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Informal Working Group on Securities Clearing and Settlement Systems, Including Rules of Central Securities Depositories

Report

(submitted by the Co-chairs of the informal Working Group)

The Working Group on Securities Clearing and Settlement Systems, including the rules of central securities depositories ("CSDs"), which was one of the three informal Working Groups established by the Committee of Governmental Experts at its fourth session (see Doc. 95, par. 248), considered two issues.

The first issue relates to which Contracting State or States would designate a system under the Convention where multiple securities settlement systems ("SSSs") are operated by the same operator. This issue may arise where the laws of more than one Contracting State govern the uniform rules of the system, such as in the case of CREST.

The second issue is whether the rules of a CSD should be recognized under the Convention. The current draft of the Convention expressly recognizes the rules of the SSS and SCS in a number of provisions.

The Group, which consisted of participants listed in **Appendix A** and held four conference calls, after considering the issues, would like to share the following findings.

I. The First Issue - Designation of Multiple SSSs Operated by the Same Operator

The Convention provides the following definition of a Securities Settlement System (Article 1(n)):

> *"Securities settlement system means a system which:*
>
> *(i) settles, or clears and settles, securities transactions;*
>
> *(ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules; and*
>
> *(iii) has been notified, on the ground of the reduction of risk to the stability of the financial system, as a securities settlement system in a declaration by the Contracting State the law of which governs the rules of the system."*

The point which was raised by the EU observers at the last session of the negotiations (*see* paragraph 109 of Doc. 95) relates to details of the designation mechanism as this is reflected in point (iii) of the definition to the extent that a designation affects multiple systems operated by one and the same entity.

A. Examples

It is not uncommon for CSDs to operate more than one system. For instance, Monte Titoli, the Italian CSD operates two systems, namely Express II and an FOP which is called "Servizio di gestione accentrata gestito dalla Monte Titoli SpA limitatamente al transferimento di strumenti finanziari attraverso operazioni di giro". Although these systems have different rules and may have different participants, they are both governed by Italian law.

Equally, Clearstream Banking AG Frankfurt, the German CSD, operates a number of different systems, such as "Cascade" and "Creation Frankfurt" governed by German law.

In those situations, the law that governs all the systems operated by the CSD is the local law, *i.e.*, the law of the Contracting State where the CSD is established. There is therefore no question as to which Contracting State will provide the notification of these systems under Article 1(n) of the UNIDROIT draft Convention.

However, there are cases where public authorities and/or financial market participants in a State have decided not to create the relevant technical infrastructure for the settlement of securities covered by their national law but rather to entrust (under proper authorisation and supervision or recognition) its setting-up and operation to an operator located in a different State. In such cases, while the *technical* infrastructure is operated by an entity situated in another State, the first State will (under its local laws) put in place statutory provisions to support the validity and effect of electronic transfer orders sent into the system.

In those type of situations, it is necessary to distinguish between the law that gives validity, enforceability and binding effect to a transfer order within any given system and the law that might govern the contractual relations between the system operator and the system participant in relation to their participation in that system, including their acceptance. It is true that these two laws may coincide, but not necessarily.

The two systems operated by Euroclear UK & Ireland Limited (formerly CRESTCo – a single legal entity established in the UK and incorporated under English law), namely the system for UK securities (the CREST UK system) and the one for Irish securities (the CREST Irish system), provide the best such example.

In the UK and Ireland it is a legislative instrument (and not a contractual instrument) that primarily supports the "execution" of securities transfer orders in relation to securities constituted under UK law and Irish law respectively - and the law that is applicable to those legislative instruments is properly considered to be the law governing the respective systems, rather than the law governing the contractual rules to which the members of the system are subject in their relationship with the operator.[1]

[1] There are in fact two different legislative regimes that govern the validity and effectiveness of securities transfer orders that enter CREST depending upon whether the securities, which are the subject of the order, are UK securities or Irish securities. The UK Uncertificated Securities Regulations 2001 (as amended) give effect to dematerialised instructions that enter CREST as they affect UK securities; whereas the Irish Companies Act 1990, Uncertificated Securities Regulations 1996 (as amended) give effect to such instructions that enter CREST as they affect Irish securities.

As these enactments are the primary legal instruments that govern the execution of securities transfer orders in CREST, then in fact two different systems are operating - one UK designated system (under the UK USRs) and one Irish system (under the Irish USRs).

In other words, in the CREST Irish system, as a direct-holding system for, *e.g.,* corporate shares, only Irish law can give validity and effect to an electronic transfer order instructing a transfer of Irish shares (*i.e.*, shares in an Irish company); and, in relation to English shares, only English law can do this - hence the respective designations, under the relevant EU regime, in Ireland and the UK for the CREST Irish system and the CREST UK system.

