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Comments from the Danish NUG on the URD

The Danish T2S National user Group (Danish NUG)[1] welcomes the opportunity to comment on the second draft User Requirement Description concerning Target2Securities that was released by the European Central Bank on December 19th, 2007.

Please find below the comments from the Danish NUG.[2]

The comments are divided into tree parts:

1. The first part contains general comments of major concern for the Danish capital market.
2. The second part contains more detailed description of comments we would like ECB to take into consideration before releasing the final URD.
3. The third part contains a list of technical discrepancies we have found where the URD may benefit from clarification.

First part
General concerns:

1. A question of paramount importance for single investor systems is the coming pricing policy of T2S. The Danish NUG therefore welcomes statements, that T2S will offer a fair and undiscrimatory fee structure. We strongly recommend that the ECB releases a note on the structure of the intended fees and an indicatory level before asking financial markets to indicate whether they will participate in T2S. The treatment of CA in the pricing structure seems to be of major importance in this regard.

2. Though legal responsibility remains with the CSD clearing and settlement is handled by T2S. We therefore find that there is a risk for settlement in T2S overtakes legal registration in the CSD when dealing with single investor registration systems. The issue was discussed with Mr. Helmut Wacket at the Nordic NUG meeting held in Helsinki on March 11 and we very much welcomes that T2S recognises the problem and look forward to further discussing it with T2S.

3. The Danish NUG welcomes the proposal concerning closing days in T2S received after the launching of the URD. Quoting from a mail received from Mehdi Manaa on 26th February:

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[1] Current Members: Danske Bank, Nordea, Nykredit, PFA Pension, SEB, Sydbank, BRFkredit, Association of Danish Mortgage Banks, Danish Bankers Association, Regional Bankers Association, Danmarks Nationalbank and VP Securities Services.
[2] Please note that Nordea is actively participating in the Danish NUG. There are though a few issues in this consultation where Nordea has a slightly different view than the rest of the Danish market. Therefore we kindly ask you also to refer to the response send in the name of Nordea.

About your issue on the 1ˢᵗ of May, we have received similar concerns from other markets. It seems that the current wording of the URD is open to different interpretations and the reference to the integrated or the interfaced model seems confusing for some people. We will try to clarify this matter in the next version of the URD that we will issue after the end of the market consultation period. The suggested clarification would be the following:
- *for settlement of free of payment (FoP and CoSD) transactions, T2S will be open from Monday to Friday every week (i.e. settlement of free of payment transaction is possible on TARGET2 closing day);*
- *for settlement against payment or free of delivery transactions in a given T2S currency, T2S will be open according to the calendar of opening days of the relevant Central Bank (i.e. the TARGET2 calendar for DvP settlement in Euro, and the Danish Central Bank calendar for DvP settlement in DKK if the DKK is inside T2S).*

We trust item T2S.03.330 will be corrected accordingly.

4. In case an external CSD fully owns or is fully owned by a T2S participating CSD it is of major importance that the role as maintenance issuer for securities issued outside T2S is handled by that T2S participating CSD.

5. By transferring Danish clearing and settlement to T2S VP partially hand over sovereignty of clearing and settlement, accounts and holdings. It is of major importance for the Danish financial sector to receive assurance that both legal initiatives (Danish as well as international) and market needs can be implemented in T2S at a cost comparable to implementation in the current domestic systems. The URD does not contain descriptions on how this is intended to be handled. To this we need information on procedures, response times and costs occurring hereof. Furthermore the URD does not address how direct connected user and CSD interaction is foreseen for system changes - major as well as minor.

6. All T2S functionality must be provided via a system-to-system interface in the way which makes it possible to pass on system generated transactions and events without manual interference. This is especially important for types of transactions which either are repeated on a frequent basis and/or requires synchronization between CSDs and T2S. This is the case for a long range of transactions like creation/maintenance of ISINs, accounts and corporate actions.

7. As the scope of T2S includes also settlement in EUR outside the Euro zone as well as potentially also settlement in other currencies than Euro, the Danish financial sector find it of major importance that T2S is based on a principle of level playing field for all CSDs regardless of their location inside or outside the Euro zone, as specified below.

