TARGET2-SECURITIES

LEGAL FEASIBILITY

1. Introduction
On 6 July 2006 the Governing Council of the European Central Bank (ECB) decided to explore further the setting up of a new service for securities settlement in the euro area, known as TARGET2-Securities (T2S), stating that the project should fulfil the following three principles:

- It should provide settlement for securities transactions in central bank money;
- It should be fully owned and operated by the Eurosystem; and
- It should be an integrated platform providing delivery versus payment (DvP).

To fulfil the Governing Council’s mandate, a feasibility study has been conducted. This chapter summarises the outcome of the legal assessment as performed by the Eurosystem through its Legal Committee. It should be noted, however, that this legal assessment is without prejudice to the additional legal work that would be required following approval of the T2S project by the Governing Council.

2. Legal basis
T2S follows a strictly technical approach, given that it is a tool for the provision of certain securities settlement services to the central securities depositories (CSDs) for the benefit of their participants. The technical approach for T2S resembles the one chosen for TARGET2: T2S is envisaged to be a purely technical platform providing harmonised IT facilities to CSDs for the settlement of securities transactions in central bank money. Hence, it is not the Eurosystem’s intention to create a new securities settlement system. For this technical platform to work effectively, database functionality will be needed. This will be limited to the basic function of compiling and electronically storing accounts-related data in a common technical location. The respective securities accounts will remain legally attributed to the CSDs.

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1 For the purposes of this legal assessment, a “CSD” is understood to be a securities settlement system within the meaning of Article 2(a) of the Settlement Finality Directive, established by national legislation or by the agreement of market participants in order to perform securities settlement functions at a national or international level, and which has been designated as such by the competent authorities of Member States.
The assessment of the legal basis for establishing T2S has taken full account of the Treaty\(^2\) and the Statute\(^3\), which set out exhaustively the provisions under which the Eurosystem may take action to fulfil its tasks. Since T2S adheres to a strictly technical approach which closely resembles the one chosen for TARGET2, Articles 17, 18 and 22 of the Statute were considered as a potential legal basis for establishing and operating T2S, since they constitute, together with Article 3.1 of the Statute, the legal basis for establishing and operating TARGET2. The assessment of the legal basis for T2S has been made on the assumption that no new securities settlement system or legal entity will be set up.

In particular, Article 17 allows the ECB and the national central banks (NCBs) to open accounts for “credit institutions, public entities and other market participants and [...] accept assets, including book-entry securities”, “in order to conduct their [ECB and NCB] operations”. Article 18 additionally provides the European System of Central Banks (ESCB) with the competence to set the conditions under which it is willing to carry out its monetary policy operations and payment transactions, in particular collateralised credit operations. Finally, Article 22 permits the ECB and the NCBs to “provide facilities [...] to ensure efficient and sound clearing and payment systems within the Community and with other countries”.

T2S will offer DvP model 1 settlement, i.e. settlement in real time of the cash leg of a securities transaction in central bank money alongside simultaneous settlement of the securities leg. Through its interconnection with TARGET2, T2S will provide DvP model 1 settlement for the connected CSDs, irrespective of (i) where the security is issued or (ii) with which CSD the participants involved in a transaction have entered into an account arrangement, by offering a real-time DvP linkage between the securities leg settled on securities accounts held by participants with their CSDs, and the settlement of the corresponding cash leg made on Eurosystem cash accounts attributed to TARGET2. Thus, T2S is conceived as a feature that supplements the operation of TARGET2.

In creating the final parameters of the legal and operational set-up of T2S, particular care should be paid to the interrelation with TARGET2-Cash. Furthermore, the Eurosystem should ensure that T2S supports Eurosystem credit operations against collateral as part of the basic tasks of the Eurosystem, and facilitates DvP settlement in central bank money of securities transactions in close conjunction with the operation of TARGET2 in compliance with the Statute.