This is so even though (a) the "technical" system (core processor) for both the CREST Irish system and the CREST UK system is the same single system; and (b) the contractual rules of the two systems are governed by English law (*i.e.,* the contracts between Euroclear UK & Ireland Limited and the members that govern their relationship in respect of the system's operation).[2]

Similar situations might be more frequent in the future, especially in areas where the cross-border integration of financial markets is more advanced. Mergers between operators of various systems coupled with the development of appropriate supervisory and oversight arrangements may lead to the operation of a number of systems by the same operator in a single location.

B. Question for Consideration by the Working Group

The issue that needs to be addressed in that context is which State will be entrusted with the power to notify such systems in the context of the UNIDROIT Convention.

It is submitted that the State to do it should be the State whose law determines the validity, enforceability and binding effect of a transfer order and not the State where the operator is located and whose law may, or may not, govern the contractual relations between the operator and the participants in the system. In other words, notification should be effected by the State whose law gives effect to instructions to dispose of securities credited to a securities account maintained in the system.

As a result, where one entity operates two (or more) systems governed by different laws as explained above, each system should be notified by the State whose law gives effect to instructions to dispose of securities credited to a securities account maintained in the system. In the example discussed in the previous section, the UK will notify the system in relation to the securities settled under English law and Ireland the system settling the securities under Irish law.

The reason for this seems obvious. It is this law which will determine the content of the rules of the SSS which may be affected by the UNIDROIT convention and need therefore to take precedence over those of the Convention.

This approach also appropriately reflects the situation of international securities settlement systems for Eurobonds and similar securities. Although these systems settle securities which are issued by issuers of different jurisdictions, the validity, enforceability and binding effect of transfer orders in those systems in relation to such securities is determined by one law – as the governing law of the system. It will be the Contracting State whose law gives that effect that will notify this system.

The Working Group agrees with this policy approach, thus the next question is how best to reflect this in the text of the draft Convention.

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[2] It is also possible to hold international securities through CREST. However, in such cases, a separate "depository interest" is constituted under English law (or, in principle, Irish law) and is held in the system. It is this depository interest, and not the underlying international security, which is transferred through the system in response to a transfer order. Accordingly, the UK USRs will govern the validity, enforceability and legal effect of transfer orders relating to English law depository interests held in CREST, and the Irish USRs will govern such issues in relation to Irish law depository interests. This is the case irrespective of the governing law of the underlying security to which the particular depository interest relates.

At the May 2007 meeting of the Committee of Governmental Experts the EU observers felt that the current wording of point (iii) of the definition, and more specifically the use of the words *"the Contracting State the law of which governs the rules of the system,"* might not address the issue in the most effective way. In essence, it felt that the use of the words ***"the rules of"*** the system in order to qualify the Contracting State in question might be confusing to the extent that they might imply, or be interpreted as, also including membership rules. A better solution would be for the definition to refer to the law that "governs the system," if it can be made clear through text or commentary that the law in question is the law that gives effect to instructions to dispose of securities credited to a securities account maintained in the system.[3]

The group did not take a position on the drafting aspects of this issue. It considers that this should be left open to be decided by the plenary with the help of the Drafting Committee.

II. The Second Issue - Whether the Rules of Central Securities Depositories Should be Given Recognition by the Convention

The uniform rules of an SSS and an SCS are given recognition under various provisions of the current draft Convention. Specifically, the rules of an SSS are given effect by Article 7 (Withdrawal of intermediated securities), Article 13 (Invalidity and reversal), Article 14 (Acquisition by an innocent person of intermediated securities), Article 20 (Instructions to the intermediary), Article 21 (Holding or availability of sufficient securities), Article 23 (Loss sharing in case of insolvency of the intermediary), Article 24 (Effect of debits, credits, etc. and instructions on insolvency of operator or participant in SSS), and Article 25 (Obligations and liability of intermediaries). The rules of an SCS are given effect by Article 24. These articles of the Convention also defer to non-Convention law ("NCL") and where permitted by NCL, an account agreement. In the cases where the CSD's rules are part of an account agreement, the rules will be given effect by those provisions of the Convention. However, in some systems there is no account agreement between the CSD and its participants. In some systems, the rules may be given effect directly in the NCL, but more commonly the NCL authorizes the CSD to issue binding rules.

The Working Group on Transparent Systems raised the question of whether the rules of CSDs should be recognized under the Convention in its paper presented during the May 2007 meeting of the Committee of Governmental Experts (Document 88). The Committee of Governmental Experts discussed whether the draft Convention should extend similar recognition to the rules of CSDs. Some participants were strongly of the opinion that the rules of a CSD should be recognized in the Convention; the delegation from Brazil, for example, submitted a working paper to this effect which is part of the Report on the May 2007 meeting (Doc 95, Appendix 5). The plenary came to no resolution on this question and simply recommended the formation of this Working Group to conduct post-sessional work on the question.

