCBs), but technically maintained on a single platform, enable real-time DvP securities settlement in central bank money. T2S will allow for the most secure and effective form of securities settlement (i.e. DvP in central bank money) on a cross-system and cross-border basis. Further, under harmonised technical conditions it will technically and economically allow any CSD to offer settlement services for securities which are issued and held in another CSD not belonging to the same group. The interfaced model does not work on a single platform but requires constant interaction between the different systems in order to perform securities and cash settlements in DvP. Given the necessary discrepancy between the settlement of the cash side in TARGET2 and the settlement of the securities leg, possibly in two different CSDs (hence on three different platforms under different technical and operational rules), the interfaced model does not perform as efficiently as T2S.

ii) The progress will benefit consumers. The term 'consumers' includes all direct and indirect users of the products or services covered by the arrangement (both direct customers and subsequent purchasers)[15]:

By providing settlement facilities to the CSDs, T2S will contribute to transforming the existing local/domestic monopolies and it will introduce scope for competition between

[14] This could be interpreted to mean, in the language of Article 81(1) of the Treaty, that the Eurosystem would 'limit investment' and/or 'indirectly or directly fix selling purchase or selling prices or any other trading conditions' by not considering building an 'own settlement platform' and applying the common conditions (including pricing) of the service via T2S.

[15] The French word 'utilisateurs' used in Article 81(3) in the French language version of the Treaty describes the meaning better than the English word 'consumers'. See also Communication from the Commission – Notice – Guidelines on the application of Article 81(3) of the Treaty, OJ C 101, 27.4.2004, p. 97, paragraph 84.

CSDs. By enabling all CSDs to settle on a single platform under harmonised technical and economic conditions, T2S will enable them, for the first time, to actually compete against one another for the provision of settlement services.[16] The price transparency principle for T2S services, which T2S will comply with, enables customers to select a CSD according to its specific merits (in view of the value of the additional non-T2S-services the CSD may offer). A reduction in the price of settlement and increased efficiency (just one access account needed) will also benefit CSD customers. Moreover, competition will cover holding and settlement, thereby allowing customers to choose the CSD with which to open a securities account allowing for the holding and settlement of all securities that are accessible through T2S[17].

iii) The establishment of a single technical platform to enable DvP settlement in central bank money is required for the achievement of the above objectives:

Only central bank involvement will allow for real-time DvP settlement in central bank money as the most secure and efficient form of DvP settlement. Moreover, so far the market has not managed to establish a pan-European cross-system settlement service comparable to T2S, for which there is a genuine need.

iv) T2S does not eliminate competition:[18]

On the contrary, as set out above at ii), T2S will enable competition between CSDs. Concerning securities settlement services, T2S is the only viable mechanism which will enable cross-system DvP settlement of securities in central bank money, due to the Eurosystem's statutory role as the exclusive provider of central bank money. Since the Eurosystem will continue to offer access to central bank money via the existing means,[19] the CSDs are not forced to use T2S. The service offered by T2S will be unique (real time DvP settlement in central bank money on a single platform). Should it be considered that settlement in central bank money could be substituted by settlement in commercial bank money, which the ECB does not consider to be likely,[20] T2S would not hinder any third party from offering settlement in commercial bank money. The pricing of T2S services will comply with the full cost recovery principle, thereby ensuring that there is no

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16 T2S will establish a technical platform that enables DvP settlement in central bank money and in fact harmonises conditions. Even in the absence of legal harmonisation of substantive law, T2S will increase the predictability and legal certainty of the completion of the legal transfer, due to the transfer order finality on both sides of a cross-system transaction and the standardised simultaneous settlement in T2S on the accounts of both CSDs involved, resulting in the legal exchange of cash and securities. In this situation the harmonised access and pricing conditions between T2S and CSDs, as well as the required level of transparency regarding these conditions, will facilitate competition between CSDs to the benefit of the customers of CSDs.

17 There will not yet be competition on the issuance side, which still depends to a large extent on non-harmonised national laws, except in relation to holding and settlement.

18 Regarding the intra-Eurosystem relationship, as noted already, this is based on an ECB Guideline that establishes the common Eurosystem approach. It will thus ensure that uniform conditions apply to all CSDs.

19 i.e. through the TARGET2 interfaces. For reasons related to the performance of central bank duties and the prohibition of outsourcing of core central bank tasks, the outsourcing of central bank accounts to CSDs will no longer be offered.

20 This view is shared by various international standards (CPSS, IOSCO etc.). See also Marco Lamandini, 'The ECB and Target2-Securities: questions on the legal basis', Report to the Financial Services Panel of the European Parliament's Economic and Monetary Affairs Committee, 2006, p. 18. Even if settlement in commercial bank money were to be considered interchangeable with settlement in central bank money (and hence considered to be a competing service), T2S would not hinder third parties from offering settlement in commercial bank money.

artificial pricing element that would discourage the establishment of a competing service or prevent the current settlement systems from continuing or increasing the provision of their services to the market.

All decisions concerning T2S will be taken by the Eurosystem. It is intended to involve interested CSDs in an advisory committee, the advice of which will not be binding for T2S. The Eurosystem will take care to ensure that the advisory committee and other T2S forums involving external parties will not discuss matters that are of strategic interest for CSDs and which might raise competition law questions. In any event, the CSDs are responsible for their own conduct and, in particular, must not use involvement in the advisory committee for anti-competitive purposes.

3.2.2. The relationship between T2S and the CSDs

In order to analyse T2S in light of the open market economy principles, and using the competition rules of the Treaty as interpretative guidance (as referred to in Chapter 3.2.1), the following paragraphs set out the reasons why, *inter alia*, the relationship between T2S and the CSDs does not involve restrictions that would infringe the open market economy principles. The Eurosystem will offer CSDs an opportunity to use services based on the single T2S platform to facilitate DvP settlement in central bank money. The conditions of these services, e.g. mutual rights and obligations, and the level of services provided by the infrastructure, will be determined by the Eurosystem and will be implemented through contractual arrangements between the Eurosystem and individual CSDs.

In respect of Article 81 of the Treaty, this will be a vertical relationship.[21] The typical negative effects of such a relationship dealt with by Article 81 could be the foreclosure of other suppliers or buyers by raising barriers to entry, the reduction of inter-brand competition between the companies operating on the market (including facilitating collusion between suppliers or buyers), the reduction of intra-brand competition between distributors of the same brand, or the creation of obstacles to market integration (restriction of consumer freedom to purchase goods/services in any Member State they may choose). As stated already in Chapter 3.2.1, T2S would not have any of these kinds of effects (but rather the contrary effect of facilitating competition) and the relationship between the Eurosystem and the CSDs should not give rise to concerns related to Article 81 of the Treaty.

Regarding Article 82 of the Treaty[22], the Eurosystem (when offering the T2S service) would be in a situation comparable with a dominant position[23] or even a monopoly. In order to

21 In general, vertical relationships are less likely to lead to breaches of Article 81 than horizontal ones. Depending on the situation, the main attention is focused on the effects of the arrangement on competition at the level of trade of either or both of the parties concerned.

22 The Article prohibits the abuse of a dominant position but not its existence.

23 Even a market share of 40 % may indicate dominance. A market share of 50 % is a strong indication of the existence of a dominant position, and 70 % is conclusive evidence of it. A market share of 25 % or less is usually a clear indication of the absence of dominance.

comply with the principles of an open market economy, the Eurosystem will ensure that the pricing and other conditions – such as access – for T2S services (both ancillary and core services) are neither discriminatory[24] nor abusive (and exclude exclusionary or predatory conditions)[25]. Therefore, T2S would not infringe Article 82 of the Treaty. In fact regarding access,[26] T2S settlement services will be offered to all securities settlement systems protected under the SFD. The restriction of access to such entities is objective, as only systems which qualify for the level of harmonised and mutually recognised protection granted by the SFD achieve adequate legal protection of finality of transfer orders and netting (protection against adverse insolvency effects, certainty about the applicable law and insulation from systemic risks).

3.2.3. Service of general economic interest

Since T2S would not restrict competition in a manner that would be prohibited under the specific competition rules of the Treaty, if these were applicable to the Eurosystem, it is not relevant to apply Article 86(2) of the Treaty as interpretative guidance[27]. This Article applies in circumstances, such as lack of competition in the market or market failure, where a public intervention in the market is deemed justified and it provides that undertakings entrusted by Member States with the operation of services of general economic interest are only subject to the rules on competition insofar as the application of such rules does not obstruct their performance or duties[28]. This means that some practices that would otherwise infringe competition law may be allowed for an entity which provides services of general economic interest.