**Without prejudice of further legal work in this regard, and on the basis of the legal assessment, the Eurosystem is of the view that there is an adequate legal basis for the development and operation of the T2S project.**

The Eurosystem will take into account its obligation to act in accordance with the principle of free competition and an open market economy, as provided for in Article 2 of the Statute. The Eurosystem will duly ensure that conditions for access will neither be discriminatory nor abusive, will reflect the “public task” nature that the provision of central bank liquidity has, and will strive for cost-recovery and not to seek to make a profit. The Eurosystem is highly conscious of the fact that T2S should neither distort competition nor run counter to the proportionality

\(^2\) The Treaty establishing the European Community, as amended.

\(^3\) Statute of the European System of Central Banks and of the European Central Bank.
principle. These principles have to be complied with in the decision-making process for the setting up of T2S, for instance when deciding whether T2S will be the only technical means in which settlement in central bank money in euro is offered, or in which Eurosystem credit operations are undertaken.

3. The legal assessment of the T2S model

The contractual aspects of the account relationship between a CSD and its participants would continue to be governed by the contractual or other legal arrangements governing the account agreement/participation in the CSD, as T2S will not interfere in this relationship. For the purposes of the legal assessment of the model, a distinction is made between the two main components of T2S, namely the settlement engine and the securities accounts database.

The settlement engine is the basic building block that would support the processing of transfer orders placed by the CSDs and their authorised participants. This single technical platform would be operated and owned by the Eurosystem, and would provide a technical infrastructure to support the CSDs in performing all the tasks that are part of the full cycle of a settlement transaction (e.g. the receipt and verification of transfer instructions, system verification regarding available stocks and funds, queue management, optimisation mechanisms, debits and credits on securities accounts and settlement-related reporting, etc.). For their part, the CSDs would continue to provide services associated with the custody function as well as asset-servicing and added-value services. As part of the settlement process, the single technical platform will make entries in the database and arrange for the required cash transfer orders in TARGET2.

The securities accounts database would electronically compile and store data regarding securities accounts, i.e. the positions of account holders in respect of securities held in such securities accounts. Although from a technical viewpoint the database would be part of the T2S technical environment, from a legal perspective the CSDs would continue to maintain securities accounts for their participants, thus retaining legal responsibility for them regarding the entering, maintaining and cancelling of records on their respective participants’ accounts, as well as regarding the accuracy of the information processed.

The Eurosystem notes that neither the specific physical location of the technical infrastructure (consisting of the settlement engine and the securities accounts database) nor the fact that accounts data are to be processed in such a common technical database is a determining criterion when it comes to establishing the legal location of an account, given that CSDs will continue to maintain the securities accounts of their participants from a legal point of view. The common technical location of the technical infrastructure will therefore have no impact on determining which national law is applicable.

The Eurosystem has therefore concluded that there are no major legal obstacles to the technical establishment of a settlement engine or to the operating of securities accounts in a database infrastructure that is not necessarily located in the same jurisdiction as that of the

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4 The principle of proportionality refers to the requirement that any action taken does not go beyond what is strictly needed to achieve the objectives of the Treaty.

relevant CSD. The common technical location of the technical infrastructure (or parts of it) would therefore not affect this legal set-up.

The Eurosystem also noted that the contractual aspects of the account relationship between each CSD and its participants would continue to be governed by the contractual or other legal arrangements governing the account/their participation in the CSD, as T2S will not interfere with this relationship. The Eurosystem does not foresee any substantial impediments in respect of the database set-up, provided that the legal arrangements for the single technical infrastructure clearly specify the respective legal rights and obligations of CSDs and the Eurosystem members.

4. Settlement finality

Settlement finality refers to the legal protection of settlement activity against potential adverse effects, for example caused by revocation, insolvency or unwinding events. For the purpose of this legal assessment, it is also understood to encompass the transfer of proprietary rights in securities in an enforceable and irrevocable manner. Settlement finality is thus an important element of the legal soundness of T2S.