A. Current Treatment of CSDs in the Draft Convention

The CSD is an "intermediary" under the Convention when acting as such, that is, when maintaining securities accounts for others as part of a course of business or other regular activity (Article 1(d)). In accordance with Article 5, the functions of a CSD acting as intermediary can be performed by one or more persons. However, the CSD may have some functions that are not within the scope of the Convention (Article 4). The activities of creation, recording or reconciliation of securities *vis-à-vis* the issuer are not covered by the Convention.

[3] If this position is adopted by the plenary, a conforming change should be made to the definition of SCS as well.

It is commonly understood that CSDs perform significant functions in settlement or clearing and settlement. Settlement typically takes place within the system on the books of the CSD by crediting and debiting participant accounts. The CSD may be the operator of the SSS or be a unit or entity within the SSS. As a result some commentators believe that the CSD is already included in the definition of the "securities settlement system" (the term "system" is not further defined). In the view of those commentators, a Contracting State will make a declaration in accordance with Article 1(o) designating the CSD as an SSS on the grounds of systemic stability leading to the following result: where the Convention refers to SSS rules, the uniform rules of that designated CSD will be recognized where they are relevant to the matters governed by a particular Article of the Convention.

Some also believe that it is inconsistent with the functional approach to refer specifically to a type of entity, a CSD, in the Convention and that therefore the issue of CSD rules should be dealt within the framework of SSS rules.

Other commentators have expressed the concern that judges and other experts reading the Convention might narrowly construe the term "uniform rules" of the SSS and securities clearing system ("SCS") to include only the SSS and SCS rules that strictly speaking relate to the activity of clearance and settlement because those are the only activities by which the SSS and SCS are defined. The definition of SSS is a "system which…settles, or clears and settles securities transactions…". The definition of SCS is a "system which…clears but does not settle securities transactions…". The further concern is that by a narrow construction, CSD rules that relate to activities other than settlement, in fact the very activities that are explicitly covered by the Articles of the Convention that currently refer to SSS or SCS rules, would be unintentionally excluded. These include rules related to for example: withdrawal of intermediated securities (Article 7), rules relating to validity of debits and credits, whether such debits and credits can be reversed and the effects of such a reversal (Article 13 and 14) and other rules relating to instructions, sufficient securities, loss sharing, irrevocability of instructions, and liability (Articles 20, 21, 23, 24, and 25). All of these articles refer to activities that are broader than clearance and settlement and relate more closely to the depositary functions of the CSD and the integrity of debits and credits. These CSD rules may determine the finality of credits and debits, and hence may need to be taken into account in determining the duties of an intermediary in case of a shortfall or insolvency.

B. CSD Role and Functions/ Overlap with SSS and SCS Functions

In order to more fully explore CSD functions and the relationship and overlap of those functions with the functions of the SSS and SCS, the Working Group received very helpful working papers from the experts in Brazil, Finland, South Africa, and the Czech Republic.[4] These papers are attached as **Appendices B-E** respectively to this Working Group Report.

[4] Reference can also be made to various descriptions of CSD functions in public sector and private sector reports. The ECB in its Blue Book defines a CSD as "*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 the safekeeping and administration of securities, a CSD may incorporate clearing and settlement functions.*"

IOSCO in its "Recommendations for Securities Settlement Systems" defines the CSD as "[a]*n institution for holding securities that enables securities transactions to be processed by means of book entries. Physical securities may be immobilised by the depository or securities may be dematerialised (so that they exist only as electronic records)*."

The G-30 defines a CSD as *"a facility (or an institution) for holding securities, which enables securities transactions to be processed by book entry. Physical securities may be immobilized by the depository or securities may be dematerialized (that is so that they exist only as electronic records). In addition to safekeeping, a [csd] may incorporate comparison, clearing and settlement functions."*

1. Brazil

In Brazil, the main function of the CSD is to immobilize and/or to dematerialize securities, by keeping accounts of securities holdings in book-entry form. While the SSS is the party responsible for assuring delivery versus payment, by collecting information about net positions from the SCS and giving instructions to ensure proper settlement, the CSD is actually the entity responsible for effecting debits and credits in the securities accounts that it holds for participants. All entities operating a CSD also operate an SSS and are licensed by governmental authority. CSD rules are approved by the securities commission; SSS rules are approved by the central bank. In the case of public bonds, the CSD and SSS rules are approved by the central bank. Brazilian national law thus distinguishes between entities that serve as SSSs and CSDs, although recognition of the rules of both is important to the functioning of their system.

More broadly the CSD performs activities to effect security interests and attachments and to effect different types of securities transactions between participants by debit and credit (beyond settlement).

In furtherance of those activities, the Brazilian CSD issues rules directed to its relationship with its participants on:

- Securities eligibility and account maintenance;
- Book entry transfer (debits and credits);
- Operational rules—instructions, authorizations;
- Means to effect pledges and attachments (by transfer and designating entry) and corporate actions;
- Errors and liability.

These rules relate to the issues governed by Articles 7, 13, 14, 20, 21, 23, 24, and 25. As a consequence, Brazil believes the Convention should refer to CSD rules where the Convention refers to the SSS rules in order to ensure clarity in application of the Convention.