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24 'Discriminatory' means that dissimilar conditions are applied to equivalent transactions (placing one trading party at competitive disadvantage), or that the same treatment is given to situations that are dissimilar. Differentiation in pricing requires objective justification, such as volume discounts.

25 'Predatory pricing' means attempting to drive a smaller competitor out of the market e.g. by systematically undercutting its prices, or by selectively offering lower prices only on such services/products as can be offered by a competitor. Another prohibited form of pricing is 'price squeezing', where an entity that is active both in primary and secondary markets can use its pricing or other conditions to exclude entities that would need its service/products in the primary market in order to compete in the secondary market.

26 In competition law terms T2S will constitute an essential infrastructure (in view of real-time DvP settlement in central bank money). A typical example of abuse would be the denial of access to competitors to essential infrastructures or grant of access on unfair terms, thereby preventing competitors from providing their service effectively. The same applies when a dominant company controls a 'bottleneck', meaning that it controls an input in the production process which is necessary for upstream or downstream firms to carry on their activities, and when the dominant company forecloses vertically related markets by denying or otherwise limiting access through its bottleneck to one or more competitors. Denial of access or refusal to supply is not objective if its purpose is to eliminate competition; Joined Cases 6/73 and 7/73 Commercial Solvents v Commission [1974] ECR 223; Case 311/84 CBEM [1985] ECR 3261. In this sense, access to the service/supply would have to be indispensable for entering the market (and/or there must be no actual or potential substitute for the supply/service/facility). Indispensability could mean that it is not economically viable to establish an alternative; Case C-7/97 Bronner [1998] ECR I-7791 (para 46). In general, whether some conduct is deemed to be objectively justified requires case-by-case analysis. In a recent opinion of 6 March 2008 in Case C-49/97, MOTOE Advocate General Kokott stated that '[T]he existence of such an objective reason is particularly evident where, at a planned motorcycling event, the safety of the racers and spectators would not be guaranteed because the organiser did not take the appropriate precautions.'

27 Nevertheless, on the basis of the criteria set out in Chapter 3.2.1, the establishment and offering of T2S would have a character of a service of general economic interest.

28 Communication from the Commission – Services of general interest in Europe, (OJ C 17, 19.1.2001, p. 4).

4.1 General

In order to maximise the efficiency gains both for domestic and for cross-border settlement, the services provided by T2S to CSDs will be offered in a standard form and, most significantly, on a centralised technical platform (the 'T2S platform'). As has been stated in the comments on Principle 5 of the General Principles of T2S, as approved and published by the Governing Council of the ECB 'the centralised platform should cover the full functionality needed for such harmonised services' and 'the objective of T2S is to provide a level of functionality that frees CSDs from maintaining securities balances on a separate platform or from duplicating processes.' In the same vein, Principle 6 states that 'securities account balances shall only be changed in T2S.' Thus, on the one hand the services provided by T2S include the technical maintenance of databases, including account balances and account holder and securities related data, and on the other hand they include the operation of instructions relating to such account holdings (primarily settlement instructions resulting in debits and credits on securities and dedicated cash accounts, and aiming at the transfer of or the establishment of rights in securities and the transfer of central bank money).

In contrast to the integrated operational set-up of T2S, the legal analysis of the processes to be undertaken by T2S largely maintains the set-up and qualification of the existing settlement infrastructure. Thus, as part of its legal conception, T2S maintains a legally decentralised structure of securities settlement based on individual (national) CSDs: 'The respective CSD users' securities accounts shall remain legally attributed to each CSD' (Principle 4). Each CSD will continue to be legally responsible (under their applicable laws) for opening, maintaining and closing the securities accounts of its users in T2S and, where relevant, those of the clients of these users as well (for account operators in direct holding systems).[29] SSSs operated by national CSDs will continue to be 'systems' within the meaning of, and as designated under, the SFD.[30] As a consequence, the services provided by T2S will be shaped so as to enable CSDs to meet their obligations both as CSDs and as operators of SSSs in their respective markets under the applicable national laws and regulations. In particular, proprietary aspects such as the finality (i.e. completion) of the transfer of, or establishment of rights in, securities will be determined in accordance with the laws of the country in which the CSD that has opened the securities accounts is located.[31]

4.2 Location of accounts

In the existing settlement infrastructures at national level, at least with regard to domestic securities[32] proprietary aspects relating to the CSD settlement of securities are subject to the

29 See the comments on Principle 4.

30 According to Principle 7, T2S will require participating CSDs to be designated SSSs under the SFD, notified by the competent national authority to the European Commission, in order to benefit from protection under the SFD.

31 See the comments on Principle 7.

32 With regard to foreign securities (i.e. those for which the CSD is not the issuer CSD) the laws applicable to proprietary aspects have not yet been fully harmonised at EU level. See also below Chapter 6 on the treatment of foreign securities.

laws of the country in which the CSD that has opened the securities accounts is located. However, in T2S, there is operational centralisation of all securities accounts on a single technical platform, on which account data and changes to account balances resulting from the settlement process are to be recorded. There is a question as to whether the location of this technical platform in a country other than that where a CSD is located could affect the legal qualification of the securities account as being maintained in the country where the CSD is located.

The issues of the location of accounts and applicable law relate to both the substantive concept of 'securities account' and the conflict of laws rules approach in each country.

4.2.1 Conflict of laws approach

As regards the current conflict of laws regime in the EU for book-entry securities, harmonised national laws exist for certain limited topics: the provisions on the determination of the applicable law in the SFD, the Financial Collateral Directive[33] and the Directive on the Reorganisation and Winding-Up of Credit Institutions[34] apply to the matters governed by these directives (i.e. collateralised transactions in the context of systems and central bank operations or as part of financial collateral arrangements between qualifying counterparties and the rights in securities held with credit institutions that are subject to reorganisation or winding-up proceedings) and the place of the relevant account approach (also known as 'place of the relevant intermediary approach' – PRIMA). The currently harmonised EU regime does not address the basic scenario of an outright transfer of securities nor, with regard to matters to which it is applicable, does it define harmonised criteria for determining the location of securities accounts in complex models of securities holdings involving technical infrastructures such as T2S.

As a result, it is sometimes claimed that the problem with classical PRIMA approach of Community law is that, in rare cases, deciding where securities accounts are located lacks certainty, depending on the jurisdictions involved. In the absence of a harmonised definition of the location of a securities account, or a statutory definition in the country in question, it is necessary to base the decision of the location of a securities account on the national substantive law applicable in each jurisdiction.

4.2.2 Concepts of securities accounts

In contrast to a 'cash account', there is no general definition of a 'securities account'. In some countries, the term is understood to refer to a genuine form of securities holding, subject to a specific legal framework determining the legal nature of such holdings and the method of

[33] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (OJ L 168, 27.6.2002, p. 43).

[34] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions (OJ L 125, 5.5.2001, p. 15).

transfer (e.g. Belgium, Luxembourg, Finland, Denmark, Sweden). In others, the term merely points to a technical means of accounting, relating to underlying property rights in securities that exist legally and are transferred independently from the account (hence, only declaratory account entries) (e.g. Austria and Germany). At CSD level, in some countries, securities accounts are maintained directly on behalf of investors, thereby providing, at least in principle, a record of ownership (direct holding systems), while in other countries, only financial institutions are eligible to hold CSD accounts, aggregated for their customers ('omnibus accounts'). In turn, these financial institutions maintain accounts for investors or other lower-tier intermediaries, so that beneficial owners can only be identified at the lowest level of the holding chain (indirect holding systems).

The different approaches to the legal nature of securities accounts, as well as the different structures of the securities holding systems, are reflected by the different legal (proprietary) effects which national laws attribute to settlements at CSD level (and the resulting debits and credits on the participants' CSD accounts). In direct holding countries, account entries (usually referred to as book entries) resulting from CSD settlements are generally considered to have immediate proprietary effects (e.g. Bulgaria, Denmark, Finland, Malta, Romania, Slovenia and Sweden). The same may also hold true for certain indirect holding countries (e.g. Belgium and Luxembourg). However, in most indirect holding countries account or book entries resulting from CSD settlements (i.e. on CSD participant's accounts) are not considered to have immediate legal effects on the transfer of ownership in favour of a customer/investor (e.g. France, Italy and Slovakia). However, they may have immediate legal effects, if the transfer relates to a transaction which the CSD participant has carried out on its own (proprietary) account. To add further complexity, CSDs (including those in direct holding systems) use various records/accounts to which the holdings of account holders are posted, even if only temporarily; most of these exist for internal technical purposes, such as for confirmation of instructions, bookkeeping, etc., thus without any transfer of ownership.