Second part
Detailed comments:

Management summary
Remarks:
P 6.
The URD states that all parties and all securities can be used in auto-collateral processes. However, according to the ECB's rules on this there is one major obstacle as only euro denominated securities registered through a euro zone CSD are eligible for collateralisation through the ECB. These restrictions establish an unfair and uneven competitive situation for CSDs outside the euro zone.

Especially chapters 6 and 7 at several occasions state that there is no limitation in the auto-collateral procedures.

Chapter 3.
<u>Remarks:</u>
Figure 3-1. p 4.
Especially for the direct holding markets the proposed schedule must be considered too tight. In case of a corporate event affecting more than hundred thousand accounts the time left for processing in the local CSD will not be sufficient. We recognise the fact that the schedule is only tentative, and we will suggest that the final schedule will leave more time for local processing.

T2S.03.080 and T2S.03.170. p 8, 9 and 11.
T2S will most likely have a significant impact on securities markets within EU. Therefore it is very important that the Danish CSD is offered same conditions as other CSDs with respect to granting euro liquidity for night time settlement for ensuring level playing field for all markets participating in T2S despite Denmark not being part of the euro zone.

T2S.03.330
Should be corrected according to the new wording in general remarks, Bullit point 3

Chapter 4.
<u>Remarks:</u>
T2S.04.070. p 6, l 13.
It must be stated more clearly that directly connected participants will not be able to open accounts. This must always be the role of a CSD.

Chapter 5.
<u>Remarks:</u>
T2S.05.060. p 11, l 17.
For a single investor account system storing the cash account directly on the securities account is not a possibility since all private investors can not hold cash accounts with the ECB. Nor can't it be a specific broker's account since private investors are not linked to one broker. T2S must link cash account to parties. If in specific cases another cash account should be used, this is to be reported in the trade.

Chapter 6.
<u>Remarks:</u>
General comments
In the URD it is often stated (e.g. T2S.06.150, T2S.06.190 and Annex 7), when referring to RTGS accounts, that the RTGS account specifically adheres to TARGET2. Since T2S will be a multicurrency system and TARGET2 only handles euro liquidity, stated references to RTGS accounts should not be explicitly to TARGET2 accounts, since non-euro liquidity to T2S settlement will be supplied to T2S via the participating non-euro central banks' RTGS systems (e.g. the Danish Kronos system).

Specific comments

<u>T2S.06.370</u>
In cases where sufficient liquidity is not available when processing a standing liquidity transfer order, it should be optional for each standing order whether it should be executed partial or not at all.

Proposed solution /Suggested drafting change
Partial execution of standing liquidity transfer orders should be optional and not mandatory.

T2S.06.380
The comment stated in T2S.06.370 applies also for pro rata execution in case of several standing liquidity transfer orders.

Proposed solution /Suggested drafting change
Pro rata execution of standing liquidity transfer orders should be optional and not mandatory.

Chapter 7.
Remarks:
7.1.2.2. p 5, l 11.
We find that auto collateral should be used before using cash i.e. the process should be reversed. Using auto collateral before cash will provide liquidity and save cash - especially during night time settlement.

Further we would like the T2S team to clarify whether it will be possible to leave the dedicated T2S cash accounts with a zero limit and in this way solely use holding on flow and stock as collateral for all trades. In addition it is important to receive information on the intended price for using auto-collateral.

7.1.2.3. p 7, l 7.
We fail to see how T2S can foresee that a trade can settle later (the same day) and therefore only recycle these trades. And more important: which trades or type of trades are not recycled?

T2S.07.020. p 10, l 3.
What is the definition on "Corporate Events related settlement"? Is trade with rights needed for subscription included?

T2S.07.030. p 10, l 13.
As mentioned in chapter 3 the proposed schedule doesn't leave Denmark with sufficient time to handle large Corporate Actions. Therefore we request at least 3 night time settlement cycles.

A Corporate Event must always settle "all or nothing". See chapter 8.

Chapter 8.
Remarks:
T2S.08.040. p 5, l 11.
Same remark as 7.1.2.2. p 5, l 11.
We find that auto collateral should be used before using cash i.e. the process should be reversed. Using auto collateral before cash will provide liquidity and save cash - especially during night time settlement.

T2S.08.600. p 28, l 22.
We strongly disagree with the concept of negative accept from account owner. According to MiFID, private investor holdings can't be used as collateral of the account controller/custodian/bank unless positive accept is given from the account owner. T2S must apply the same principle.