2. Finland

In Finland, the CSD operates the SSS and acts as the relevant intermediary (both functions require a license). Finnish law clearly specifies separate legislative rules and license requirements for the two functions. In Finland the rules on settlement are part of the CSD rulebook.

Due to its central role, the legislation authorizes the CSD to issue rules on settlement and other matters covered by the Convention (most of which deal with account maintenance and entries made to securities accounts) which are important for ensuring the finality of debits and credits. In some systems CSD rules may be part of an account agreement but not in Finland where there is no such agreement with the CSD and the account holder being the final investor. The account holder has an agreement with the account operator but the CSD rules are not part of this agreement either. The rules address matters covered in Articles 7, 8, 13, 20, 21, 23, and 25 of the Convention including:

- Securities account maintenance;
- Authority and procedures for making entries;
- Actions of the account operator;
- Errors and liability;
- Exercise of rights by the holder and corporate actions.

Finland believes the Convention should clarify the status of CSD rules where the Convention refers to SSS rules in order to ensure clarity of application of the Convention. One way this could be done is to explicitly include a reference to CSD rules in the Convention but the representatives of Finland are flexible on the means by which any ambiguity is clarified.[5]

3. South Africa and Czech Republic

The CSD in South Africa is a "self regulatory organization" engaged in custody, administration of accounts, and clearing and settlement. It is empowered to issue rules on its authorized activities including custody, administration, clearing and settlement and other matters. Various aspects of the rules (*i.e.* those related to listed shares and those related to dematerialized securities) are governed by different statutes and the CSD rules are different from those of the "system operator" (the exchange or clearing house). In the Czech Republic, the CSD is in formation and is intended to be similar to the system in Finland. South Africa and the Czech Republic believe that the CSD rules should be included.

C. Options for Clarification of the Position of CSD Rules

There is the possibility of a misconstruction of the Convention in the area of CSD rules which would be a very undesirable outcome. Therefore, the Working Group believes that it is useful to reduce ambiguity on the position of CSD rules under the Convention. This would ensure clarity of application and serve a principal objective of the Convention which is internal soundness. The Working Group believes that this issue is not necessarily confined to transparent systems. There are several options that could be considered to achieve this result.

Option 1. Clarify the Issue in the Official Commentary to the Convention

This option preserves the text as it currently stands and provides a great deal of flexibility which is certainly an advantage. The Commentary can describe the wide variety of roles that the CSD performs in different jurisdictions. It can state that the reference to "securities settlement system" and "securities clearing system" encompasses a variety of institutional arrangements for clearance and settlement that may include central security depository functions of holding, dematerializing, and immobilizing securities and processing securities transactions by book entry. It can further state that uniform rules of CSDs are included where reference is made to SSS and SCS rules in the Convention, provided a Contracting State has designated the CSD as an SSS or has designated the SSS or SCS of which the CSD is a part in accordance with Article 1(o) of the Convention. The disadvantage of this option is that in some jurisdictions commentary may not be considered or referred to by judges as authoritative sources of interpretation.

Option 2. Amend the Convention Text to Refer Explicitly to CSD Rules

Under this option, each article that refers to SSS or SCS rules would be amended to refer explicitly to uniform CSD rules. This leaves no ambiguity about the position of CSD rules under the Convention which is an advantage. However, it does raise the question as to whether the Convention would need to explicitly define CSD.

As noted above the Convention refers to CSD in Article 1(d) and Article 4. CSD is not currently defined. One might reach the conclusion that it is not necessary to define CSD even if the reference to CSD rules is made explicit in the text. However, that would be a result at odds with the

[5] The Finnish paper also recommends that Contracting States consider whether the Convention should recognize the rules of CSDs in several provisions that do not recognize the rules of SSSs such as Article 7(1) and Article 8. Upon consideration, however, the Working Group decided that this was unnecessary.

approach taken with respect to the definition of SSS and SCS, an important part of which is the requirement of governmental oversight and designation by the Contracting State. Nonetheless, given the diversity of CSD functions, the fact that CSDs are intermediaries under the Convention when acting as such, and the fact that some CSD functions are excluded, it may be challenging to create a definition that will be broad enough yet have sufficient specificity and could invite further confusion.

One approach might be to adopt a definition that parallels, for the most part, the definitions of SSSs and SCSs. In the current draft, these definitions consist of a first clause that functionally describes the entity, followed by the two "gatekeeper" clauses that act to ensure that only appropriate entities are given recognition – first, ensuring that these entities are either central banks or are supervised by a governmental authority, and second, ensuring that these entities have been declared as an appropriate entity by a Contracting State. As far as a functional description for the first part of the definition, this Working Group would defer to the Drafting Committee, but the definition might usefully make reference to the role that CSDs play in immobilizing, dematerializing, and holding securities in book-entry form. It is important to emphasize that this should not affect the exclusion of certain CSD functions from the Convention by Article 4.