Where book entries are historically linked to certificated securities, there is widespread consensus that the location of the account is linked to the country of the place of business of the CSD in which the securities are or (prior to dematerialisation) used to be physically located. With regard to securities for which the CSD is also the issuer CSD, this follows directly from the traditional *lex rei sitæ* rule. With the growing demand for holdings in foreign securities, the physical transfer of these securities from the foreign issuer CSD to the investor CSD has largely been replaced by custody-link relationships between CSDs, and the traditional *lex rei sitæ* rule has evolved in some, but yet not all,countries to become today's PRIMA rule, with securities accounts being the determining factor, as the legal complement to the modified depository structure. The PRIMA rule no longer assumes the existence of securities certificates for defining the location of securities, and it applies equally well to dematerialised securities.

On the other hand, in the United Kingdom and in Ireland ownership rights in investment securities are not traditionally linked to certificated securities, and thus not to the location of a CSD maintaining accounts, but instead to the issuer or its registrar which maintains the register in which the transfer of title is legally effected. Even though the legally relevant registration may since have been shifted to the 'Operator register of securities'[35], which is in effect a CSD account, UK law explicitly requires this CSD account to be maintained in the UK[36].

In all other Member States (except for Ireland, where CSD account entries are neither of constitutive nor declaratory relevance), either substantive rules of law or the applicable conflict of laws rules or both point to the law of the country in which the CSD that has opened the securities accounts is located as the law governing the proprietary issues relating to the settlement of (at least) domestic securities held with the CSD, or they at least provide strong legal arguments in favour of this result. In all these countries the technical maintenance and operation of CSD accounts on a platform located outside the country of the CSD is considered a matter of outsourcing, and is subject to the applicable supervisory laws and regulations.[37]

4.2.3 Legislative initiatives

There are some residual legal uncertainties in some jurisdictions regarding the determination of the legally relevant location of securities accounts of CSDs and the applicable laws governing proprietary matters relating to those accounts (in particular, relating to securities for which the CSD is not also the issuer CSD). The work currently being undertaken at EU and international level on conflict of laws regimes is expected to provide additional legal certainty to CSDs by the time T2S is planned to go live. The EU is currently looking into ways of reviewing the existing EU conflict of laws regime.

Legislative clarification, either at EU or national level, of any remaining uncertainties about the relevance of the technical location of IT infrastructure as opposed to the legal maintenance/location of accounts may make it possible to reap the full benefits of dismantling specific local legal records (e.g. in Belgium, France and the Netherlands) that are only designed to avoid such residual uncertainty, based on the absence of clear determining factors in the legal rules or relevant case law. This will not affect the legal viability of T2S, but rather its degree of integration.

In any case, T2S will have the technical facilities in place to cater for domestic requirements for the ongoing support of a domestic register where required by national law (e.g. Ireland

35 See paragraph 27 (1) of the UK Uncertificated Securities Regulations, SI 2001 No 3755.
36 See paragraph 16 (1) of Schedule 4 of the UK Uncertificated Securities Regulations.
37 See below Chapter 5 b) on outsourcing issues.

and the United Kingdom) or by specific market needs. Again, the work of the European Commission in the Legal Certainty Group may lead to changes in this respect, given the priority given to the securities accounts maintained by account providers such as CSDs.

4.3 Finality

The term 'finality' is neither defined nor used in the enacting terms of the SFD. However, it appears in two different contexts in the preamble to the SFD, namely in recital 9 referring to 'finality of settlement', and in recital 12 referring to 'finality of netting'. Both of these are concerned with the protection of operational processes against systemic risk. Hence, even though 'finality' is not used in the enacting terms of the SFD, its use in the recitals referred to establishes that, for the purposes of the SFD, 'finality' refers exclusively to the point in time when transfer orders, as defined in Article 2(i) of the SFD, (1) become legally enforceable and binding on third parties, even in the event of insolvency proceedings against the entity that has given the transfer order (Article 3 of the SFD), and (2) may not be revoked by that entity, nor by a third party (Article 5 of the SFD).

As regards the legal implications of the introduction T2S, two legal effects have to be distinguished: one relates to the finality of transfer orders according to the SFD, and the other relates to the subsequent transfer or establishment of rights in securities which, in the terminology commonly used in the post-trading industry, are often referred to as issues of 'finality'.

4.3.1 Finality of transfer orders (instructions)

With respect to the finality of transfer orders, a conceptual approach similar to that of TARGET2 is envisaged, so that different systems would be linked by a common technical infrastructure to process transfer orders. The technical processing of transfer orders submitted either by the CSDs or their authorised customers (direct connectivity) will take place in the technical environment of T2S.

From a legal perspective, transfer orders will only be executed (settled) between participants within the same system in accordance with the relevant rules of the system. As stated before, the SSSs will continue to be 'systems' of the respective national CSDs within the meaning of, and as designated under, the SFD.[38] Thus, the services provided by T2S will be part of the operations of the respective SSSs and governed by their rules (subject to the conditions laid down in the national laws governing the system in accordance with Article 3(3) of the SFD). In order to facilitate cross-CSD/SSS transfers for their participants, CSDs will have to open

[38] According to Principle 7 of the General Principles of T2S, T2S will require participating CSDs to be designated as SSSs under the SFD, and notified by the competent national authority to the European Commission in order to benefit from protection under the SFD.

and hold accounts with the other CSD in T2S and thus in fact participate in the other SSSs (see in more detail below in Chapter 4.3.3).

By its implementation in the laws of Member States, the SFD ensures the harmonised protection of transfer orders submitted to a system which has been designated by the competent national authorities and notified to the European Commission. Transfer orders processed in T2S will therefore benefit from adequate protection at the domestic level of the SSSs/CSDs under the applicable national laws. In particular, this means that transfer orders that have been entered into an SSS[39] before the opening of insolvency proceedings against the participant will be legally enforceable and binding on third parties as well as on the participant (Articles 3(1) and 5 of the SFD) for the purpose of settlement by T2S as technical service provider to that SSS. The relevant moment of entry of the transfer order into the SSS is to be defined by the rules of the SSS in question, but this may have to be adapted to the harmonised T2S framework.

At the time of its adoption in 1998, the SFD was not drafted to deal with the complexity of modern financial market infrastructures. The current review process initiated by the European Commission is expected to provide greater clarity and enhanced legal certainty, for example on adequate protection of night-time settlement[40] and to facilitate the interoperability of systems. A proposal for a revision of the SFD will be launched by mid 2008. The Eurosystem encourages and strongly supports this review process and its quick finalisation to increase further systemic stability at domestic and cross-border levels.

4.3.2 Finality of transfer

With respect to the 'finality of transfer', including the transfer of title and the establishment of rights in securities, from a legal perspective securities accounts in T2S will continue to be maintained by CSDs so that, as stated in Chapter 4.1 above, proprietary aspects such as the finality (i.e. completion) of the transfer or establishment of rights in securities will be determined in accordance with the law of the country in which the CSD that has opened the securities accounts is located. T2S will ensure that the legal effects of a credit or debit in a particular CSD will continue to be determined by the same legal regime as they are currently.[41]

4.3.3 Cross-CSD transfers / cross-system finality

As one of its central operational features, T2S aims to provide account holders in participating CSDs with the option of a seamless transfer of holdings to any account technically maintained

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39 From a legal perspective, directly connected participants are normal CSD/SSS participants with the CSD/SSS with whom a legal relationship is established, and thus any transfer order entered by such directly connected participant is legally entered into the relevant SSS.

40 See also below Chapter 4.3.4.

41 As to the diverging legal effects of debits and credits at CSD level see Chapter 4.2.2 above.

on the T2S platform for any participating CSD, thus providing the operational facility for directly instructed cross-CSD transfers.

As a technical platform servicing CSDs, TS2 will not alter the contractual structures of CSD relationships and thus not change the existing *legal* set-up of cross-CSD securities transfers. CSDs will remain responsible for deciding which cross-CSD connection they will support within the T2S environment, and will continue to be bound to satisfy the requirements of their regulatory authorities as to the adequacy of cross-border connections. However, CSD compliance with national regulatory and oversight requirements will be supported by T2S.

