Council of the European Union

Brussels, 14 November 2016
(OR. en)

14417/16

EF 342
ECOFIN 1045
DELACT 236

COVER NOTE

From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	11 November 2016
To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
No. Cion doc.:	C(2016) 7154 final
Subject:	COMMISSION DELEGATED REGULATION (EU) …/... of 11.11.2016 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council as regards the parameters for the calculation of cash penalties for settlement fails and the operations of CSDs in host Member States

Delegations will find attached document C(2016) 7154 final.

Encl.: C(2016) 7154 final

EUROPEAN
COMMISSION

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supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council as regards the parameters for the calculation of cash penalties for settlement fails and the operations of CSDs in host Member States

(Text with EEA relevance)

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE DELEGATED ACT

Regulation (EU) No 909/2014 on improving securities settlement in the European Union and on central securities depositories (CSDR) harmonises the conduct of securities settlement in the Union and the rules governing central securities depositories (CSDs) which operate the infrastructures enabling securities settlement. CSDR entered into force on 17 September 2014 but it will become fully applicable when the rules laid down in the Commission delegated and implementing acts will enter into force. This delegated act is one of them.

One of the main objectives of CSDR is to improve the safety and efficiency of securities settlement, in particular for cross-border transactions, by ensuring that buyers and sellers receive their securities and money on time and without risks. To achieve these objectives CSDR harmonises the timing and framework for securities settlement in the EU. In particular, CSDR provides for a set of measures to address failures in the settlement of securities transactions ('settlement fails'). Article 7(2) requires CSDs to impose cash penalties on users that cause settlement fails. Such penalties should be calculated on a daily basis for each business day following the settlement fail until the actual settlement date or other factor terminating the transaction. Such penalties should act as an effective deterrent to settlement fails, but should not unduly affect the smooth functioning of the financial markets concerned.

Another important objective of CSDR is to create an internal market for services provided by CSDs. To achieve this objective, CSDR lays down a common authorisation, supervision and regulatory framework for CSDs. In this sense, Article 23 of CSDR allows CSDs authorised in accordance with the rules of that Regulation to provide their services in any Member State of the Union ('passport rights'). Article 24 of CSDR provides for cooperation measures between home and host Member States' competent authorities where CSDs provide their services cross-border. Article 24(4) provides, in particular, that home and host competent authorities shall establish formal cooperation arrangements for the supervision of CSDs where their activities have become *"of substantial importance for the functioning of the securities markets and the protection of the investors"* in host Member States.

Legal background

The powers to adopt this delegated act are provided for under Articles 7(14) and 24(7) of Regulation (EU) No 909/2014. It covers the following aspects:

- the parameters for the calculation of a deterrent and proportionate level of cash penalties. According to Article 7(14) of CSDR, cash penalties should be based on asset type and liquidity of the financial instruments and type of transactions and shall ensure a high degree of settlement discipline and the smooth and orderly functioning of the financial markets concerned; and

- the measures for establishing the criteria under which the operations of CSDs in host Member States could be considered "*of substantial importance for the functioning of the securities markets and the protection of the investors*" in the host Member States concerned (Article 24(7) of CSDR).

These two aspects are closely linked because they both deal with the elements required for the implementation of the measures laid down in Regulation (EU) No 909/2014. Moreover, these measures rely on the same calculation of values of financial instruments. It is, therefore, justified to include all elements concerning measures under Regulation (EU) No 909/2014 in a single delegated act.

2. CONSULTATIONS PRIOR TO THE ADOPTION OF THE ACT

The Commission asked the European Securities and Markets Authority (ESMA) for an opinion (technical advice) on both aspects of the delegated act, i.e. the calculation of cash penalties and the criteria under which operations of CSDs in host Member States could be considered of 'substantial importance' in the meaning of Article 24(4) of CSDR.

Following in-depth technical assessments, ESMA conducted from 18 December 2014 to 19 February 2015 a public consultation on the content of the parameters and measures proposed. On 5 August 2015, ESMA provided a detailed technical advice to the Commission.

Over thirty stakeholders responded to the ESMA public consultation, including public authorities, associations of CSDs, capital markets intermediaries, investors and individual undertakings. In general, the respondents supported the approach proposed by ESMA for the calculation of cash penalties, in particular where it suggested using a common reference price for financial instruments that failed to be settled instead of a price indicated in the respective settlement instructions. The respondents commented, however, on the suggested penalties rates and their categories and made proposals to adjust them, especially in order to adequately take into account the lower level of liquidity of some instruments issued by SMEs and the specificities related to debt instruments. Concerning the measures for determining whether a CSD's activities in another Member State are of substantial importance, the respondents supported annual assessments of "substantial importance" and the assessment criteria based on the CSDs' core services provided in host Member States. The stakeholders also provided comments and suggestions on the proposed criteria. Following feedback from the public consultation, ESMA reviewed its approach with respect to some of the elements before submitting its technical advice to the Commission.

EGESC and other views

On 21 September and 28 October 2015, the Commission consulted the Expert Group of the European Securities Committee (EGESC) on the ESMA technical advice and on the content of this delegated act. EGESC has broadly supported the Commission's approach but asked for the Commission to clarify the concepts and categories of financial instruments used in the delegated act.

The Commission has also taken note of the views expressed by the relevant European Parliament's rapporteurs on the content of ESMA technical advice and of this delegated act.

3. IMPACT ASSESSMENT

Having fully considered the technical advice provided by ESMA and the feedback received from the EGESC, the Commission is proposing the parameters for calculation of cash penalties under Article 7(2) of CSDR and measures for establishing criteria for assessing the

'substantial importance' under Article 24(4) of CSDR for adoption by means of this delegated act.

Penalties for settlement fails

On the basis of its analysis of the existing penalty mechanisms applied by CSDs, ESMA elaborated a potential framework for the calculation of cash penalties in order to obtain stakeholders' input. The proposed framework covered the following aspects: (1) the underlying value on which the penalty should be calculated; and (2) the penalty rate that should be applied to the underlying value in order to determine the actual amount of penalties.