Option 3. Amend the Definition of SSS and SCS

A third option is to expand the first prong of the definition of SSS and SCS to include functions that are performed by CSDs, in particular those functions related to its depository activities. This would address the concern that the limited reference to "settles, or clears and settles" in the definition of SSS and "clears but does not settle" in the SCS definition does not mean that rules that relate to other functions and activities of a clearance or settlement system are not intended to be included. While under this option there would be no explicit reference to the CSD as an entity as in the case of Option 2, it would not be necessary because the Convention explicitly uses the word "system" and it could further be explained that clearance and settlement is performed by a variety of institutional arrangements (Appendix 8, Document 58, Report of November 2006 meeting). Thus, it is important to emphasize that Option 3 is not exclusive of Option 1. Option 3 can be supplemented by explicit commentary on the role of CSDs as is recommended above in Option 1.

APPENDIX A

Working Group on Securities Clearing and Settlement Systems, including Rules of CSD's

Groupe de travail sur les systèmes de compensation et de règlement-livraison, y compris les règles des DCT

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APPENDIX B

Recognition of CSD rules

Comments by the Federative Republic of Brazil

I. GENERAL COMMENTS

Although all the Brazilian entities currently operating a CSD do also operate settlement systems, each activity requires a specific license. Also, the rules issued by such entities regarding each function are clearly different, and are subject to the approval of the competent governmental regulatory body. For example, in the case of equities, CSD rules need to be approved by the Brazilian Securities Commission and SSS rules need to be approved by the Brazilian Central Bank. More than that, the same entity needs an authorization to function as a CSD and another one to operate as a settlement system. In the case of public bonds, both CSD and SSS rules are approved by the Central Bank.

The CSD rules which have more relation with the provisions of the draft Convention are those directed to the CSD Participants, which are the relevant intermediaries that have a direct legal relationship with the account holders. These rules basically relate to:

- Securities eligibility
- Book entry transfer of securities (debits, credits)
- Statements on holdings
- Account maintenance
- Corporate actions
- Pledges and attachments
- Operational rules on entries (methods, timetables, authorizations, instructions, errors)
- Liabilities

Consequently, we understand that the reference to be made to the CSD rules would apply in the following provisions of the draft Convention:

- Article 7.1 (intermediated securities)
- Article 13.2 (invalidity and reversal)
- Article 14 (innocent acquisition)
- Article 20 (instructions to the intermediary)
- Article 21 (sufficient securities)
- Article 23 (loss allocation)
- Article 24 (insolvency)
- Article 25 (obligations and liability of intermediaries)

II. BACKGROUND: THE ROLE OF A CENTRAL SECURITIES DEPOSITORY (CSD)

Although many institutions are organized to render depository services together with clearing and settlement services, the activities related to the depository business are quite discernible from those developed by a Securities Settlement System (SSS) and a Securities Clearing System (SCS).

For the sake of evolving the Working Group's (WG) understanding about the need for including the CSDs in the exceptions made in the UNIDROIT Convention, this contribution will try to isolate the CSD role in relation to some different processes.

1. The role of the CSD

One definition of CSD is that the CSD is an institution for holding securities that enables securities transactions to be processed in terms of book-entry[6].

The main functions of CSDs are identified as immobilizing or dematerializing securities, thereby assuring that the bulk of securities transactions are processed in book-entry form. CSDs are responsible for keeping securities deposited for its participants, and transfer those securities through book-entry registries. The most important feature of the book-entry method is that a transfer of a given quantity of an issue from one account to another can be affected by a simple debit or credit on the books of the CSD[7].

The CSD role is then to serve the participants with a system that allows the book-entry debits and credits of securities to securities accounts. These transfers are not always related to the settlement of transactions or instructed by the participants of the SSS or the CSD itself. Settlement of transactions is certainly the most important motivation for book-entry transfers of securities among CSDs' securities accounts but it is not the only one. Securities can be transferred within the CSD for different reasons such as:

1) collateral posting (including the grant of collateral securities outside organized trading systems),

2) attachments,

3) inheritance and donation (or grant) of securities, among others,

4) settlement of private transactions.

In all cases, we are referring to situations involving intermediated securities which should be treated in accordance with rules of the CSD which, for the purposes of the UNIDROIT Convention, need to be recognized and be exempted as the SSS or SCS rules.

The functions of a CSD related to corporate actions evidences even better the uniqueness of the CSD associated with the securities kept under its deposit. However, it was agreed by the WG that corporate actions, are considered to be outside the scope of the Convention.

2. The role of the CSD in the settlement process

Regarding the settlement process, in order to individualize the role of the CSD, it is important to discuss the role of the SCS and the SSS.

Usually, the SCS exists when the settlement of the transactions is guaranteed by a central counterparty. From a functional perspective, the SCS is responsible for the novation of the original transactions by substituting the contracts between original counterparties by contracts between each counterparty and the SCS, the central counterparty.