As stated above, from a legal perspective transfer orders will only be executed (settled) between participants within one and the same system in accordance with the rules of the system. In order to establish a cross-CSD transfer (e.g. from an account of a participant A in CSD 1 to an account of a participant B in CSD 2), two account movements must be executed: one between two accounts in CSD 1, namely between the accounts of A and CSD 2 in the SSS of CSD 1, and the other one between two accounts in CSD 2, namely between the accounts of CSD 1 and B in the SSS of CSD 2[42]. This requires the existence of a connection between the CSDs involved, in effect the opening of accounts for the other CSD in one's own system. The two transfer orders are only settled and accounts debited and credited within the SSSs/CSDs.

As all securities accounts must remain legally attributed to a specific CSD, and as T2S will not itself constitute a CSD/SSS[43], it follows that the structure of cross-CSD transfers leaves no room for an overarching cross-system finality regime in addition to the finality regimes applicable within such systems.

One particular area which is relevant to the adequacy of cross-border connections between CSDs can be addressed under the heading of 'cross-system finality'.

As stated earlier in this chapter, two different legal effects are often labelled as issues of 'finality', one being the finality of transfer orders in accordance with the SFD, and the other being the subsequent transfer or establishment of rights in securities. With regard to finality within the meaning of the SFD, the transfer orders (instructions) relating to each settlement become final, in other words legally enforceable and binding on third parties as well as on the participant, at the moment of their entry into the SSS as defined by the rules of the SSS in question[44]. However, since the rules of all participating systems will have to be adapted to the

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42 While the outbound account maintained by CSD 1 for CSD 2 is, in principle, a regular participant account, the inbound account maintained by CSD 2 for CSD 1 is a mere technical account, as it does not represent genuine holdings of CSD 2 but merely reflects holdings genuinely attributable to another CSD (a fact that does not affect the internal accounting requirements of the inbound CSD).

43 See Principle 3.

44 Following the previous example, the settlement services provided by T2S will be considered legally as one settlement within CSD 1 (namely between the accounts of A and CSD 2) and one settlement within CSD 2 (namely between the accounts of CSD 1 and B), each of them subject to the rules of the SSS in question and subject to the conditions of the national law governing the system in accordance with Article 3(3) of the SFD.

harmonised T2S framework, in order to facilitate seamless cross-CSD transfers, the moment of finality of transfer orders will be harmonised as far as possible on both sides of the transaction[45].

The transfer order finality within the meaning of the SFD must be distinguished from the moment at which the subsequent transfer, or more correctly, the legal or proprietary effects of the two CSD settlements, takes effect. As stated above, the proprietary aspects such as the finality (i.e. completion) of the transfer or establishment of rights in securities must be determined by the laws of the country in which the CSD that has opened the securities accounts is located.[46] Unlike the rules of the SSSs with regard to the definition of the moment of transfer order finality, which can be and may have to be adapted by the CSDs participating in T2S, the current legal regimes of the Member States which are applicable to the proprietary effects of CSD settlements do not provide for harmonised timing in the absence of EU harmonisation.

'Settlement' does not in itself have a proprietary effect. 'Settlement' refers to the completion of a transaction involving the discharge of obligations in respect of funds or securities between two or more parties.[47] The legal effect of such discharge, being the completion of a transfer or establishment of rights in securities, is to be determined in accordance with the law of the countries in which the CSDs involved in the cross-CSD transfer are located. In some countries, the moment of settlement, or more precisely the credit on the account of the transferee, coincides with the moment of acquisition of property rights by the transferee.[48] In other countries, the transfer of ownership is only completed at the moment when the entity maintaining the securities account for the transferee has credited the securities to this account, i.e. the final act causing the transfer is effected at the level of the relevant intermediary (e.g. in France, Italy and Slovakia). This may take place some time after the technical settlement at CSD level. Hence, a cross-CSD transfer may involve two countries, and thus two legislative regimes, that point to two different moments for the transfer of proprietary rights on each side of the transfer. Thus, a transfer between two such CSDs will be seamless with regard to the technical settlement time in T2S, but not with regard to the timing of the legal effect at the level of the parties involved.

The existing legal differences to which cross-border holdings, transfers of securities and, in particular, CSD links are subject will continue to exist in a T2S environment. However, the possible legal repercussions and risks will be significantly reduced since, even in the absence

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45 E.g. for A with regard to the securities transfer instruction and for B with regard to the payment instruction, as well as for the related instructions by CSD 1 and CSD 2, which are to be generated automatically by T2S in order to facilitate the cross-CSD transfer.

46 See the comments on Principle 7.

47 Source: ECB Blue Book; BIS Glossary of Terms Used in Payments and Settlement Systems.

48 This is typically the case in countries with a direct holding structure, but also in some indirect holding countries (see the examples in Chapter 4.2.2 above).

of legal harmonisation of substantive law, T2S will increase the predictability and legal certainty of the completion of the legal transfer. This is a consequence of the specific features of T2S, which ensure transfer order finality within the meaning of the SFD on both sides of a cross-CSD transaction, ensuring that the transfer will take effect and that the standardised simultaneous settlement in T2S on the accounts of both CSDs involved will result in the legal exchange of cash and securities. The further harmonisation of certain legal regimes (regarding both conflict of laws and substantive law, for example in the current revision of the SFD, or resulting from the ongoing work of the EU Legal Certainty Group and UNIDROIT[49]) could facilitate the operation of T2S, and enhance it from a legal point of view. In particular, given that the envisaged structure of T2S will be based on the relevance of book entries for the holding and transfer of securities, the soundness and efficiency of T2S could be further strengthened if there were harmonised EU rules on the rights resulting from book entries in relation to securities held through an intermediary.

4.3.4 Finality of transfer orders and night-time settlement

'Night-time settlement' (NTS) refers to the processing of large quantities of transactions during night hours, and the completion of such settlement prior to the beginning of business operations of the securities markets on the morning of the agreed settlement day (S). Even though the bulk of the processing (including settlement) might take place before midnight (thus on S-1), the fact that the settlement cycle will continue after midnight may have certain implications for the protection of transfer orders by the SFD.

According to Article 3(1), first paragraph, of the SFD[50] a transfer order that has entered the SSS to be processed in the NTS will be protected, if the opening of the insolvency proceedings took place after the transfer order entered the system. However, should the opening of insolvency proceedings take place prior to the beginning of the NTS (around 18:45), the protection of Article 3(1), first paragraph of the SFD would not be available. In this case, Article 3(1), second paragraph of the SFD would only protect transactions that have been settled 'on the [calendar] day of opening of such proceedings', provided the CSD was neither aware nor should have been aware of the opening of insolvency proceedings before settlement.

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49 The Legal Certainty Group is expected to give its advice by mid 2008. This will then have to be presented in the form of a Commission proposal for an EU legal act, e.g. a Legal Certainty Directive. UNIDROIT may finalise an international convention in September 2008. Both projects are still largely compatible. In particular the fact that UNIDROIT is aiming at harmonisation at a high level, referring the details to the applicable non-convention law, gives ample leeway to the EU to provide a higher degree of harmonisation. However, with the further progress of the Legal Certainty Group work a few, but critical, substantive divergences have emerged. These relate for instance to the status of designating entries (earmarking) and control agreements, and their interaction with acquisition in good faith and priority rules. Attention should be given to ensuring that both projects remain fully compatible.

50 'Transfer orders … shall be legally enforceable … even in the event of insolvency proceedings against a participant … provided that transfer orders were entered into a system before the moment of opening of such insolvency proceedings'.

Since the SFD predates the introduction of NTS procedures, it does not provide for a scenario in which 'the [calendar] day of opening of such proceedings' ends during the run of a settlement cycle. There is still the risk that certain national laws that were drafted in accordance with the SFD may not protect a transfer of securities from the effects of the opening of insolvency proceedings, if the settlement is carried out after midnight. However, to remove this residual risk, which is not specific to T2S, in the course of the revision of the SFD, the protection of transfer orders (and hence of the settlement process) will have to be aligned with the needs of an NTS process that does not follow the boundaries of calendar days.

4.4 Foreign securities in T2S

One essential element of the T2S project is the establishment of a pan-European post-trading environment. In order to enable securities to circulate between all CSDs using the T2S platform, national laws have to provide for the inclusion of foreign securities in the domestic securities accounts of participating CSDs ('importability') as well as for the transfer of domestic securities to foreign CSDs/SSSs ('exportability'). Furthermore, the regulations have to support the establishment and operation of such CSD connections and the admissibility of securities eligible for settlement at the issuer CSD by the investor CSD.