Furthermore we suggest that a flag in a trade can overrule the general principle.

T2S.08.700. p 32, l 8.
It is a request that T2S provides the possibility for reimbursement of collateral from securities on stock.

T2S.08.800. p 36, l 7.
A payment bank must have the possibility to request reimbursement of credits at any time during the settlement day.

T2S.08.860. p 38, l 27.
T2S can't assume that the T2 RTGS account contains sufficient funds in case default on T2S cash accounts. This might not always be the case, and therefore a possibility for reimbursement from securities on stock. See also T2S.08.700

T2S.08.910. p 40, l 1.
The proposed procedure for exchanging holdings having been used as collateral seems unnecessary complex. We do not find it necessary that the substituting securities must be transferred from specific accounts as long as sufficient collateral is available on the account used for collateral purposes.

Chapter 9.
Remarks:
The entire chapter uses only the phrase "all or none". According to the definition in chapter 8 this leads to partial settlement in a corporate action which is not acceptable.

9.1.1. p 4, l 6.
Denmark needs 2 decimals on holdings for registering Danish bonds even if Funds are not included in T2S.

T2S.09.010. p 4, l 10.
The user requirement indicates tap issue is only required for funds. This is also the case for Danish bonds no matter whether denominated in EUR or DKK.

T2S.09.050. p 5, l 8.
International market practice requires that individual stripping takes place in two new ISINs - a new for the principal and a new for interest. Only if the stripping is handled as a corporate action, the issuer can decide whether the principal should remain in the original ISIN. For harmonisation purposes it is suggested that T2S is following this standard.

T2S.09.200. p 10, l 9.
If a directly connected party wants to block a holding he must handle this through the CSD for securing legal effect of the blocking. If the CSD is to rely on information from T2S there is a risk that the holding in the meantime has been removed in CSD, and consequently that the blocking therefore is not accepted. See also general remarks concerning legal effect time.

Chapter 10.
Remarks:
T2S.10.040. p 7, l 8.
A CSD must be allowed to perform transfers, redeem holdings etc. of blocked holdings without having first to unblock if indicated so in the transaction.

T2S.10.080. p 12, l 9.
Since the BIC is used to identify a party credit lines should be linked to the party - not individual accounts.

Chapter 12.
Remarks:
Table 12-1. p 10.
A payment bank must be allowed to query transactions they are part in.

T2S.12.310. p 17, l 11.
Does this means that CSDs and directly connected parties are responsible for back-up lines?

Chapter 13.
Remarks:
13. p 3, l 19.
We need a more comprehensive description of the pull/push mechanism.

T2S.13.120. p 7, l 7.
A T2S party must be allowed to per transaction to indicate how many days a trade should be attempted settled if a shorter/longer period than default are desired.

Chapter 14.
Remarks:
T2S.14.090. p 8, l 2.
This concept for queries could in some extreme situations create many thousand replies. It must not be possible to send queries without at least getting a warning if the reply from T2S is exceeding a fixed amount.

Chapter 16.
Remarks:
T2S.16.430. p 22, l 1.
This facility is a corporate action and should therefore not be allowed in T2S while it can create asynchrony depending on the order of update. We understand that the reason for the request stem from individual parties and should be treated as national specificity. Furthermore, it is contradictory to international standards and practices, and should therefore be removed from the T2S requirements.

Chapter 17.
Remarks:
T2S.17.090. p 6, l 10.
T2S will only store data on settled trades for 3 months. Unless you expect to establish a data warehouse you force all CSD to establish mirrored systems for auditing and tax reasons.

Chapter 18.
Remarks:
When dealing with a project with this huge impact, we find it wise to build upon an international standard, and T2S has chosen to use the ISO/IEC 27002. This is fine.

However, the content in chapter 18 in our opinion is not a high level security policy. It is much too detailed and operational to be accepted as a policy (you would not normally define e.g.

password rules in a high level security policy). Instead it should be accepted as the next step in the process - namely establishment of security statements which in turn needs to be implemented via written procedures. The structure of the chapter is aligned with the ISO standard, and therefore useful when implementing the operational security measures.

Normally, an organisation or company would define a high level security policy that will consist of 3-6 pages and be approved by the Board (or similar top level in non-companies).