Underlying value for calculating cash penalties

The amount of penalties should be closely related to the value of transactions that fail to be settled in order for them to be sufficiently deterrent. ESMA, therefore, proposed in its Consultation Paper that the underlying value for calculating cash penalties should be determined taking into account the value of transactions that fail to be settled. In order to facilitate (and automate) the calculation of penalties, ESMA considered, however, that this underlying value should be objectively determined for all settlement fails in a given financial instrument rather than depend on the value of each individual transaction. The reason for this is that the price indicated in the transaction may vary depending on the contractual terms agreed between parties and as such would not provide a sufficiently consistent basis for the calculation of penalties.

ESMA proposed in its Consultation Paper that the calculation of penalties should be based on a 'reference price' that should reflect objectively the market value of the financial instruments that failed to be settled. Such a price should be determined by reference to the closing price of the trading venue where financial instruments were first admitted to trading ('primary market'). Where such a price is not available, ESMA recommended using the closing price of the financial instrument from the trading venue where most of the transactions in that instrument take place ('the most liquid market'). To determine that market, ESMA proposed to use the definition of the *"most relevant market in terms of liquidity"* provided in Article 4(6)(b) Regulation (EU) No 600/2014 (MiFIR). In this way, ESMA sought to ensure that the market value would be adequately reflected and penalties remain similar for all CSDs. ESMA further suggested that where a reference price was not available, in particular for over-the-counter (OTC) transactions, a pre-determined methodology to calculate the relevant price should be used referring to criteria related to relevant market data, e.g. prices available across various markets and brokers.

ESMA's proposal to determine a reference price instead of using the value of each individual failing settlement transaction received broad support in the public consultation. In general, however, stakeholders advocated even more harmonisation than ESMA. First, almost all respondents suggested that, in order to promote harmonisation and avoid having different reference prices for the same financial instrument, there should also be a single source providing reference prices to all Union CSDs for all instruments subject to penalties. Some respondents suggested that ESMA should become such a single source, whilst others proposed that CSDs should identify and use the same source (e.g. through a tender procedure). Second, many respondents suggested using the price available on the most liquid market as a reference price instead of the price of the primary market. Third, some respondents raised technical issues with regards to the availability and calculation of the reference price for instruments which are either seldom traded on trading venues or, indeed,

traded on multiple venues. Finally, several respondents questioned what reference price should be used if the transaction failed to be settled for more than one day after the intended settlement date.

Taking into account the feedback received in the public consultation, ESMA advised the Commission to establish the reference price by referring to the price available on the most liquid market and, where this is not available, a pre-determined methodology that uses available market data across markets and brokers.

As regards the sources for establishing reference prices, ESMA considered the options proposed by respondents (i.e. ESMA or a single provider for all CSDs). In view of the difficulties in obtaining a reference price from one source, ESMA advised the Commission to allow CSDs to have their own providers as far as the rules on reference prices are clear (e.g. if the most liquid market for an instrument is defined clearly, the price will be the same, even if provided by different information providers). Moreover, in its technical advice ESMA suggested that CSDs could implement a common approach so that the reference price would be the same for similar financial instruments in all CSDs. Finally, ESMA analysed the options for determining a relevant price if a transaction fails for more than one day. One option was the use of the same price for the same transaction (i.e. the reference price of the intended settlement date to be used for each subsequent day of the fail). Another option was to apply multiple prices (one for each day of the fail). ESMA's advice was to apply the latter approach as this would better calibrate the penalties to the evolution of reference prices over time, in particular in case of a chain of fails (i.e. where several fails are provoked at different level of intermediation by one party who failed to settle on time).

Penalty rates

In its Consultation Paper, ESMA considered that the rates to be applied on the underlying value should result in amounts of penalties that provide incentives for the failing parties to settle trades by borrowing the relevant financial instruments from the market rather than incur penalties. An approach that would link the penalty rate to the prevailing market conditions for borrowing financial instruments on the securities lending market was, however, considered as too complex and costly to be implemented. Considering the need to automate the application of penalties, ESMA proposed to fix penalty rates in the form of a set table of values that is determined upfront, but that would still provide an adequate incentive to avoid settlement fails. According to ESMA, this approach would also better take account of the specificities of the relevant financial instruments, in particular their liquidity and settlement features.

In its Consultation Paper ESMA proposed four penalty rates: 1.0 basis point for equities and other financial instruments not covered in other categories; 0.25 basis points for government bonds; 0.5 basis points for corporate bonds; and a discount rate per currency for cash (i.e. official interest rate for overnight credit charged by the central bank that issues the relevant settlement currency). ESMA also suggested a review of these penalty rates when market conditions change.

Stakeholders generally supported the proposed approach, but they had mixed views on the specific rates to be levied. Some argued that the rates were too low, whilst a majority considered them too high compared to the borrowing costs of specific financial instruments. One respondent presented quantitative data showing that the penalty rates suggested by ESMA were higher than the borrowing costs of the relevant financial instruments. A few respondents proposed to further detail the penalty rate at a single instrument level (i.e. ISIN

code) taking into account the liquidity of each financial instrument. As concerns SMEs and less liquid equities in particular, many respondents considered the rate of one basis point to be too high and proposed to add at least another lower rate for them. They argued that too high penalties would lead to intermediaries (market makers) withdrawing from the trading of SME or less liquid equities and would, therefore, undermine their liquidity on the market. The penalty rate for SME equities proposed by the respondents was around 0.25 basis points. As concerns corporate bonds, some respondents felt the penalty rate to be too high given their unstandardized settlement and lower liquidity. Several respondents recommended additional categories and lower rates for penalties for Exchange Traded Funds, depository receipts and certificates.

In view of the feedback received in the public consultation, ESMA proposed to change the categories and levels of penalty rates. ESMA added new categories for equities and bonds traded on SME growth markets and assigned a penalty rate equal to 0.25 basis points and 0.15 basis points to them respectively. ESMA has also added a new category and a lower penalty rate of 0.5 basis points for illiquid equities in general.