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6 CPSS-IOSCO Recommendations for Securities and Settlement Systems (2001).
7 G-30 Recommendations (1989, 2004).

Also, the SCS nets the transactions either on a bilateral or multilateral basis and guarantees to the SSS that in case a participant fails to pay, the SCS has the adequate risk management mechanisms in place in order to assure the continuity of settlement without any disruptions. These risk management mechanisms normally involve collateral deposited by the SCS's participants and a Clearing Fund composed of participants' contributions. The collateral deposited by each participant is calculated by the SCS and is proportional to the participants' portfolio risk.

> *The SCS does not instruct or affect any securities and cash movements in order to settle the transactions.*

The SSS receives information from the SCS regarding the net obligations of each participant to deliver or pay. From a functional perspective, the SSS's main responsibility is to assure the DVP (Delivery versus Payment). For this purpose, the SSS will instruct its participants:

- to deliver cash to the SSS's cash account at the settlement bank or, preferably, at the central bank, and
- to deliver securities to the SSS's securities account at the CSD.

Both SSS's cash and securities accounts are transitory and have the only purpose of serving the settlement. Once the SSS receives confirmation:

- from the bank/central bank (payment system) that the cash was credited and
- from the CSD that the securities were transferred,

the SSS will instruct the CSD and the bank/central bank (payment system) to debit simultaneously the SSS's transitory settlement accounts in securities and cash respectively and credit the securities accounts of the participants that are net creditors in securities as well as the cash accounts of participants that are net creditors in cash. At this point, the SSS coordinates the delivery versus payment.

In relation to settlement, the CSD is responsible for effecting the debits and credits in securities accounts according to the instructions received either from the CSD's participants involved in the settlement as well as from the SSS who is coordinating the delivery of securities against payment.[8]

Clearly, the functions of the SCS, the SSS and the CSD are very correlated and dependable on each other. However, as each one of these entities plays a specific role (with different activities, purposes and scope) it seems that there is no functional overlap and that it is possible to identify the specific responsibilities involved in each activity.

As an example to better understand this segregation of roles, we can mention guaranteed settlement of government bonds in the Brazilian market. BM&F plays the role of trading environment, SCS and SSS for those transactions. As a SSS, BM&F instructs participants to deliver cash in BM&F's cash account at the Brazilian Central Bank's payment system and to deliver securities in BM&F's securities account at the SELIC[9]. Once the Brazilian payment system confirms to BM&F the credit of funds and the SELIC confirms the delivery of securities, BM&F confirms to the participants the delivery versus payment and the finality of settlement. BM&F is the SSS with no doubt and such a fact is legally recognized both by the Central Bank and the Securities Commission. However, the CSD is the SELIC and this fact is also legally recognized.

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[8] One example of CSD rules that could be considered are the ones that establish in which manner these instructions are to be given and processed.

[9] SELIC is the Brazilian CSD for Government bonds, managed by the Brazilian Central Bank.

Similarly, as far as we understand, FICC plays the role of SCS and SSS for government bonds in the US market and its participants should effect payment through the Fedwire and instruct the securities delivery within the Fed. Once FICC knows that both movements were completed, FICC informs the DVP and the finality of settlement to the participants. The SSS is the FICC and not the Fed but the CSD for government bonds in the US is the Fed.

In other countries the interaction between private market institutions and central banks as central depositories for government bonds should reproduce the dynamics described above. One idea could be to better understand and analyze those cases.

3. The role of the CSD regarding security interests and posting of collaterals

Securities interests can be granted by participants according to the SCS's needs as a central counterparty. However, our understanding is that the rules governing securities interests regarding securities that are deposited at a CSD are defined by the CSD itself.

One example relates to eligible securities. Although the SCS defines the eligible securities from a risk management perspective, securities interests are also subject to the eligibility criteria defined by the CSD. A SCS can accept letters of credit as a guarantee which is not an eligible security from the CSD perspective.

Another example is that some CSDs monitor securities approaching maturity and request substitution. This is typically a CSD rule and a SCS's participant burden.

4. The role of the CSD regarding securities attachments

In the Brazilian securities holding system, the CSDs are also responsible for effecting the attachments to securities deposited in attendance of the judicial or administrative authorities' orders. The responsibility for the attachment made as well as for keeping the attached securities segregated from the other non-attached securities belongs to the CSD.

The rules of the CSD are the ones defining how the attachment is actually accomplished, if the attached securities are book-entry transferred to a different securities account, if they are kept in the same securities account with an earmark or otherwise. This derives directly from the CSD safekeeping function.

5. Other situations

The rules of CSD also apply in situations that are not necessarily related to settlement of transactions held in organized markets, such as the following:

- transfer of securities as a result of inheritance and novations
- settlement of private transactions, in accordance with instructions received by a CSD participant,

which are both situations in which the participation of the CSD is not as the one performed by an intermediary but instead reflects its role as the top tier of the respective intermediated chain.