4.4.1 Establishment and operation of CSD connections in T2S

Currently, relatively few CSDs maintain large volumes of foreign securities by way of CSD links. Where foreign securities are held on accounts with investor CSDs, these CSDs do not necessarily maintain those holdings directly with the issuer CSD (or another investor CSD via a relayed link), but also with custodian banks (e.g. Luxembourg, Spain and Romania). More often, foreign securities are held by investors through holding chains that do not involve the domestic CSD but are linked to domestic or international custodian banks that maintain accounts in foreign markets (e.g. Germany, Finland, Spain, Greece and Malta). This may be either because the domestic investor CSD does not or legally cannot offer holdings in foreign securities, at least not from this particular country or for this International Securities Identifying Number, or for other market-related reasons, such as corporate action service.

The establishment of connections between CSDs (such as link relationships) may be subject to prior supervisory approval (e.g. Romania) or even a specific licence (e.g. Slovenia). It may also be subject to detailed statutory requirements as to the applicable legal framework in the country of the prospective link partner, usually the issuer CSD, as to the legal rights of a holder of securities (e.g. Germany and Slovakia). The level of supervision of the foreign CSD may also be a concern.

In accordance with the 'European Code of Conduct for Clearing and Settlement' of 2006, agreed by European CSDs, stock exchanges and clearing houses, CSDs can have access to all

other European CSDs as well as to transaction feeds from trading venues and/or central counterparties.[51] Hence, restrictions on the establishment of connections will not originate with issuer CSDs or from other market participants. Further, Articles 34 and 46 of the MiFID[52] give market participants the right to choose the settlement system (i.e. the CSD) for their trades and a right of access to CSDs from other Member States, thereby providing a wider scope for CSDs to make use of CSD connections/links. However, the precondition for using a CSD connection is the applicability of the substantive law to the transfer of securities that are subject to the CSD connection.

4.4.2 Admittance of foreign securities to a domestic CSD

A CSD may only enter into a CSD connection/link relationship with another CSD if the laws of the investor CSD allow for the inclusion of foreign securities in its domestic securities accounts ('importability'), and if the laws of the issuer CSD allow for the transfer of domestic securities to foreign CSDs/SSSs ('exportability')[53]. In order for T2S to reach its goal of providing comprehensive access to all securities from participating markets through one account in any participating CSD, the level of admissibility of securities to a CSD connection is of high importance.

Restrictions on exportability may arise if the law of the issuer country either does not allow its securities to be kept in a foreign CSD, or if it requires certain securities holding or registration methods or stipulates other requirements that make the holding in the investor CSD effectively impossible. For instance, securities issued in a direct holding country might not be permitted, or might only be permitted with limited rights for the holder, through an omnibus account offered by an investor CSD in an indirect holding system, unless the law of the issuer CSD provides for such an exception (e.g. in Finland). The same is true if the law of the issuer CSD, even though an indirect holding system, generally restricts the number of holding tiers that can provide ownership rights to its immediate participants (see the exception for omnibus accounts opened on behalf of clients in foreign markets in Spain).

On the side of the investor CSD, possible restrictions on importability may include requirements as to where securities must be kept or listed on a stock exchange, or the form of issuance (certificated or dematerialised). If the investor CSD acts in a direct holding environment, the holding function for foreign securities has to be detached from a possible domestic registration function. Most legal systems with a direct holding structure for domestic investors and/or domestic securities provide exemptions from their general rules for the import of foreign and the export of domestic securities, allowing the holding of foreign

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51 See Chapter IV of the Code of Conduct.

52 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 145, 30.4.2004, p. 1). Directive as last amended by Directive 2008/10/EC (OJ L 76, 19.3.2008, p. 33).

53 See Legal Certainty Group, advice on Giovannini Barrier 9, Doc. LCG-20, page 70 et seq.

securities through omnibus accounts, and the holding of domestic securities through an omnibus account on behalf of a foreign CSD at the domestic CSD (e.g. Finland, Denmark, Sweden, Slovenia, Slovakia, Romania and Bulgaria).

As stated above, CSDs will remain responsible for deciding which cross-CSD connections they will support within the T2S environment, subject to the legal and regulatory limitations mentioned. Remaining limitations are being addressed by the work undertaken by the European Commission in the context of the Legal Certainty Group; the restrictions identified as part of Giovannini Barrier 9 are due to be removed entirely.

4.4.3 Law applicable to the transfer of foreign securities

The inclusion of foreign securities in a domestic SSS presupposes that the foreign securities can be transferred by the same means as apply to domestic securities. As stated in Chapter 4.2.1, under the current conflict of laws regime in the EU for book-entry securities, harmonised national laws only exist for certain limited topics, but not for the basic scenario of an outright transfer of securities. In the current circumstances, CSDs from countries that apply the PRIMA rule may have to obtain specific assurances to enter into a CSD connection with a CSD from a country that still follows the *lex rei sitæ* rule, unless the law of the other country corresponds sufficiently to its own law (see, e.g. the requirement for the establishment of a CSD connection under German law). Again, as stated in more detail in Chapter 4.3.3, the further harmonisation of certain legal regimes (conflict of laws and substantive law) could facilitate the cross-border holding and transfer of securities, whether through a single technical platform such as T2S or through other means currently available in the market.

5. REGULATORY REQUIREMENTS

5.1 General

A CSD which uses the services of T2S will continue to be responsible for compliance with applicable regulatory requirements. In accordance with Principle 20 of the General Principles of T2S[54], T2S will facilitate compliance by CSDs with regulatory requirements by various means, including operational and documentation support. The Eurosystem also promotes coordination between the competent authorities and supports national, EU and international initiatives to standardise cross-border clearing and settlement requirements.

In the context of T2S, the regulatory requirements of CSDs have a particular bearing on the following issues:

- Outsourcing;
- anti-money laundering;
- data storage;

[54] 'T2S shall support the participating CSDs in complying with oversight, regulatory and supervisory requirements'.

- audit requirements.

For these regulatory requirements, and in particular concerning outsourcing, CSDs will need to continue to comply with their authorisation requirements, so any material changes to the conditions under which CSDs operate will need to be assessed from a regulatory point of view. This includes assessing compliance with regulatory requirements under binding laws (EU Directives such as the MiFID and the Banking Directive[55], which apply to some but not all CSDs, given their different legal statuses, and which have already been transposed into national law, as well as national laws applicable to CSDs which have no banking licence) and standards applicable to CSDs, both at international and national level (e.g. MiFID, CPSS and IOSCO standards). Many of these requirements are directly relevant to a project of this nature, such as those relating to legal soundness, DvP, preservation of entrepreneurial control and responsibility, legal liability vis-à-vis customers and the supervisory authorities, finality, operational reliability, security and integrity, business continuity, modification of services or provision of new services, etc.

Also, it needs to be taken into account that CSD requirements may be derived not only from regulatory provisions, but also from commercial and procedural laws, such as provisions on archiving and data retrieval, or freezing or attachment orders.

Finally, in addition to the regulatory requirements mentioned above, there are the general principles of company law as well as specific corporate governance issues. Corporate governance assessments relate to matters such as the identity of the service provider, liability for errors or service failure, and the rights of CSDs in relation to project and contract management, including issues such the basis for decisions on priorities and sourcing of developments, how CSDs sign off on requirements, or how T2S will support the evolution of services.

Although T2S is designed to operate under the existing legislative and regulatory frameworks, the Eurosystem should encourage further harmonisation and convergence of regulatory requirements which are relevant to T2S, as this would further facilitate the environment in which T2S and CSDs using T2S services will operate.

5.2 Outsourcing

5.2.1 General

Outsourcing is generally understood as an arrangement of any form between a firm and a service provider by which the service provider performs a process, a service or an activity

[55] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (OJ L 177, 30.6.2006, p. 1). Directive as last amended by Directive 2008/24/EC (OJ L 81, 20.3.2008, p. 38).

which would otherwise be undertaken by the firm itself.[56] International and European high level principles on outsourcing for the financial sector, for financial intermediaries, and for the banking sector[57] have certain common elements. Although not legally binding, these principles may be considered as guidance/best practice by supervisory authorities in situations where clear statutory or administrative rules are not available or where such provisions require further interpretation. In addition, the MiFID contains detailed requirements for the outsourcing of essential activities, which could play a direct or indirect role in the assessment by national regulatory authorities of the services provided to CSDs by T2S.[58]

5.2.2. Legal framework for outsourcing by CSDs

Legal provisions on outsourcing which are explicitly applicable to CSDs can be found in Belgium, Finland, Greece (for one of the two Greek CSDs), Hungary, the Netherlands, Poland[59] and the UK[60]. In other countries, general legal provisions on outsourcing which do not explicitly refer to CSDs apply to CSDs, either because they apply to credit institutions in countries where the CSD is licensed as a credit institution (Austria, Germany and Luxembourg), or because they are general civil law rules applicable to all (Estonia).