As regards bonds, ESMA assessed the data provided as part of the consultation according to which the penalties rates proposed in its Consultation Paper for bonds were 7-8 times higher than the borrowing costs. In view of this data, ESMA proposed lowering the rates applicable to sovereign and corporate bonds (0.10 and 0.20 basis points respectively). With respect to Exchange Traded Funds, depository receipts and certificates, ESMA took into account that these instruments may have a very limited liquidity. Using the same penalty rates in those cases as for liquid equities was considered inappropriate and potentially endangering the affected markets. ESMA proposed, therefore, to align the penalties rate for those instruments with the one for illiquid equities (i.e. 0.5 basis points).

Finally, ESMA's technical advice to the Commission included a proposal for ESMA to review the proposed penalty rates if market conditions change. The mechanism for a review of CSDR and its implementing acts is already provided in Articles 74 and 75 of CSDR. Nonetheless, given the likelihood of changing market conditions, it is appropriate to add a specific provision in the delegated act which provides for a review by the Commission of the penalty rates at the latest three years after publication of the delegated act in the Official Journal (i.e. after one year of application of the proposed rates taking account of a proposed two year phase-in in the application of the penalties).

Decrease / increase of penalty

ESMA has also reflected on whether CSDs should be able to increase or decrease, on a case by case basis, the amount of cash penalties in order to better influence the behaviour of market participants. ESMA argued that a reduction or an increase of the penalty in certain circumstances (e.g. repeated fails) would hinder the collection and automated application of penalties. Additionally, in view of the analysis of exiting penalty systems, ESMA noted that even though some of them provide for a possible increase of penalties on a case by case basis, such an increase is usually not applied in practice. The respondents to the public consultation agreed with ESMA's proposal not to have the possibility to increase or decrease penalties on a case by case basis. Accordingly, ESMA did not propose any increases or decreases of penalties in its technical advice to the Commission. Instead, ESMA has underlined that the penalty rates should be regularly reviewed and updated in a general manner to take account of the evolving market conditions.

Application of penalties regime

In its Consultation Paper, ESMA considered that sufficient time should be allowed for CSDs and their users for the application of the relevant measures concerning the calculation of cash penalties. The reason for this was that the application of the proposed measures requires significant IT system changes, market testing and adjustments to legal arrangements between the CSDs and their users. Both market participants and public authorities unanimously supported the introduction of a phase-in during the public consultation.

Substantial importance

In its preparation of the technical advice on measures to assess substantial importance of CSDs' operations in host Member States, ESMA considered several aspects. First, the assessment should focus on the services provided by CSDs to users from host Member States in accordance with CSDR (i.e. initial recording of securities ('notary service'), maintenance of securities accounts at top-tier level ('central maintenance service') and settlement services). The rationale is that such services are provided by CSDs in their capacity of financial market infrastructures and not by other entities. Second, the assessment should take account of the size of such services in the affected host Member States given that, where such size is sufficiently large, any failures or deficiencies in the operations of a CSD may affect the smooth functioning of securities markets and the protection of investors in the host Member States concerned. Finally, the assessment criteria should be based on indicators that can be regularly assessed by competent authorities and ensure an efficient and effective supervision and oversight of CSDs without creating an excessive number of cooperation arrangements.

Working on this basis, ESMA provided a list of indicators for each individual core services provided by CSDs to measure their relevance in host Member States. The *rationale* of ESMA's approach is that when the size of the core service provided by a CSD reaches 15 per cent of the size of the service provided by all Union CSDs in a host Member State, the CSD's activities become of substantial importance for the host Member State concerned.

ESMA suggested that the indicators should be applied on an annual basis so that the competent authorities could assess the substantial importance every year. This frequency took into account the necessary time for gathering data required for the calculation of indicators and their aggregation at Union level.

In their feedback to public consultations, stakeholders broadly supported the suggested frequency of one year for conducting the assessment. As regards ESMA approach and proposed indictors, while many stakeholders agreed with ESMA's approach to focus its assessment on core CSD services, they provided specific comments related to each indicator.

Scope of 'substantial importance' for notary and central maintenance services

In its Consultation Paper, ESMA provided the following indicators for assessing substantial importance of notary and central maintenance services:

(a) *Notary service indicator*: threshold of 15% for the value of securities issued by issuers from the host Member State initially recorded in the CSD against the value of all securities issued by issuers from the host Member State initially recorded in all CSDs in the EU;

(b) *Central maintenance indicator:* threshold of 15% for the value of securities centrally maintained by the CSD of the home Member State for participants and other holders of securities accounts of the host Member State against the value of securities centrally maintained by all CSDs in the EU for participants and other holders of securities accounts of the host Member State.

Maintenance sub-indicator: threshold of 10% (only in conjunction with central maintenance indicator of at least 5%) for the value of securities issued in a CSD established in the EU and non-centrally maintained by the CSD of the home Member State for participants other than CSDs as well as for other holders of securities accounts of the host Member State against the value of securities non-centrally maintained in all CSDs in the EU for participants other than CSDs as well as for other holders of securities accounts of the host Member State.

Most of the respondents agreed on the relevance of the indicators for notary and central maintenance services. It was, however, pointed out by some stakeholders that in some Member States, the notary service may be performed by other entities than CSDs (e.g. registrars), which could make the indicator for notary services inapplicable in their jurisdictions. In addition, the introduction of a sub-indicator under the indicator for central maintenance, in view of the respondents, made its application too complex. In its technical advice ESMA took these comments into account. As regards the first issue, ESMA developed a joint indicator for notary and central maintenance services based on the value of securities initially recorded or centrally maintained by a CSD for issuers from a host Member State. As regards the second issue, ESMA removed the sub-indicator from central maintenance indicator arguing that these services are partially captured under the indicator for the settlement service.

Scope of 'substantial importance' for settlement services

In its Consultation Paper, ESMA provided for the following indicators for assessing substantial importance for settlement services.