As a preliminary remark, a distinction has to be made between two distinct concepts that occur at different points in time:

- The finality of transfer orders, whereby transfer orders that are entered into a securities settlement system are protected from insolvency or unwinding risks; and
- The finality of transfer, whereby entitlement to securities is legally transferred to the receiving entity.

With respect to the finality of transfer orders, a similar approach to that of TARGET2 is envisaged. Domestic systems would be linked by a common technical infrastructure for the processing of transfer orders. The technical processing of transfer orders submitted by either the CSDs or their authorised customers will take place in the technical environment of T2S. From a legal perspective, however, transfer orders will be executed either between participants within a given CSD, or between two CSDs in accordance with the relevant CSD’s rules.

The Settlement Finality Directive (SFD)\(^6\), by way of implementation in the domestic laws of Member States, ensures the harmonised protection of transfer orders submitted to a system which has been designated by the competent national authorities. Transfer orders processed in T2S will therefore benefit from adequate protection at the domestic level of the CSDs, as they rely on the rules of the individual CSDs that are designated under the SFD.

With respect to the finality of transfer, securities accounts opened by CSDs for their participants will from a legal perspective continue to be maintained by the respective CSD. Hence, the key legal aspect is to ascertain the legally relevant location of such securities accounts. This legal

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location determines the law governing the proprietary rights in securities held on securities accounts, inclusive of the modalities of transfer of rights to securities.

Considering Article 9(2) of the SFD and the respective national conflict-of-laws rules, the Eurosystem holds the view that a securities account is legally located in the same country in which the CSD that has opened and is maintaining this securities account is established. Proprietary aspects determining the finality of transfers will thus be determined in accordance with this law, so that the location of the technical infrastructure is thus not relevant in this respect.

5. **Required legal arrangements**

The required legal arrangements for the development and operation of T2S will need to specify unambiguously the rights and obligations of both the CSDs and the Eurosystem. They will have to address governance aspects and the legal set-up as well as technical functions in respect of administering and executing transfer orders and ensuring DvP. In structuring these legal arrangements, two distinct legal dimensions have to be distinguished: Eurosystem-internal legal aspects, and the external legal (contractual) arrangements between the Eurosystem and the CSDs.

With regard to the internal legal aspects, the Eurosystem considers that an ECB legal instrument, such as a Guideline adopted by the ECB Governing Council, should provide a harmonised legal regime governing the establishment and operation of T2S. Such a legal instrument could for example provide management and governance principles and access rules. Careful consideration will have to be paid to the operational, oversight and supervisory functions of the Eurosystem in order to avoid any conflicts of interest, for example by establishing appropriate “Chinese walls” regimes.

The Eurosystem does not anticipate any obstacle to the setting up of a single Eurosystem legal instrument for the internal legal regime, which would then enable T2S to be established and provide for its functioning, and nor does it envisage any major legal impediment to developing an appropriate harmonised legal regime.

With regard to external legal relationships, T2S will necessitate contractual arrangements between the Eurosystem and the CSDs willing to connect to T2S. It is noted that the current legal relationships held by CSDs with their market participants would in principle remain unchanged as the CSDs will continue to be responsible for maintaining their contractual and business relationships with their respective market participants and for the opening and maintaining of participants’ securities accounts with them. However, these legal relationships might have to reflect the euro area-wide single common technical functionality of T2S.

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7 Article 9(2) of the SFD states that when securities or rights in securities are provided as collateral security to participants and/or the Eurosystem, and when their right (or that of any nominee, agent or third party acting on their behalf) with respect to the securities is legally recorded on a register, account or centralised deposit system located in a Member State, the determination of the rights of such entities as holders of collateral security in relation to those securities shall be governed by the law of that Member State.