In other countries outsourcing is subject to soft law provisions such as regulatory requirements and supervisory practices. Soft law provisions either apply explicitly to outsourcing by CSDs (Belgium, Denmark, France, Greece, Italy, the Netherlands, Slovenia, Sweden, and the UK) or are mere general provisions that are also applicable to CSDs without being tailor-made for them (Austria (as a credit institution), Czech Republic, Finland[61], Germany (as a credit institution), and Luxembourg (as a credit institution)).

A combination of hard law and soft law provisions is frequently found.

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56 See the definition in Article 2(6) of Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (OJ L 241, 2.9.2006, p. 26).

57 For the whole financial sector the Joint Forum (consisting of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors) has issued high level principles in its paper 'Outsourcing in Financial Services' of February 2005. For financial intermediaries the Technical Committee of IOSCO has elaborated sector-specific high level principles in its paper 'Principles on Outsourcing of Financial Services for Market Intermediaries' of February 2005. For the banking sector CEBS (Committee of European Banking Supervisors) has provided high level principles in its Guidelines on Outsourcing of December 2006.

58 *One LEGCO member wishes to expressly underline that the interpretation and application of supervisory rules in relation to outsourcing lies in the hands of national authorities and that views of the Eurosystem will not be binding on them.*

59 In Poland, a draft law amending the Law on trading in financial instruments was submitted to the Parliament in May 2007. It provides inter alia for several amendments to the provisions regulating the operating of the KDPW and includes substantial changes to the provisions governing the outsourcing of KDPW's tasks.

60 Since Euroclear UK and Ireland is an English company subject English law, Irish law has not been taken into account in this overview.

61 In Finland, the Law on the book-entry system is in the process of being amended. The new draft provides for the insertion of a new article stating that, in the event of cross-border outsourcing by CSDs, an adequate back-up system must be maintained in Finland.

In a minority of countries, no specific legal or regulatory provisions are deemed to be applicable to outsourcing by CSDs, either because no rules are available dealing with outsourcing issues in general, or because CSDs do not fall within the field of application of the outsourcing provisions: Bulgaria, Denmark, Lithuania, Malta, the Netherlands (until the end of 2008[62]), Portugal, Romania Slovakia and Spain.

Where outsourcing provisions are available, they are often based on the principles and requirements provided for in the MiFID, for example in Austria, Belgium, Cyprus, Germany, Greece, Hungary, Italy, and Luxembourg.

5.2.3 Distinction between critical and non-critical activities

According to the international high-level principles on outsourcing for the financial sector and the MiFID, the materiality or criticality of the outsourced activity is relevant and the outsourcing of critical activities requires particular attention. Pursuant to Article 13 of the MiFID, institutions which outsource operational functions which are critical for the provision of continuous and satisfactory service to clients and the performance of investment activities on a continuous and satisfactory basis, have to comply with specific outsourcing requirements.

A similar distinction between critical and non-critical functions, though sometimes using different terminology (such as essential, important or necessary functions), is provided for in the rules applicable to outsourcing by CSDs in Austria, Belgium, Greece, Hungary, Latvia, Luxembourg and Slovenia.

In a number of countries, specific requirements apply to the outsourcing of certain functions: Czech Republic (ancillary activities which have only a minimum impact on the provision of services such as advertising, accounting, legal advice etc.), Germany (essential functions, to be determined by the outsourcing entity; those that are immediately related to the operation of the regulated activities and would otherwise have to be performed by the institution itself etc.), Finland (ordinary activities which are listed and supporting activities), Italy (activities of strategic importance – operational/technical activities etc.), Poland (specific activities connected with the fulfilment of the CSD's listed responsibilities etc.), Spain (core tasks which concretise the general responsibility exclusively attributed to Iberclear and technical functions) and the UK (relevant functions, exempt functions or regulatory functions, which are listed etc.).

No such distinction is made in Bulgaria, Cyprus, Denmark, Estonia, France, the Netherlands and Sweden.

[62] In the Netherlands, as of 1 January 2009, inspired by the international standards outsourcing rules applicable to financial enterprises or market operators will be extended to CSDs. These rules have been taken into account in this overview.

Subject to further investigation, services to be provided by T2S generally seem to qualify as critical activities in most countries, as is the case in Austria, Belgium, Czech Republic, Finland, Germany, Hungary, Italy, Luxembourg, and Slovenia.

In Greece, however, the T2S services seem to be considered to be merely technical functions, the outsourcing of which is not subject to specific requirements in the legislation.

There is a need for further investigation into whether the services to be considered to have mere technical functions, the outsourcing of critical activities in Cyprus, Latvia (they might also be core functions), Poland, Spain, and the UK (at least in part, but an exemption might be applicable).

5.2.4 Conditions for the outsourcing of critical activities

Most national laws allow the outsourcing of critical activities: (Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Estonia, Finland, Germany, Greece, Hungary, Italy, Latvia, Luxembourg, the Netherlands, Poland, Slovenia, Spain, Sweden, and the UK).

Consequently, outsourcing to T2S seems to be allowed in Austria, Belgium, Bulgaria, Cyprus, Estonia, Germany, Greece, Hungary, Italy, Luxembourg, the Netherlands, Poland, Sweden, the UK.

There is a need for further investigation as to whether the same applies to outsourcing to T2S in Denmark, Finland (the Ministry of Finance can approve outsourcing only when the requirements of national legislation are fulfilled), Latvia (there may be core functions which may not be outsourced), Lithuania (although unofficial preliminary consent by the supervisor seems already to have been received), Portugal (doubts exist as to whether outsourcing to a public law body or institution would be allowed), Slovakia and Slovenia (however this seems not to be problematic, given that legal relationships and instruction rights remain unaltered).

In most countries where specific requirements have to be met in the event of the outsourcing of critical functions to T2S, the following common conditions must be complied with:

- The outsourcing entity must remain fully responsible for discharging all its obligations and remain answerable to the supervisory authorities, i.e. no delegation of senior management responsibility allowed: Austria, Czech Republic, Estonia, France, Germany, Hungary, Italy, the Netherlands, Spain and Sweden.
- The outsourcing entity must exercise due skill, care and diligence when entering into, managing or terminating an outsourcing arrangement, e.g.:

  - the service provider must have the ability, capacity and authority to perform the outsourced functions (due diligence of potential service provider): Belgium, Czech Republic, France, Germany, Hungary, Luxembourg, Slovenia and the UK
  - the outsourcing entity must supervise the outsourced functions (outsourcing entity must appoint a department within its organisation for the ongoing monitoring of the outsourced tasks): Austria, Belgium, Czech Republic, France, Germany, Hungary, Italy, Latvia, Luxembourg, the Netherlands, Slovenia and the UK;
  - the service provider must cooperate with and provide the necessary information to the competent authorities (supervisor, external auditor) of the outsourcing entity: Austria, Belgium, Czech Republic, Germany, Hungary, Italy, Latvia, Luxembourg, the Netherlands, Slovenia, Spain, Sweden and the UK;
  - the outsourcing entity must be able to terminate the outsourcing arrangement if necessary: Belgium, Germany, Latvia, Luxembourg, the Netherlands, and Slovenia; and
  - the outsourcing entity and the service provider must establish contingency or emergency plans and risk management procedures: Czech Republic, Germany, Greece, Hungary, Italy, Latvia, Luxembourg, the Netherlands and Slovenia.
- The rights and obligations of the outsourcing entity and the service provider must be set out in a written agreement: Austria, Belgium, France, Germany, Italy, Latvia, Luxembourg, the Netherlands, and Slovenia.

In Belgium, an exemption from any requirements may apply to outsourcing to T2S, due to the fact that the Eurosystem will operate T2S.

In Greece, it is possible that no specific requirements will be applicable since merely technical functions will be outsourced to T2S, which will not itself be a CSD.

In Poland, under the new draft law, outsourcing of specific functions connected with the fulfilment of its responsibilities will only be allowed to a subsidiary of the CSD.

5.2.5 Specific aspects of the outsourcing of essential activities to a service provider located abroad

The outsourcing of essential activities to a service provider located abroad within the European Union does not alter the requirements to be complied with in most countries: (Austria, Denmark, Estonia, Hungary, Cyprus, Czech Republic, France, Germany, Italy, Latvia, Slovenia, the Netherlands, Poland, Sweden, and the UK.