(a) *Settlement indicator (issuers' perspective):* threshold of 15% for the value of settlement instructions settled by the CSD of the home Member State in relation to transactions in securities issued by issuers from the host Member State against the value settlement instructions settled by all CSDs in the EU in relation to transactions in securities issued by issuers from the host Member State; and

(b) *Settlement indicator (participants perspective):* threshold of 15% of the value of settlement instructions settled by the CSD of the home Member State for participants and other holders of securities accounts of the host Member State against the value of the value of settlement instructions settled in all CSDs in the EU for participants and other holders of securities accounts of the host Member State.

The *rationale* for this approach is that if a CSD settles more than 15% of all securities issued by issuers from a host Member State or more than 15% of all securities settlement performed by CSD participants (intermediaries that hold securities on behalf of investors) from a host Member State, the settlement service performed by that CSD becomes of substantial importance. As regards the reference to participants, ESMA believed that the origin of participants could be a proxy for assessing the substantial importance of the activities of a CSD from the perspective of final investors.

Several respondents questioned whether settlement services may be considered for the purpose of assessing substantial importance. They believed that such an assessment should be limited to notary and central maintenance services by referring to Article 23(2) of CSDR that deals with the procedure to be followed by a CSD when it intends to provide its services cross-border. This interpretation was not supported by ESMA in its technical advice. While Article 23(2) of CSDR limits the procedure to be applied by a CSD when offering certain services (notary and central maintenance services), this provision should be read jointly with Article 23(1) that establishes the principle of CSD's freedom to provide services in the Union and covers all services provided by a CSD.

Other stakeholders questioned whether participants could be considered as an appropriate proxy for investors. According to them, the nationality of the participant is not appropriate for the measurement of the CSDs' impact on the protection of investors. They argued that while participants provide often their services to investors from their jurisdiction, it is still possible that participants hold securities and provide services to foreign investors. It was, however, generally recognised by respondents that the CSDs do not have information on the country of their participants' clients (i.e. final investors). ESMA was aware of the limitations of using the participants of host Member States as a proxy for investors in those Member States. However, to the extent that a CSD does not have the necessary information on indirect provision of settlement services (i.e. to indirect participants or end investors) and given that CSD participants usually provide services to investors established in the same jurisdiction, ESMA concluded that the participants could still be used as a proxy for investors.

Other criteria

In addition to their core market infrastructure services (notary, central maintenance and settlement services), CSDs may provide services ancillary to their core functions (e.g. collateral management, regulatory reporting, IT services etc.) in competition with other entities. In its Consultation Paper, ESMA excluded such ancillary services from the assessment of substantial importance given that they are not indispensable for the provision of core market infrastructure services of CSDs and they are usually provided by other entities than CSDs. Similarly, ESMA did not take into account the establishment of branches in host Member States as a separate criterion for assessing substantial importance. ESMA considered that the presence of branches of CSDs in host Member States does not reflect as such their substantial importance for those Member States. ESMA recommended that the substantial importance of CSDs should only be determined by reference to the actual services provided to users from host Member States regardless of whether such services are provided cross-border or through branches. This approach received broad support in the course of the public consultation but was questioned by some CSDs.

Measures to apply the proposed indicators

Several stakeholders underlined the difficulty of providing the necessary statistical data to apply the proposed indicators in practice because they refer to services provided by CSDs across the Union. The respondents considered that ESMA is well placed to consolidate the data from all relevant CSDs across the EU in order to allow competent authorities and CSDs to calculate the indicators. Given the need to use consistent data at the EU level for the calculation of the indicators, ESMA stated in its technical advice to the Commission that it may consider issuing guidelines to further specify the process for the collection and calculation of indicators.

Several respondents underlined that CSDs do not currently hold sufficient data to be able to calculate entirely the indicators for central maintenance and settlement services. This was confirmed by a simulation exercise performed by ESMA in parallel to the public consultation. ESMA assessed this issue more closely and concluded that some time will be needed for CSDs to implement the record keeping requirements and IT processes needed to collect and filter data for the assessment of substantial importance. In its technical advice, ESMA proposes that the joint indicator for notary and central maintenance services is applied immediately, while the other indicators should be applied within two years from the date of entry into force of the delegated act.

As regards the calculation of the market value of securities relevant for the application of several indicators, ESMA proposed in its Consultation Paper to determine it by reference to the closing price of the trading venue where the securities were first admitted to trading or of the most relevant market in terms of liquidity. Several stakeholders called for further clarifications on how to apply these notions. In its technical advice, ESMA underlined that the notion of market value of securities should be aligned with a similar notion to be developed in the draft regulatory technical standards on settlement discipline and with the existing notions used in Regulation (EU) No 600/2014 (MiFIR).

This Regulation consistently follows the measures proposed by ESMA in its technical advice.

3.1 ANALYSIS OF COSTS AND BENEFITS

Cost and benefits of the parameters for the calculation of the level of cash penalties and measures for establishing the substantial importance included in this delegated act were analysed in the Impact Assessment Report for Commission proposal for CSDR (SWD(2012) 22 final), as well as in the Impact Assessment carried out by ESMA and annexed to ESMA technical advice.

Concerning the cash penalties, as described in the Commission Impact Assessment Report, the principle cost of the choices exercised is the implementation cost for CSDs. The Commission's Report also pointed at the costs for those market participants who systematically fail to settle (e.g. certain short sellers) and will have to pay cash penalties. Those costs will be, however, offset by the overall benefits to investors resulting from the increase in settlement efficiency and discipline.

The impact assessment carried out by ESMA indicated specific compliance costs for CSDs such as the costs of identifying the 'reference price' for financial instruments that failed to be settled. These costs will be sustained by CSDs that will have to pay data service providers to identify 'reference prices'. CSDs will, however, recover these costs as part of their services to users. Given that these 'reference prices' are widely available and, when they are not, a pre-determined methodology can be used, the costs related to their identification should be limited.

