Main conclusions of the meeting
between Slovenian NUG and the ECB on T2S issues

Date of the meeting: 5 March 2008

Participants: **Mehdi Manaa** and **Robert Neitzel** (both ECB), **Peter Centrih** and **Peter Černuta** (both Banka Slovenije), **Davor Pavič** and **Rok Šketa** (both KDD), **Varja Dolenc** (Nova Ljubljanska banka), **Primož Pinoza** (Securities Market Agency), **Polona Trampuš** (Ministry of Finance)

Main open issues (the list is not exhaustive) for Slovenia based on current T2S User requirements and conclusions (in the form of the ECB answers) regarding them:

1. Settlement

Identified problems for discussion:
a) Pricing of the additional messages required for enrichment - the pricing for settlement for direct holding CSD requiring enrichments should be cost efficient and not discriminatory towards settlement of indirect holding CSDs.
b) Proposed solutions for enrichments of stock exchange trades in T2S are not fully in line with KDD requirements. Proposed allocations of securities on end investor accounts are possible but are not as efficient as current allocations in KDD system (requires additional messaging). Also, functionalities for KDD's register codes are not provided. The registry code system is required by law, enabling KDD members to take over rights and obligations of any other stock exchange member steaming from their stock exchange trades[1].
c) According the URD, T2S schedule will provide CSDs the window to perform securities lending services for failed settlements. However, securities lending is just one mechanism for managing fails, which is not used in KDD. Instead, KDD uses buy-in procedures, which require some time to be executed. How will these procedures be enabled in T2S according to the URD?
d) Multilateral netting is currently not foreseen in T2S URD, which only foresee the optimization mechanisms that have different effects for participants as currently used multilateral netting (which some CSDs are required to perform by law).

---

[1] Slovenian market has another enrichment type which is used for settlement of stock exchange trades of fund management companies and trustee banks. This type of enrichment is called registry codes which are a necessity as it is currently the only way that settlement can be done for trustee banks and fund managers according to Slovenian legislation. Registry codes are a registry setup to link securities accounts between two KDD members in order to automatically route settlement instructions execution from trading member to settlement and/or clearing member. The routing information is managed and stored in the KDD registry system. Slovenian Law (ZISDU-1) explicitly forbids fund management companies to maintain securities accounts for the investment funds (i.e. mutual or pension funds) that are managed by them. These securities accounts have to be opened at a trustee bank (another KDD member) which at the same time can not offer stock exchange trading services related to these accounts. In this way the fund management company has to appoint a broker or bank different (another KDD member) from the appointed trustee bank which already manages securities accounts for fund management companies. In order to enable fund management company to trade securities on stock exchange, the appointed broker uses the registry codes (three types exist (1) for security settlement only, (2) for cash settlement only and (3) for cash and securities settlement). During this process, settlement instruction is enriched with settlement member code and account number based on the setup in settlement data at KDD. For example, in case the registry code is used for cash settlement only, cash settlement for such trades is done by appointed broker and the securities are settled directly on the (e.g. mutual fund) securities account opened at the trustee bank.

Conclusions:
- **Ad a)** The pricing of the messages required for enrichment is the matter of the pricing policy, which is yet to be developed. The ECB will take note of the concerns of Slovenian NUG when preparing the proposal for pricing policy with the goal of avoiding the disadvantages for direct holding countries.
- **Ad b)** Regarding the use of registry codes the ECB considers them as a value added service, which will continue to be provided by the KDD (by creating settlement instructions using these codes and sending them to T2S) and will not be supported by T2S. This also affects the Ljubljana Stock Exchange, which will have to send all instructions for settlement via the KDD.
- **Ad c)** Regarding the fails management T2S does not impose any restrictions on the CSDs, who can perform the fails management procedures according to their internal rules as value added services. T2S will provide enough options for CSDs (in terms of schedule and ability to block the accounts/positions/parties as necessary) to carry out their procedures (in terms of schedule and functionalities). This also includes buy-in procedures.
- **Ad d)** ECB explained that the issue of multilateral netting has already been taken on board and the project team is currently working on the proposal to include this functionality to the URD.