In Belgium, if a service provider is located abroad, the King may impose similar requirements to those applicable to service providers located in Belgium. The exemption for outsourcing to T2S mentioned above may also apply to cross-border outsourcing.

In Finland, a draft law proposes an obligation to maintain an adequate back-up system within the country in cases of cross-border outsourcing.

In Greece, the cross-border outsourcing of technical functions which concern the maintenance of accounts requires the application of Greek law as to these accounts, and this can only be ensured when taking into account the jurisdiction governing T2S.

In Luxembourg, the institutional requirements which apply to 'professionals of the financial sector' do not apply to service providers located abroad, but some additional requirements must be met in the areas of accounting, data access and protection, and confidentiality. In Spain, reference is made to the CESR-ESCB standards for cross-border outsourcing.

5.2.6 Requirement for prior approval by the regulator/supervisor for the outsourcing of essential activities

No prior approval by or notification to the supervisory authority for the outsourcing of critical functions to a service provider located abroad is required in Austria, Germany, Hungary, or Slovenia.

In Belgium, Czech Republic, France, Italy, Spain, and the UK, the outsourcing CSD need only notify the supervisory authority about the planned outsourcing and/or obtain *ex post* approval. The same will apply in Poland once the new law enters into force.

However, regardless of the location of the service provider, the supervisory authority's prior approval is required in Cyprus, Denmark, Finland, Latvia, the Netherlands, Poland (under the current legislation) and Romania,. Prior approval for cross-border outsourcing is expressly required in Greece when outsourcing the SSS function.

5.3 Anti-money laundering

5.3.1 EU law applicable to CSDs:

In relation to the prevention of money laundering (which for the purposes of this note includes terrorist financing), the relevant provisions are to be found in the Third Money Laundering Directive[63] (which was to be transposed by the Member States by 15 December 2007) and the Regulation on information on the payer accompanying the transfer of funds (directly applicable in Member States)[64].

Where a CSD falls within the scope of the Directive (being licensed as a credit institution or financial institution, and not exempted), it has to comply with obligations in relation to:

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63 Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (OJ L 309, 25.11.2005, p.15).

64 Regulation (EC) No 1781/2006 of the European Parliament and of the Council of 15 November 2006 on information on the payer accompanying transfers of funds (OJ L 345, 8.12.2006, p.1).

- customer due diligence (in particular, customer identification and monitoring of transactions),
- record-keeping (minimum of five years) and
- reporting of suspicious transactions.

5.3.2 National laws applicable to CSDs:

Information gathered from all Member States shows that in Austria, Bulgaria, Cyprus, Czech Republic, Estonia, Finland, Germany, Hungary, Italy, Luxembourg, Netherlands, Poland, Romania, Slovakia, and Slovenia anti-money laundering requirements for CSDs are imposed by the laws implementing the Third Money Laundering Directive (and in some cases on the basis of additional regulation or internal CSD practices). Even though the Directive has not yet been transposed in Belgium, anti-money laundering requirements apply to CSDs and it is expected that this will still be the case following the transposition of the Directive. In Greece, the anti-money laundering requirements that currently apply to the CSD operated by the Bank of Greece are based solely on an internal circular of the Bank of Greece. In the UK and Ireland, CREST is not covered by the anti-money laundering legislation, but it has adopted its own rules in this respect. As regards Denmark, France, Lithuania, Malta, Portugal, Spain, and Sweden, the CSDs do not fall directly under legal, regulatory or internal anti-money laundering requirements, but this may change in Lithuania and Malta, where the laws implementing the Directive may cover CSDs. The Malta Stock Exchange plc, as operator of the CSD, currently applies the anti-money laundering obligations as a 'subject person carrying out relevant financial business'. In Latvia the current legislation on money laundering covers the CSD, but this will no longer be the case following the transposition of the Directive.

According to the information gathered, the legislation (including draft measures implementing the Directive) in Austria, Belgium, Czech Republic, Germany, and Italy imposes customer due diligence requirements on CSDs. However, those requirements are limited with regard to customers that are credit or financial institutions subject to under equivalent customer due diligence requirements. There do not appear to be such limitations in Bulgaria, Estonia, Finland, Hungary, Luxembourg, the Netherlands, Poland, Romania, or Slovakia (also due to the fact that in some of these jurisdictions CSDs are direct holding systems). In Ireland and the UK limited due diligence requirements apply based on the internal rules of the CSD.

As regards the possibility of CSDs outsourcing anti-money laundering obligations, Article 19 of the Directive has been implemented in Austria, Estonia, Italy, Luxembourg (in part), the Netherlands, and Slovakia. Cyprus, Romania, and Slovenia have made use of their discretion and not implemented Article 19 in their national laws. This situation needs further investigation in Belgium, Bulgaria, Czech Republic, Finland, Germany, Hungary, Ireland

Poland, and the UK, where legislation is not clear mainly due to delays in the transposition of the Directive.

In almost all Member States where CSDs are subject to anti-money laundering obligations, they have to report suspicious transactions to the designated financial intelligence unit (and in limited cases also to the financial regulator). The CSD operated by the Bank of Greece has to report to its compliance officer. There are no such reporting obligations in place in Ireland and the UK despite the fact that the CSD is subject to anti-money laundering requirements under its internal rules.

As regards record-keeping requirements, Austria, Finland, Luxembourg, Malta, Poland, and Romania have implemented the minimum period of five years provided by the Directive, whereas in Germany a CSD has to store relevant data for six years. As regards Belgium, Bulgaria, Czech Republic, Estonia, Hungary, Ireland, Italy, the Netherlands, Slovakia, Slovenia, and the UK, the period for which a CSD has to store relevant data is not yet clear, mostly due to delays in the transposition process.

5.4 Data storage/archiving

As explained in Chapter 1, T2S consists of three blocks of relevant data, namely: the lifecycle management, the settlement engine, and T2S static data. However, these types of data may vary across Member States with regard to the level of detail recorded by CSDs, since there are a number of national specificities, so the technical set-up of T2S has to cater for these national differences.

5.4.1 Duration of data storage:

As regards the duration of data storage applicable to CSDs, a basic distinction can be made between the storage of the transactions themselves and storage of the records made in securities accounts. As regard transaction data, many CSDs are required to store data for a minimum of five years following a transaction or following the end of the business relationship, as the case may be. This appears to be the minimum period across the EU (Austria, Belgium, Denmark, Latvia, Poland, Romania, Slovenia, and Spain). Several CSDs have a minimum period of between six and ten years (Czech Republic, Estonia, Finland, Germany, Greece, Italy, Luxembourg, Malta, Slovakia, and Sweden), while a number of other countries have periods of between 12 and 20 years (Czech Republic, Greece, and UK). The picture is similar with regard to the securities accounts data, though with a greater number of CSDs having to comply with a minimum period of more than five years. In Lithuania a period of 75 years applies, and in Bulgaria and Finland there is an unlimited period. In Austria, Germany, Lithuania and Slovakia (at least), proprietary claims relevant to CSDs fall under the statute of limitation for proprietary claims, so that certain records have to be kept for a longer period for a CSD to have legal certainty (up to 30 years). Since CSDs also have to store

additional data in certain Member States, e.g. for tax, bookkeeping or regulatory purposes, the period for which these data have to be stored by a CSD could also be relevant to T2S.

5.4.2 Legal requirements for the structure of records held by CSDs:

The records which CSDs have to keep have a number of common features in almost all Member States. In most instances this is based on detailed legal provisions, but in other instances it is based on a general legal obligation to maintain complete, accurate and timely information. These common features relate to the identification of the account holder (either via a code or client details), the financial instruments held, and transactions relating to these holdings.

However, these types of records vary between Member States as regards the level of detail to be recorded by CSDs. Some CSDs are required to keep records of additional information, such as pledges or other rights attached to securities (Bulgaria, Cyprus, Czech Republic, Netherlands, Portugal, Slovenia, and Sweden), a unique identifying number for each operation (Spain), the opening date of the account (Germany), dividend payments (Bulgaria, Hungary and Portugal), tax information (Finland), and data required for operational risk purposes (Austria and Germany).

Thus the technical and operational requirements for the databases that CSDs have to maintain to store these data are also relevant to T2S, in particular whether a CSD is required to provide real-time access to the data or whether it is sufficient for the data to be archived. It appears that for most CSDs no real-time access is required, but this issue needs additional input from CSDs which are in the best position to provide this information to T2S.