It is, therefore, recommendable to the ECB to draft a high level security policy before (or parallel with) establishing the operational level documents.

Chapter 19.
Remarks:
The system shall acknowledge when a transaction has been processed ("business acknowledgements")
This applies to all types of transactions in T2S, including changes to static data. The system should not only send technical receipts, and participants should not be required to query task queues in order to verify transaction status in normal processing.

Chapter 20.
Remarks:
T2S.18.250. p 9, l 18.
See general remarks. What is a major release and how long time in advance is a minor release announced

Chapter 21.
Remarks:
21.1. S 3, l 21.
We believe that the suggested "double migration model" will lead to additional cost for those of the actors expected to use direct connectivity. Adoption cost will of course depend on the approach of the local CSD., However, parties wanting to use direct connectivity will be affected by a two-step migration, and this will eventually lead to extra IT development cost, testing cost, human resources etc.. We suggest that it is evaluated if double migration can be avoided.

Annexes

Annex 7.
Remarks:

Specific comment to example on page 18
A credit of 175 is missing on account A-1. This missing credit adheres to booking No. (8).

We find it puzzling that booking No. (11) is recorded on the accounts prior to booking No. (12). In our view the order of these bookings should be reversed.

Annex 12.

Remarks:

2.2 Corporate Events - generic steps. p 5, l 19

The annex should include a description of how preclusion/blocking of ISINs registered in several CSD should be administered.

Annex 14.

Remarks:

The proposed model is less efficient than the current model used in Denmark. Pros and cons of different models have been discussed in TG4 and for facilitating this we wrote a note which is attached as an appendix and we understand from discussions with Mr. Bengt Leidström that it will be possible to use other models and that commissionaire accounts will not be a request. We would like to see this reflected in the URD. For your easy reference we attach the mentioned document already presented to TG4.

Annex 16.

Remarks:

2.1 T2S usage. S 4, l 13.

Does this means that segregation will not be possible in the first version? For the members of TG4, this was a major requirement and never disputed. We must insist on that "account segregation level and accounts restrictions" will be possible in the first version of T2S.

2.3 Specificities and specific procedures. S 6, 2.3

We strongly object to this. As long as a CSD follows T2S' rules when settling in T2S, T2S should not try to harmonise settlement procedures. For competitive reasons CSD must be allowed to organise it's internal business as it pleases. And why should this only apply to direct holding markets?

2.3 Specificities and specific procedures. S 6, 2.3.2

As long as this means that multilateral netting would be introduced for all CSDs we have no objections.

Annex 17.

Remarks:

Non-fungible securities. S 6 l 9.

Denmark doesn't uses lottery for redemption of mortgage bonds. However, we are at present in the Danish NUG discussing whether Denmark should change the present settlement procedure for redeemed bonds.

Third part

Findings and discrepancies

Chapter 3

T2S.03.130. p 10, l 1.

There is a discrepancy between figure 3.1 which indicates that reports will be produced at the end of each night time settlement cycle and top page 10 where it is stated that reports will only be produced at the end of the last settlement cycle. We need to receive reports at the end of each settlement cycle.

Chapter 8.
T2S.08.420. p 22, l 7.
The definition on "all or none" and "all or nothing" given here are not used in the same way in other chapters. T2S.07.030, several times in chapter 9, Annex 12, p 10

Chapter 16.
Example on page 24. S 24, l 1.
The example seems wrong since there can't occur a situation where an issue doesn't relate to an issuer.

T2S.16.570. S 31, l 2.
Please bear in mind that a party can have several BIC's.

p 33.
Cash accounts should be linked to the party - not the securities account.

Chapter 17.
p 4, l 6.
You can't calculate average this way unless you expect only one night time settlement and it is expected to last the whole night - 10 hours.
Furthermore the numbers are worthless since you miss several countries which can expect to create a substantial number of transactions.

Annex 6.
Table 6-1.
In example "Account holder 4" rights holder should be Danish bank. "Account number 7" rights holder should be Broker.

Annex 12.
2.3 General Settlement. p 6, l 34.
T2S will provide the possibility for "bulk" messages, when a corporate event affects a high number of accounts and holdings. For big companies this could result en creating more than 500,000 updates.

4.1 T2S settlement functionality. p 10, l 16.
Should be "all or nothing".