---

2. Validation:

Identified problems for discussion:

a) KDD is obliged by law to check for legal validity and preconditions before any instruction execution. KDD has therefore established very complex validation matrix for the validation purposes that includes all local legal requirements and KDD rules regarding the settlement instructions, accounts, restrictions and members. The main difficulty arises from the fact the relations between different rules are not always straightforward and require specific rules (e.g. the validation has to encompass the rules regarding third party rights (restrictions) that exist over the security which are different for private persons and companies and for tax authorities). Incorrect legal or technical validation could result in strict liability of KDD for damages.

In order to allow complete validation for all transactions, such validation would have to include validation between different transaction types (in KDD more than 80 transaction types exist), freeze types - restrictions (altogether 15), account types (11) and membership types (3). As already indicated, CSDs must be allowed to define large numbers of validation parameters for their accounts, restrictions, membership types and transactions types. Validation requirements can constantly be changed in accordance with legal changes or KDD rules. Will T2S provide such complex and nationally specific validation?

b) According to the URD T2S shall provide validation, but some validation might still have to be performed at the CSD level. This implies that all trade or settlement instructions would have to go through KDD. This would require additional functionality for KDD at additional cost.

Also, in case T2S would not provide for adequate legal and technical validation, direct connectivity for KDD members would not be very efficient (instructions sent by directly connected participants to T2S would have to be put on hold in the T2S until KDD performs appropriate validation checks and grants or cancels further processing in T2S) or not even possible if the members were required to send all instructions via KDD to enable correct validation of their instructions

Conclusions:

o **Ad a/b)** The ECB provided the description of the mapping of KDD securities accounts to the T2S accounts. According to the ECB the current conceptual account structure model covers the needs of the CSDs also for the validation, but will have to be further detailed, tested and developed with the specifics of restrictions types in individual CDSs. If all the needs of the CSDs will not be accommodated, some validation might still have to be performed at the CSD level. For this purpose a special meeting will be arranged between the KDD and the ECB in May 2008, which will cover the exact mapping of the KDD's account structure to the T2S account structure, restriction types and validation matrix.

3. Handling of corporate actions

Identified problems for discussion:

a) Due to the large number of settlement instructions resulting from corporate action in the direct holding country, the pricing of these instructions is critical. It these instructions are charged at the same rate as normal instructions, this would raise the cost of corporate actions by several times.

b) Processing of corporate actions in direct holding CSDs might require several days due to large number of securities accounts (e.g.: up to 1 million of transactions - e.g. mutual insurance company becomes public listed company). Large corporate action operations and related settlement process in the KDD are predominantly executed during the weekends. T2S should support settlement of corporate actions during weekends as core functionality and not as exceptional cases as stated in Chapter 3.

c) Corporate events settlement must take into account all freeze types - restrictions (e.g. pledge), order of concurrent restrictions on same account or ISIN, reservations placed on securities accounts or holdings in T2S, at the moment of corporate event settlement. This is the reason why corporate events instructions are composed of linked instructions taking into account existing restrictions/reservations, which must all be subject to validation as required by national legislations. Unblocking instructions and the corporate event settlement instructions must be linked to ensure that no other instruction can intervene in the corporate event settlement.

Conclusions:

o **Ad a)** The pricing the instructions resulting from corporate actions is the matter of the pricing policy, which is yet to be developed. The ECB will take note of the concerns of Slovenian NUG when preparing the proposal for pricing policy with the goal of avoiding the disadvantages for direct holding countries.

o **Ad b)** ECB explained that T2S will offer required flexibility to the CSDs when processing corporate actions by enabling them to block the securities subject to corporate action for the time needed (during both nighttime and daytime processing) and also by being open during the weekends.

o **Ad c)** The URD currently do not cover the processing of corporate actions regarding the securities accounts with different restrictions. ECB will provide the analysis and proposals for correct processing of corporate actions in such cases.