ESMA's impact assessment has also mentioned the potential indirect costs. The proposed system for calculation of cash penalties is not strictly calibrated to the borrowing costs of the relevant financial instruments, but is based on an *ex-ante* penalty rates that take account of the features of different financial instruments. As such, the proposed system might have an impact on the liquidity of certain less liquid financial instruments, such as instruments issued by SMEs (if penalties are set up at a too high level, the increased costs for market

intermediaries resulting from cash penalties may lead to their withdrawal from markets, which could affect the liquidity of such markets).

ESMA is aware that, if calibrated inappropriately, such system might have distortive effects. It has, therefore, proposed lower penalty rates for illiquid shares and corporate bonds and the lowest penalty rates for instruments traded on SME-growth markets.

Should the deterrent effect of the penalty turn into a deterrence to trade such instruments, the objective of limiting fails would be fulfilled at the price of the liquidity of such instruments. In such cases, the Commission should review the penalty rates. The first review of the penalty rates will take place after a sufficiently short period of time to address any potential liquidity problems (i.e. one year after application of penalty rates). Nevertheless, the Commission is free to review the penalty rates at any time prior to the date set in the delegated act, if serious problems emerge.

Concerning the substantial importance, the costs related to involvement of other Member States in the supervision of CSDs that are active cross-border are described in the Commission's Impact Assessment Report as regulatory costs to be borne by some large CSDs.

The impact assessment carried out by ESMA confirmed this and analysed in more details the cost of options chosen for each indicator. ESMA has also conducted a simulation exercise to identify the authorities which under the chosen options would need to enter into cooperation arrangements in accordance with Article 24 of CSDR. Due to the unavailability of data, the simulation exercise was limited to the issuers' indicator for notary and central maintenance services.

3.2 PROPORTIONALITY

With respect to the calculation cash penalties and in line with Article 7(14) of CSDR, the parameters provided for in the delegated act ensure that the penalties are deterrent and proportionate.

With respect to measures to establish substantial importance, the indicators are calibrated at levels, which ensure that only CSDs with sufficiently significant cross-border activity are captured under the requirements of Article 24(4) CSDR (i.e. mainly large CSDs).

In view of the above, this delegated act ensures the proportionate application of CSDR rules, thus taking into account the principle of proportionality.

3.3. SUBSIDIARITY

The objective of this delegated act is to specify parameters for the calculation of cash penalties to be applied in a harmonised way across the EU and to establish the criteria under which the operations of a CSD in a host Member State could be considered of substantial importance for the functioning of the securities markets and the protection of the investors in that host Member State.

Member States cannot take such actions by themselves, because the parameters for calculation of penalties and measures for establishing substantial importance require harmonisation across the EU in accordance with CSDR. This delegated act complements the CSDR, whilst

respecting the principle of proportionality as set out above, and therefore is in line with the principle of subsidiarity.

4. LEGAL ELEMENTS OF THE DELEGATED ACT

4.1 ARTICLE 1

This Regulation introduces the criteria for establishing the substantial importance. One of those criteria concerns settlement services provided by a CSD in a host Member State. In order to evaluate the importance of such settlement service, this Regulation provides thresholds for quantifying the size of settlement by referring to the value of settlement instructions.

'Settlement instruction' is a technical term, which was not defined in CSDR. Article 1 clarifies that it means both instructions referred to in point (i) of Article 2 of Directive 98/26/EC[1].

4.2 ARTICLE 2

This provision explains how the level of cash penalties needs to be calculated on the basis of the parameters that are provided in the Regulation. The level of cash penalty is to be determined by applying a penalty rate provided in the Annex of the Regulation to a 'reference price' of the financial instrument underlying the transaction which failed to be settled.

4.3 ARTICLE 3

This provision defines how the 'reference price' of a financial instrument should be determined. Such a reference price should be based on the market value of the financial instrument as determined in accordance with Article 7.

4.4 ARTICLE 4

This article explains that the fulfilment of any of the criteria set out in Article 5 and Article 6 is sufficient to establish substantial importance for the functioning of the securities markets and the protection of the investors in the host Member State.

4.5 ARTICLE 5

This provision sets out the criteria under which CSDs providing notary and central maintenance service in host Member States should be considered of substantial important for the markets of those host Member States. Two criteria are included (to be applied alternatively):

- a threshold of 15% for the value of securities issued by issuers from the host Member State initially recorded or centrally maintained in the CSD against the

[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 11.6.98, L166, p. 45

value of all securities issued by issuers from the host Member State initially recorded or centrally maintained in all CSDs in the EU;

- a threshold of 15% for the value of securities centrally maintained by the CSD of the home Member State for participants and other holders of securities accounts of the host Member State against the value of securities centrally maintained by all CSDs in the EU for participants and other holders of securities accounts of the host Member State.

This provision also states that market value should be determined in accordance with Article 8.

Furthermore, this article provides that, once the operations of a CSD are determined to be of substantial importance for host Member States, they shall be considered of substantial importance for renewable periods of three years starting from 30 April of the year following fulfilment of the criteria. This should allow authorities from home and host Member States to set up cooperation arrangements for a sufficiently long period of time.

4.6 ARTICLE 6

Article 6 focuses on the thresholds for substantial importance for settlement services. Three alternative criteria are included:

- a threshold of 15% for the annual value of settlement instructions settled by the CSD of the home Member State in relation to transactions in securities issued by issuers from the host Member State against the value settlement instructions settled by all CSDs in the EU in relation to transactions in securities issued by issuers from the host Member State; and

- a threshold of 15% of the annual value of settlement instruction settled by the CSD of the home Member State from participants and other holders of securities accounts of the host Member State against the value of settlement instructions settled in all CSDs in the EU from participants and other holders of securities accounts of the host Member State;

- cases where a CSD operates a securities settlement system governed by the law of the host Member State, designated and notified to ESMA under Directive 98/29/EC.