APPENDIX C

Recognition of the CSD rules

Comments by Finland

1. GENERAL COMMENTS

In the report by the Working Group on Transparent Systems, a question was raised whether or not the rules of the central securities depository ("CSD") should be recognised in the draft Convention, in the same way as the rules of the settlement systems, to determine certain questions if permitted by the non-Convention law. It was noted that the CSD, when acting as an operator of a settlement system, can benefit from the specific rules of the draft Convention regarding the rules of a settlement system. Nevertheless, the Working Group called attention to the question of whether there is a distinct need for recognising the role of the CSD rules which could be applied even though an entry is not made within a settlement process. This question was considered to be relevant at least in those provisions of the draft Convention where a reference to the rules of a settlement system is made.

In our view it is first of all important to clarify the question in which situations the CSD can benefit from the rules of the settlement system taking into account that in practice many CSDs operate a settlement system. If the CSD could use the rules of the settlement system only when acting as such a system, a separation of the function of a settlement system and the function of a CSD should be made. This is not necessarily easy and may make the application of the future Convention more difficult.

We would also like to point out that most provisions of the draft Convention deal with securities accounts, entries made to such accounts and intermediaries maintaining them. It is recognised in the draft Convention that the CSD can carry out account maintenance activities and act as the relevant intermediary (Article 1.d). Such activities of the CSD are not excluded from the scope of the draft Convention by Article 4. Due to the central role of the CSD in many holding systems, legislation may permit the CSD to issue rules on certain matters. Such rules might deal with questions that are not related to settlement but to account maintenance (as well as corporate actions). If the CSD had issued rules that come into the scope of the draft Convention, it would, in our view, seem quite logical to recognise their relevance in the draft Convention, where necessary.

2. SITUATION IN FINLAND

In Finland, the CSD acts as a CSD, but also operates a settlement system. There are separate legislative rules for the functions of the CSD and of the operator of the settlement system. Both functions require a license, which could, in theory, be granted independently of each other.

Moreover, for both functions, there are legislative provisions that allow rules to be issued on certain matters by the CSD/the settlement system. So even though many matters are legislated, the law recognises the need for more detailed practicable and technical system-specific rules. In Finland the rules of the settlement system are part of the CSD rules. Despite the fact that the same entity is fulfilling the CSD and the settlement system functions and the fact that the rules are contained in the same rulebook, those functions are from the legal perspective different.

> In practice, it may, however, be difficult to differentiate between the functions of a CSD and a settlement system in the Finnish settlement framework. The settlement of securities takes place on real time directly between seller's and buyer's securities accounts with the CSD.

It might be that the question on the CSD rules is more relevant in transparent systems due to the central role of the CSD in the maintenance of securities accounts. In the Finnish holding system all domestic investors shall have investor specific accounts at the CSD level. Because of the great number of such accounts, it is crucial that the CSD can rely on account operators who make the actual entries to securities accounts in accordance with the instructions by the account holder. As to the definitions of the draft Convention, the CSD would be regarded as the relevant intermediary, although the maintenance of securities accounts is shared with account operators. Account operators, which are licensed by the CSD, are bound by the CSD rules.

> In the Working Group, it has been argued that the rules of the CSD could benefit from the references to account agreements in the draft Convention because they will normally form an integral part of the account agreements with the CSD and its account holders. This may be generally true for non-transparent systems. Unfortunately, this argument does not work in the Finnish situation because there is no account agreement with the CSD acting in that capacity and the investor as regards the investor specific account with the CSD. The investor has an agreement with the account operator, and the CSD rules are not part of this agreement.

Considering those provisions of the draft Convention where a reference to the rules of a settlement system is currently made, we note that many of them would benefit from the reference to the CSD rules from the account maintenance point of view. The Finnish CSD has issued rules on the centralized book-entry system (e.g. securities accounts, operations of the account operator and its agent) and on common practices in making entries to securities accounts (e.g. what information is registered in the account, the procedure to make entries and who is entitled to make entries in different situations). In addition, rules have been issued on correcting errors and discrepancies as well as on liability and the tasks of the account operator vis-à-vis the CSD. On the basis of these rules, the reference to the rules of the CSD would be beneficial at least in 13.2 (invalidity and reversal), 20 (instructions to the intermediary) and 25 (obligations and liability) of the draft Convention.

Moreover, it should be taken into account that the implementation of the future Convention might require legislative changes and modifications at national level. Also the CSD might need to adapt current rules or issue new ones. Considering the provisions of the draft Convention from this perspective, we would see references to the CSD rules beneficial also at least in Articles 21 (sufficient securities) and 23 (loss sharing) where a reference to the SSS rules already exist.