5.4.3 Rights of access to data by third parties:

As regards rights of access by third parties to data held by CSDs, in almost all Member States the competent financial regulator has such rights. In particular, in a number of Member States (Czech Republic, Estonia, Finland, Greece, Poland, Slovakia, and Slovenia) the tax authorities have to be given access to data held by CSDs; in Austria, Belgium, and Sweden auditors also have certain access rights. As regards Cyprus, Lithuania, Romania, Spain, and the UK, the relevant CSD has to make data available to issuers. Finally, data protection authorities are explicitly given access to CSD databases in Finland and the Netherlands. Access by such third parties is usually provided to archived data. However, the technical set-up of T2S will also have to ensure that any rights of access by third parties on a real-time basis can be facilitated. CSDs need to identify – vis-à-vis T2S – all entities which are authorised to have such access for full compliance with data protection and banking secrecy requirements.

5.4.4 Requirements for data protection/banking secrecy (client and accounts related data):

In virtually all Member States, professional secrecy obligations are applicable to CSDs. Moreover, in a number of Member States, client and account-related data fall under the banking secrecy obligations or similar obligations (Austria, Belgium, Bulgaria, Germany, Greece, Hungary, Luxembourg, the Netherlands, Spain, and Sweden). In some Member States breaches of such obligations may be subject to criminal prosecution. In all Member States, rules for the protection of data relating to natural persons apply, and T2S will have to facilitate compliance by CSDs.

5.5 Audit requirements

T2S will facilitate CSDs' compliance with the rights of auditors and regulators in carrying out audits of outsourced activities or responding to requests for information in relation to the services. Details, such as the frequency of audit inspections or the processing of requests for documentation, should be agreed when negotiating agreements.

5.5.1 Audit regulatory environment at European/ international level:

The recast Banking Directive 2006/48/EC requires that the internal audit, or other comparable independent auditing function, must review at least annually a credit institution's rating systems and its operations.

Recommendation 11 (Operational reliability) of the CPSS-IOSCO Recommendations for securities settlement systems proposes that an independent periodic audit (preferably an external audit) of information technology should be carried out, and the operational risk controls should be reviewed.

The European Code of Conduct for Clearing and Settlement provides that: 'The Organisations will task their external auditors, or another external auditor of the Organisation's choice, to verify their compliance with the Code' (Rule 45).

The International Standards on Auditing will potentially apply to TS2, in particular for the review of the financial information of the project.

5.5.2 Existence of audit rules:

All Member States have audit rules in respect of securities settlement systems.

In some Member States, the audit rules are all laid down in hard law provisions (Bulgaria, Cyprus, Czech Republic, Denmark, France, Germany, Poland, Portugal, Slovakia and Slovenia), in others, they are contained in soft law provisions (Finland and Italy) or best practice (the UK), while in the rest of the Member States, there is a combination of both hard and soft law provisions (Austria, Belgium, Latvia, Malta, Luxembourg, the Netherlands, Spain, and Sweden).

5.5.3 Requirement for financial accounts to be audited by an external auditor:

The requirement that the annual reports of CSDs/SSSs should be audited by an external auditor applies in all Member States except the UK, where the best practice of the SAS 70 auditing standard applies.

Depending on the country, such a rule applies because the CSD/SSS is organised in the form of a company (Belgium, Bulgaria, Estonia, Latvia, Malta, the Netherlands, Spain, and Sweden), a listed company (Greece), a credit institution (Austria, Germany, and Luxembourg), is part of the NCB (Belgium and Bulgaria), or is subject to a specific regime applicable to the CSD/SSS (Belgium, Czech Republic in legislation soon to be adopted, Portugal and Slovenia), or stock exchange (Cyprus).

While in most of the countries, the powers of the external auditor are limited to the auditing of financial accounts and financial information, in some countries the external auditor has a duty to investigate additional issues.

In Austria, the external auditor verifies, on a voluntary basis, the compliance of the CSD with the terms and conditions with the Law on deposits.

In Belgium, external auditors are under an obligation to cooperate with the Banking, Finance and Insurance Commission (BFIC) in the exercise of its supervisory tasks, and to send special reports concerning the organisation, activities and financial structure to BFIC on demand.

In Denmark, the external auditor, in cooperation with the internal auditor, must carry out risk assessments of CSDs, including their governance and compliance procedures. Furthermore, the auditors must evaluate the design, implementation and effectiveness of internal controls.

In Germany, when auditing the annual accounts, the auditor must also examine the institution's financial circumstances and compliance with supervisory requirements, including anti-money laundering requirements.

In France, the external auditor carries out operational audits of the CSD in the form of (1) a biannual audit of the internal control organisation and environment to comply with CBFA requirements, and (2) annual reviews of (i) the accuracy of the description of the controls that are relevant to clients' internal control environments, (ii) the relevance of these controls for achieving the control objectives specified in the description, and (iii) the effective implementation of these controls. The scope of the external audit covers the CSD's processes such as operations, IT and support functions.

In Greece, the external auditor carrying out the annual audit of DSS financial statements includes details in the audit report of any problems or weaknesses found in the internal audit system during the audit. The external auditor is required to audit compliance with the Code of conduct of market infrastructures, in particular in respect of the unbundling of services and accounting.

In the Netherlands, in accordance with Recommendation 11 of the IOSCO Recommendations for securities settlement systems, the external auditor reviews the business continuity arrangements of Euroclear Netherlands in the light of operational liability. This recommendation requires information systems to be subject to periodic independent audits, and external audits should be seriously considered.

In Slovenia, the external auditor has to examine the quality of information systems and compliance with the rules on risk management. The auditor also has to report to the supervisory authority about any circumstances that would constitute a serious breach of the rules and regulations defining the activities of the CSD, or which could influence the continuous operation of the CSD or result in a qualified or adverse auditor's report or in the rejection of such report.

5.5.4 Requirement for an internal audit division:

The requirement for CSDs/SSSs to have internal audit divisions also applies in all Member States.

In all the Member States specific rules have been laid down to ensure the functional independence of such divisions, which usually report directly to the board of directors.

As for the scope of internal audits, some countries expressly enumerate obligations with regard to the following issues:

- compliance with laws, rules and regulations (Austria[65], Belgium, Bulgaria, Denmark, Estonia, Finland, Germany, Greece, Lithuania, the Netherlands, Poland, Portugal, Slovenia, Sweden and the UK);
- internal organisation (Belgium, Denmark, Finland, Germany, Greece, Luxembourg, Poland, Portugal, Slovenia, Spain, Sweden, and the UK);
- accounting measures, integrity and reliability of financial information (Belgium, Denmark, Finland, Germany, Greece, Lithuania, Slovenia, and Sweden);
- risk management and business continuity (Belgium, Bulgaria, Czech Republic, Denmark, Germany, Estonia, Greece, Spain, Luxembourg, the Netherlands, Portugal, Slovenia, Finland, Sweden and the UK);

[65] In Austria, the internal audit division verifies the CSD's compliance with the applicable terms and conditions of the Law on banking.

- European Code of conduct (Austria, Lithuania, the Netherlands, and Portugal),
- money laundering (Czech Republic, Greece, and Latvia).

Such obligations are not specifically stipulated in some other countries (Cyprus and France), but here *de facto* the tasks performed by internal auditors are similar.

5.5.5 Impact of outsourcing:

Specific rules on carrying out audits where there is outsourcing have been adopted in some countries (Belgium, Denmark, Finland, Germany, Italy, the Netherlands, Slovenia, and Sweden). Such rules, which are largely in line with the basic principles set out by the Joint Forum paper 'Outsourcing in financial services' (see Chapter 5.2.1), usually stipulate the inclusion of the outsourced functions in the internal audit of the CSD/SSS, the identification of the risks related to the outsourced functions and the periodic monitoring of such risks, a specific control function for the outsourced activities that reports to the company management and the internal audit, and business continuity procedures relating to the outsourced functions.

In some other countries, although rules have not been expressly adopted for these purposes, a similar regime applies by virtue of the interpretation of the current rules (France and Luxembourg).

In other countries, no rules have been adopted in this area (Austria, Bulgaria, Cyprus, Czech Republic, Estonia, Greece, Lithuania, Poland, Portugal, Slovakia, Spain, and the UK).

5.5.6 Communication of information to regulators – specific investigations:

In all the Member States, the reports of the internal and external auditors are communicated to the supervisory authorities. In some cases the authorities may request additional information on the basis of the reports.

In some Member States (Denmark, Germany, Italy, Luxembourg, Malta, the Netherlands, Slovenia, Finland and Sweden), the authorities may require external auditors and/or internal auditors to carry out additional tasks.