This provision also states how the value of settlement should be determined in case of different types of settlement instructions:

(i) for settlement instructions against payment, the value of the corresponding transaction in financial instruments as entered into the securities settlement system and

(ii) for free of payment (FOP) settlement instructions, the aggregated market value of the relevant financial instrument as determined in accordance with Article 7.

Finally, similarly to Article 5, this article also provides that once the operations of a CSD are determined to be of substantial importance for host Member States, they shall be considered

of substantial importance for renewable periods of three years, starting from 30 April of the year following fulfilment of the criteria.

4.7 ARTICLES 7-9

The general, transitional and final provisions cover the common provisions for calculation of cash penalties and application of the criteria to determine substantial importance.

Article 7 provides how different values referred in this Regulation are to be determined.

Article 8 sets out transitional provisions for application of the criteria for substantial importance. First, it sets out when the data for the assessment criteria shall be collected and be applied. The assessment of notary and central maintenance services should be based on the values of securities on 31 December of the calendar year in question. Following the adoption of this delegated act, the first assessment of various services shall be undertaken within four months from the date of application of relevant provisions and be based on values from 31 December of the previous calendar year. Moreover, given that market value of the financial instruments is to be determined by reference to the most relevant market in terms of liquidity referred to in Article 4(1)(a) of Regulation (EU) No 600/2014, this article provides how the market value of the financial instruments should be determined until Regulation (EU) 600/2014 starts applying.

Article 9 sets a two year phase-in for the application of some of the provisions of the Regulation. This choice takes into account the need for a longer period of time for stakeholders to put in place measures for implementation of cash penalties in accordance with this Regulation and the time needed for the CSDs to implement the record keeping requirements and IT processes necessary for collection and consolidation of data for the assessment of substantial importance for certain services.

Article 9 sets out also specific dates for the application of some provisions of the Regulation which refer to or are linked with other regulations. The date of entry into application of such provisions should be aligned with those other regulations.

COMMISSION DELEGATED REGULATION (EU) …/...

of 11.11.2016

supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council as regards the parameters for the calculation of cash penalties for settlement fails and the operations of CSDs in host Member States

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012[1] , and in particular Article 7(14) and Article 24(7) thereof,

Whereas:

(1) The provisions of this Regulation are closely linked since they deal with the elements required for the implementation of the measures laid down in Regulation (EU) No 909/2014. To ensure coherence between those measures and to facilitate a comprehensive view and easy access by persons that are subject to these provisions, it is desirable to include all these elements concerning measures under Regulation (EU) No 909/2014 in a single Regulation.

(2) Regulation (EU) No 909/2014 requires that central securities depositories (CSDs) impose cash penalties on participants to their securities settlement systems that cause settlement fails (failing participants).

(3) To ensure that cash penalties imposed on failing participants act as an effective deterrent, the parameters for the calculation of the level of cash penalties should be closely related to the value of financial instruments that fail to be delivered, and to which appropriate penalty rates should be applied. The value of the financial instruments underlying the transaction should also be the basis for the calculation of the level of cash penalty where the settlement fail is due to a lack of cash. The level of cash penalties should provide incentives to failing participants to promptly settle transactions that failed to be settled. In order to ensure the effective achievement of the objectives pursued by the imposition of cash penalties, the adequacy of the parameters for their calculation should be monitored on an ongoing basis and adjusted, as necessary, on the basis of the impact of those penalties on the market.

[1] OJ L 257, 28.8.2014, p. 1.

(4) In view of the considerable price differences of financial instruments in the multiple underlying transactions and in order to facilitate the calculation of cash penalties, the value of financial instruments should be based on a single reference price. The same reference price should be used by CSDs on a given day for calculating cash penalties for settlement fails concerning identical financial instruments. Cash penalties should be therefore the result of multiplying the number of financial instruments underlying the transaction that failed to settle by the relevant reference price. The establishment of reference prices should be based on objective and reliable data and methodologies.

(5) Taking into account that the automation of calculations of cash penalties should ensure their effective application by CSDs, appropriate penalty rates should be based on a single table of values that should be easy to automate and apply. Penalty rates for different types of financial instruments should be set at levels that would result in cash penalties that fulfil the conditions of Regulation (EU) No 909/2014.

(6) Settlement of transactions in shares is usually highly standardised. Where shares have a liquid market and could therefore be bought easily, settlement fails should be subject to the highest penalty rate in order to provide incentives to failing participants to settle failed transactions in a timely manner. Shares that do not have a liquid market should be subject to a lower penalty rate given that a lower penalty rate should still have a deterrent effect without affecting the smooth and orderly functioning of the markets concerned.

(7) The level of cash penalties for settlement fails of transactions in debt instruments issued by sovereign issuers should take into account the typically large size of these transactions and their importance for the smooth and orderly functioning of the financial markets. Settlement fails should therefore be subject to the lowest penalty rate. Such a penalty rate should nevertheless have a deterrent effect and provide an incentive for timely settlement.

(8) Debt instruments that are not issued by sovereign issuers have less liquid markets and the size of transactions in such instruments is smaller. Such debt instruments also affect the smooth and orderly functioning of the financial markets less than debt instruments issued by sovereign issuers. The penalty rate for settlement fails should therefore be higher than for debt instruments issued by sovereign issuers.

(9) Settlement fails of transactions in debt instruments should be subject to lower penalty rates than settlement fails of transactions in other financial instruments in view of their overall larger size, non-standardised settlement, greater cross-border dimension and importance for the smooth and orderly functioning of the financial markets. Such lower penalty rate should nevertheless have a deterrent effect and provide an incentive for timely settlement.

(10) Financial instruments other than shares and debt instruments that fall within the scope of Regulation (EU) No 909/2014, such as depository receipts, emission allowances and exchange-traded funds, do not usually have a highly standardised settlement and liquid markets. They are also often traded over-the-counter (OTC). In view of the limited volume and size of transactions and in order to reflect their non-standardised trading and settlement, settlement fails should be subject to a similar penalty rate to the one for shares that do not have a liquid market.