Finally, we think it should be considered whether there are other provisions in the draft Convention where a reference to the CSD rules would be beneficial even though no reference to the rules of the settlement system is made. As explained above, the tasks of the intermediary in the Finnish holding system are shared between the CSD and the account operator. Although the legislation stipulates the tasks of the CSD and the account operator, the CSD has issued more detailed rules. We think the relevance of these rules with respect to new Article 5 that recognises the performance of functions of the intermediary by other persons would merit of discussion (i.e. whether the reference to the non-Convention law in Article 5 is sufficient). Likewise, the CSD has issued rules on enabling the account holders to exercise their rights (for example the payment process of dividends and on performance of corporate actions) which deal with the issues covered by Articles 7 (intermediated securities) and 8 (measures to enable account holders to receive and exercise rights). The relevance of the CSD rules in these provisions could also be discussed.

APPENDIX D

Comments from South Africa

SHOULD THE RULES OF THE CSD BE EXPRESSLY INCLUDED?

1. I am of the view that the CSD rules must be included.

2. The "system operator" in South Africa may be the exchange itself or a clearing house appointed by the exchange in terms of the applicable legislation (s 11(e) of the *Securities Services Act, 2005*). In terms of the Act (s 18), the Exchange Rules must provide for the manner in which transactions in listed securities must be cleared and settled. These rules of the exchange are not the same as the rules of the CSD on settlement and clearing as it deals with different aspects thereof. Both exchanges in South Africa (JSE Limited and BESA), have very technical and detailed contracts with the CSD, Strate Ltd, to perform these functions.

3. Also, Strate Ltd is the only CSD in South Africa and licensed with a central securities depository license by the Financial Services Board in terms of the *Securities Services Act* (s 32). The licence specifies the "securities services" that may be provided by the CSD, including the functions of custody and administration of securities, the clearing of transactions in listed securities and the settlement of transactions in listed securities. There is a specific definition of "securities services" in the *Securities Services Act* referring to these functions.

4. Strate, the CSD, is a "self-regulatory organization" in terms of the *Securities Services Act* and is also "regulated" by the Financial Services Board as the "super-regulator".

5. The CSD must have depository rules (published in a *Government Gazette)* on certain matters and it must also enforce them as stipulated by the *Securities Services Act.* These CSD rules include provisions on clearing and settlement, but also deal with additional matters.

6. The *Companies Act, 61 of 1973* deals with uncertificated securities (such as dematerialized shares) and specifically the transfer of securities, the issue of evidence, inspection of register, the sending of statements, the account maintenance and operations, the sending of authenticated messages or instructions to transfer, pledge, etc., the re-materialization of securities, the protection of the bona fide purchaser, the liabilities of participants, etc. The *Companies Act* refers specifically to the **rules of a CSD** (see s 91A)**.**

7. It is submitted that the Convention addresses many issues that fall in the scope of the South African CSD rules, as opposed to the pure domain of the SSS. Currently, as indicated in paragraph 1 above, the CSD acts as the CSD and also operates the settlement system. However, this may not necessarily always be the case. In South Africa the rules of the settlement system are part of the CSD rules. Despite the fact that the same entity is fulfilling the CSD function and the settlement function, a distinction may be made from a legal point of view.

8. In conclusion, it is submitted that in line with the functional approach, the reference in the Convention to the SSS rules must be amended to specifically include the CSD rules. This will ensure the necessary legal certainty.

APPENDIX E

Recognition of the CSD rules

Comments by the Czech Republic

First of all we would like to clarify the situation in the Czech Republic that makes our contribution a bit theoretical. The new Act No. 256/2004 Coll. on Business Activities on the Capital Market (also referred to as Capital Market Undertakings Act) adopted in April 2004 governs a formation of the Central Securities Depository which will in the future take over the activities of the Prague Securities Centre. Until the new Central Securities Depository is established, the Prague Securities Centre will continue in its activity in accordance with the already repealed part of the existing Securities Act (as amended by 30 April 2004). Unfortunately the process of establishing a new CSD seems to be endless. For this reason there are no CDS rules in place that we could examine.

According to the law the holding scheme of dematerialized securities, once the Central Securities Depositary obtains its licence, shall be organised closest to the described Finnish system, with the main exception, that omnibus accounts shall be kept also for securities owned by domestic, not only foreign investors. So everything as regards describing the system that was said in the Finnish contribution is valid as well for our future system, i.e. the legal recognition of the CSD as the SSS and provisions for both the CSD rules and SSS rules.

Especially, the Czech securities evidential system will be based on a relationship between the CSD and its participants, who will act as account operators, and on an agreement between account holders and the CSD participants. There will be no contractual relationship between the account holder and the CSD, unless the account holder will be a participant of the CSD. The investor will have an agreement with the account operator, and the CSD rules will not be a part of this agreement.

We consider the reference to the rules of the CSD to be useful in the case of correcting errors and discrepancies in general. We think that these references would be beneficial in the Article 13.2 (invalidity and reversal), 14.5 (Acquisition by an innocent person of intermediated securities), 20 (instructions to the intermediary) and 25 (obligations and liability) of the draft Convention.

– END –