8 The legislation in some Eurosystem Member States refers to the location of the account, but without any further specification.
In this external legal relationship, the harmonised conditions and parameters for the settlement service should include inter alia the scope of services, governance and involvement of the CSDs in the design, operation and change management of T2S, as well as access rights, clarification of each CSD’s responsibility for the operation of its own system and for the holding of securities vis-à-vis its participants under its contracts with its clients governing securities accounts, a fee structure, liability issues, and the confidentiality duties of the parties.

Particular attention should be paid to the CSDs’ responsibilities for maintaining the securities accounts database with a view to protecting the integrity of T2S, since both the Eurosystem NCBs and the CSDs will have certain administrative and access rights with respect to this database. Some other matters, such as banking secrecy issues, will also have to be addressed in due course.

The Eurosystem does not anticipate any major legal impediment to constructing appropriate external contractual arrangements.

6. Possible need for national legislative adaptations or further EU harmonisation measures

The general legal feasibility assessment suggests that T2S could be established without any significant legal adaptations, notwithstanding that in a few jurisdictions, it might prove necessary to adapt existing national regulations for securities settlement.

The SFD and its implementation into national law by the Member States already provides sufficient protection. Given that finality will be achieved via T2S at domestic CSD level, the legal protection of settlement activity would maintain the same level as today. However, the further harmonisation of certain legal regimes could facilitate the operation of T2S, and enhance it from a legal point of view. In particular, given that the envisaged structure of T2S is based on the relevance of book entries for the holding and transfer of securities, the soundness and efficiency of T2S could be further strengthened if there were harmonised EU rules regarding the nature and transfer of proprietary rights resulting from book entries in relation to securities held through an intermediary.9

7. Other legal issues arising in connection with T2S

In addition to the general legal assessment of the feasibility of the T2S project, the Eurosystem has identified three other legal issues that will require attention, subject to further policy decisions.

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9 In November 2006 the European Commission concluded its work on a Code of Conduct for best market practice. In this code of conduct, the industry undertakes to deliver results regarding effective rights of access on a fair, transparent, non-discriminatory basis in particular, so that the conditions are set for implementing interoperability between exchanges, central clearing counterparties and central clearing depositories. In addition, the EC Legal Certainty Group has made considerable progress in its work regarding the removal of legal barriers to efficient cross-border clearing and settlement, while the UNIDROIT draft convention on intermediated securities is at an advanced stage of preparation. In June 2006 the Legal Certainty Group published an Advice to the Commission, proposing principles for Community legislation to remove any identified legal obstacles. However, this work and the negotiations in UNIDROIT have not yet resulted in legislation.
The first issue refers to the possibility of offering some services to ancillary systems not using TARGET2 for cash payments which differ from those generally offered to the connected CSDs. This matter refers specifically to the free of payment (FOP) delivery of securities in T2S, while the execution of the corresponding cash payments would take place in the relevant ancillary system. In this regard, the Eurosystem recognises that any difference between the range of services to be provided by T2S to the connected CSDs and that to be provided to ancillary systems should be based on objective and transparent criteria, also taking into account any possible legal impediments stemming from national legal regimes and from Community law.

The second issue concerns the question whether or not there would be any legal impediment to allowing custodian banks to connect to T2S in the same way as a CSD. In this regard the Eurosystem notes that custodian banks may not qualify for the same degree of settlement finality protection under the SFD as designated CSDs. In the event that the Governing Council of the ECB were to decide to allow custodian banks to connect to T2S in the same way as CSDs, it would need to be satisfied that transfer orders from such custodian banks are adequately protected under the SFD, e.g. by extending the personal scope of the SFD to cover custodian banks as well, in order to avoid prejudicing settlement finality within T2S.

The third issue discussed was the legal obstacles to linking the provision of Eurosystem collateral to T2S. Here, Article 18.2 of the Statute provides the Eurosystem with the capacity to set general principles in order to determine the most appropriate and effective means and channels to obtain collateral. This has led the Eurosystem to conclude that there are no legal obstacles to such a limiting of the provision of Eurosystem collateral to T2S, provided that the principles of proportionality and non-discrimination, as elaborated above, are complied with.