(11) The parameters for calculating cash penalties should be adapted to the specificities of certain trading venues, such as SME growth markets as defined in Directive 2014/65/EU of the European Parliament and of the Council[2]. Cash penalties for settlement fails should not hinder access by small and medium enterprises (SMEs) to capital markets as an alternative to bank lending. In addition, Regulation (EU) No 909/2014 allows SME growth markets the flexibility not to apply the buy-in process to settlement fails until up to 15 days after the intended settlement date. Consequently, cash penalties for settlement fails in financial instruments traded on SME growth markets may apply during a longer period of time than for other financial instruments. Given the length of application of cash penalties, lower liquidity and specificities of SME growth markets, the penalty rate for settlement fails of transactions in financial instruments traded on such trading venues should be set at a specific rate that should provide incentives for timely settlement but should not affect their smooth and orderly functioning. It is also appropriate to ensure that settlement fails of transactions in certain financial instruments, such as debt instruments traded on such venues, are subject to a lower penalty rate than similar debt instruments traded on other markets.

(12) Settlement fails due to a lack of cash should be subject to a single penalty rate for all transactions given that such a situation is independent from the asset type and liquidity of the financial instrument concerned or the type of transaction. In order to ensure a deterrent effect and incentivise timely settlement by failing participants through cash borrowing, it is appropriate to use the costs of borrowing cash as a basis for the penalty rate. The most appropriate penalty rate should be the official interest rate of the central bank issuing the settlement currency that should evidence the borrowing costs for that currency.

(13) Regulation (EU) No 909/2014 allows CSDs to provide their services in the Union under the supervision of competent authorities of their home Member States. To ensure an appropriate level of safety in the provision of services by CSDs in host Member States, Regulation (EU) No 909/2014 requires the competent and relevant authorities of home Member States and host Member States to establish cooperation arrangements for the supervision of the activities of CSDs in the host Member State when their operations become of a substantial importance for the functioning of the securities markets and the protection of investors in the host Member States concerned.

(14) To comprehensively establish whether the operations of CSDs have become of substantial importance for the functioning of the securities markets and the protection of investors in host Member States, it is appropriate to ensure that assessment criteria consider the core services provided by CSDs in host Member States as specified in Section A of the Annex to Regulation (EU) No 909/2014 given that such core services are provided by CSDs in their capacity as financial market infrastructures.

(15) For the purposes of assessing the importance of the operations of CSDs in host Member States, the assessment criteria should consider the size of the core services provided by CSDs to users from host Member States, including to issuers, participants in securities settlement systems or other holders of securities accounts maintained by CSDs. Where the size of core services provided by CSDs to users from host Member

[2] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349).

States is sufficiently large, the operations of CSDs in such host Member States should be deemed to be of substantial importance for the functioning of the securities markets and the protection of investors given that any failures or deficiencies in the operations of such CSDs may affect the smooth functioning of securities markets and the protection of investors in the host Member States concerned. In order to ensure a comprehensive assessment, it is appropriate to apply assessment criteria which consider independently the size of each core service provided by CSDs to users from host Member States.

(16) Where CSDs issue or centrally maintain large parts of securities for issuers established in host Member States or where they centrally maintain large parts of securities accounts for participants of their securities settlement systems or other account holders established in host Member States, their operations should be deemed to be of substantial importance for the functioning of the securities markets and the protection of investors in the host Member States concerned.

(17) Where CSDs settle large values of transactions in securities issued by issuers established in host Member States or where they settle large values of settlement instructions from participants and other holders of securities accounts established in host Member States, their operations should be deemed to be of substantial importance for the functioning of the securities markets and the protection of investors in the host Member States concerned.

(18) Directive 98/26/EC of the European Parliament and of the Council[3] allows Member States to designate securities settlement systems governed by their laws for the purposes of application of that Directive when Member States consider that such designation is warranted on grounds of systemic risk. When CSDs operate securities settlement systems designated by host Member States in accordance with Directive 98/26/EC, their operations should therefore be deemed to be of substantial importance for the functioning of the securities markets and the protection of investors in those host Member States.

(19) Assessments of operations of CSDs should be conducted with sufficient frequency in order to allow the authorities concerned to establish without undue delay cooperation arrangements from the moment when the operations of relevant CSDs become of substantial importance for the functioning of the securities markets and the protection of investors in host Member States.

(20) When the operations of CSDs become of substantial importance for the functioning of the securities markets and the protection of investors in a host Member State, they should be deemed to be of substantial importance for a sufficiently long period of time to allow the authorities concerned to establish effective and efficient cooperation arrangements in accordance with Regulation (EU) No 909/2014.

(21) Calculations related to assessments under this Regulation should be based on objective and reliable data and methodologies. Given that certain calculations required under this Regulation are based on the rules laid down in Regulation (EU) No 600/2014 of

[3] 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)

the European Parliament and of the Council[4], such calculations should only be undertaken when Regulation (EU) No 600/2014 is applicable.

(22) Given that the measures to address settlement fails related to the calculation of cash penalties and certain measures for the establishing of substantial importance may require significant information technology system changes, market testing and adjustments to legal arrangements between the parties concerned, including CSDs and other market participants, sufficient time should be allowed for the application of the relevant measures to ensure that the CSDs and other parties concerned meet the necessary requirements,

HAS ADOPTED THIS REGULATION:

Article 1

Definitions

For the purposes of this Regulation, 'settlement instruction' means a transfer order as defined in Article 2(i) of Directive 98/26/EC.

Article 2

Calculation of cash penalties

The level of cash penalties referred to in the third subparagraph of Article 7(2) of Regulation (EU) No 909/2014 for settlement fails of transactions in a given financial instrument shall be calculated by applying the relevant penalty rate set out in the Annex to this Regulation to the reference price of the transaction determined in accordance with Article 3 of this Regulation.

Article 3

Reference price of the transaction

1. The reference price referred to in Article 2 shall be equal to the aggregated market value of the financial instruments determined in accordance with Article 7 for each business day that the transaction fails to be settled.

2. The reference price referred to in paragraph 1 shall be used to calculate the level of cash penalties for all settlement fails, irrespective of whether the settlement fail is due to a lack of securities or cash.

[4] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014on markets in financial instruments and amending Regulation (EU) No 648/2012 (OJ L 173, 12.6.2014, p. 84)

Article 4

Criteria for establishing the substantial importance of a CSD

The operations of a CSD in a host Member State shall be considered to be of substantial importance for the functioning of the securities markets and the protection of investors in the host Member State where at least one of the criteria specified in Articles 5 and 6 is fulfilled.

Article 5

Criteria for establishing the substantial importance of notary and central maintenance services

1. The provision of notary and central maintenance services, as referred to in points 1 and 2 of Section A of the Annex to Regulation (EU) No 909/2014, by a CSD in a host Member State shall be considered to be of substantial importance for the functioning of the securities markets and the protection of investors in that host Member State where any of the following criteria is fulfilled:

   (a) the aggregated market value of financial instruments issued by issuers from the host Member State that are initially recorded or centrally maintained in securities accounts by the CSD represents at least 15% of the total value of financial instruments issued by all issuers from the host Member State that are initially recorded or centrally maintained in securities accounts by all CSDs established in the Union;

   (b) the aggregated market value of financial instruments centrally maintained in securities accounts by the CSD for participants and other holders of securities accounts from the host Member State represents at least 15% of the total value of financial instruments centrally maintained in securities accounts by all CSDs established in the Union for all participants and other holders of securities accounts from the host Member State.

2. For the purposes of paragraph 1, the market value of financial instruments shall be determined in accordance with Article 7.

3. Where any of the criteria set out in paragraph 1 is fulfilled, the operations of that CSD in a host Member State shall be considered of substantial importance for the functioning of the securities markets and the protection of investors in that host Member State for renewable periods of three calendar years from the 30 April of the calendar year following the fulfilment of any of those criteria.

Article 6

Criteria for establishing the substantial importance of settlement services

1. The provision of settlement services as referred to in point 3 of Section A of the Annex to Regulation (EU) No 909/2014 by a CSD in a host Member State shall be considered to be of substantial importance for the functioning of the securities markets and the protection of investors in the host Member State where any of the following criteria is fulfilled:

   (a) the annual value of settlement instructions related to transactions in financial instruments issued by issuers from the host Member State and settled by the CSD represents at least 15% of the total annual value of all settlement instructions related to transactions in financial instruments issued by issuers from the host Member State and settled by all CSDs established in the Union;

   (b) the annual value of settlement instructions settled by the CSD for participants and other holders of securities accounts from the host Member State represents at least 15% of the total annual value of the settlement instructions settled by all CSDs established in the Union, for participants and other holders of securities accounts from the host Member State;

   (c) the CSD operates a securities settlement system governed by the law of the host Member State and has been notified to the European Securities and Markets Authority (ESMA).

2. For the purposes of points (a) and (b) of paragraph 1, the value of a settlement instruction shall be:

   (a) for a settlement instruction against payment, the value of the corresponding transaction in financial instruments as entered into the securities settlement system;

   (b) for free of payment (FOP) settlement instructions, the aggregated market value of the relevant financial instruments as determined in accordance with Article 7.

3. Where any of the criteria set out in paragraph 1 is fulfilled, the operations of that CSD in a host Member State shall be considered of substantial importance for the functioning of the securities markets and the protection of investors in that host Member State for renewable periods of three calendar years from the 30 April of the calendar year following the fulfilment of any of those criteria.

Article 7

Determination of market values

The market value of financial instruments referred to in Articles 3, 5 and 6 of this Regulation shall be determined as follows:

(a) for financial instruments referred to in Article 3(1) of Regulation (EU) No 600/2014 admitted to trading on a trading venue within the Union, the market value of the relevant financial instrument shall be the closing price of the most relevant market in terms of liquidity referred to in Article 4(1)(a) of Regulation (EU) No 600/2014;

(b) for financial instruments admitted to trading on a trading venue within the Union other than those referred to in point (a), the market value shall be the closing price derived from the trading venue within the Union with the highest turnover;

(c) for financial instruments other than those referred to in points (a) and (b), the market value shall be determined on the basis of a pre-determined methodology approved by the competent authority of the relevant CSD that refers to criteria related to reliable market data, such as market prices available across trading venues or investment firms.

Article 8

Transitional provisions

1. The criteria referred to in Article 5(1)(a) and Article 6(1)(c) shall be applied for the first time within four months from the date of entry into force of this Regulation and shall be based on the values of financial instruments initially recorded or centrally maintained in securities accounts by the CSD on 31 December of the previous calendar year.

2. The criteria referred to in Article 5(1)(b) and in Article 6(1)(a) and (b) shall be applied for the first time within four months from the date of application referred to in Article 9(2) and shall be based on the values of financial instruments centrally maintained in securities accounts by the CSD on 31 December of the previous calendar year.

3. For the period commencing on the date of entry into force of this Regulation and ending on the date of application referred to in the second paragraph of Article 55 of Regulation (EU) 600/2014, the following shall apply:

(a) by way of derogation from Article 5(2), the market value of financial instruments shall be the nominal value of those instruments;

(b) by way of derogation from Article 6(2)(b), the market values of the relevant financial instruments shall be the nominal value of those financial instruments.

Article 9

Entry into force and application

1. This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

2. This Regulation shall apply from [*insert date – two years following its publication in the Official Journal*].

3. By way of derogation from paragraph (2),

   (a) Articles 2 and 3 shall apply from the date of entry into force of the delegated act adopted by the Commission pursuant to Article 7(15) of Regulation (EU) No 909/2014.

   (b) Article 7 shall apply from the date referred to in the second paragraph of Article 55 of Regulation (EU) 600/2014;

   (c) Article 8 shall apply from the date of entry into force of this Regulation.

4. This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 11.11.2016

For the Commission
The President
Jean-Claude JUNCKER