4. Infrastructure decommissioning

Identified problems for discussion:

a) According to our understanding of the current functional description of T2S, T2S static data will only cover data necessary for settlement (and some additional information), while all other data (on securities, account holders, participants, accounts) should be stored in CSDs' databases.

According to this some duplication of infrastructure is necessary and there also exists the need for additional CSD functionality for merging data from two different databases (T2S and CSD) for registry and regulatory purposes and which consequently creates the risk of mistakes when merging the data, creates the costs for this additional functionalities and the interaction (communication) between the databases and prolongs the time for performing queries in one database, transport and merge the data in another database.

Therefore, T2S framework allows decommissioning of only minor part of current systems. Internal systems would have to be largely reshaped and feed with information from T2S.

b) The account balances should, according to the KDD's role as central registrar, be available to the KDD in real time to enable the KDD to update the registry. This requires the constant communication between the KDD in T2S and inflates the costs for providing the registry function.

Conclusions:
o **Ad a)** Since T2S will only store static data necessary for settlement, the CSDs will have to maintain all other data relevant for securities, accounts, account holders, etc. This means also the duplication of the databases and the need for additional support for exchanging and merging of the data.
o **Ad b)** As regards the account positions, the CSDs will be able to choose between different subscription types for obtaining the data on positions required for their processing and registry maintenance (real time synchronization, reports, etc.). Accordingly two open questions for CSDs remain: a) what is the level of replication needed to support legal requirements and market practice, also taking the costs (adaptation and running) into the account; and b) how to perform the replication (push messages, queries).

---

5. Account structure and restriction types

Identified problems for discussion:
a) As stated in T2S UR, T2S accounts should not be seen as a direct mapping of the CSDs' accounts, implying that it might not be possible to map an account in T2S directly to one account in the CSD. This will result in breaking direct link between accounts in both systems. Direct holdings CSDs would therefore need to further maintain their own supporting infrastructure for current account structure, next to the need to create new mapping technical support in order to correctly link T2S accounts and their balances with their current account structure. Could you explain the mapping of KDD account structure into T2S account structure?

b) T2S should provide solution for varieties of restriction types, which are necessary due to the national legal requirements. For example, legally, two freeze group types (restrictions) over securities exist in Slovenia (third party rights and written order - e.g. tax, courts). Although T2S documents refer to pledge only, in Slovenia pledge is only one among several third party rights and written orders which can legally be recorded in the KDD's securities register over the securities under burden. In the brackets there is the list of all third party rights and written orders legally existing in Slovenia, which must be technically supported in the T2S account structure (Block Inventory, Interim Order, Supervisory Order, Pledge Realization Interim Order, Claim Enforcement, Handover Decree, Tax Execution, Dispose Deny Right, Pledge, Redemption Right, Pre-emptive Right, Usus Fructus). In the picture above, this restriction types are recorded on sub-accounts. However, each new restriction on same position generates new sub-account with

different priority for this new restriction. This depends on legal requirements (e.g. court orders have highest priority) which can any time restructure sub-account formation.

Some of this freeze types do not prevent transfer of securities, others do, some are transferred along with securities, some cease upon transfer. It is therefore inevitable that freeze types must be subject to legal validation before any settlement instruction is executed.

Conclusions:
o **Ad a/b)** The ECB provided the description of the mapping of KDD securities accounts to the T2S accounts. According to the ECB the current conceptual account structure model covers the needs of the CSDs (also for validation purpose), but will have to be further detailed, tested and developed with the specifics of restrictions types in individual CDSs. For this purpose a special meeting will be arranged between the KDD and the ECB in May 2008, which will cover the exact mapping of the KDD's account structure to the T2S account structure, restriction types and validation matrix.

---

6. Opening of securities accounts

Identified problems for discussion:
a) In Slovenia each day up to 500 securities accounts openings/closings are required. All changes or updates of static data must also be performed in real time since they are closely connected - synchronized – with regular settlement processes. Issue and redemption accounts are opened by the KDD but, due to the direct holding nature, accounts are opened, closed and maintained in the central register by KDD participants (account operators) only, without any involvement of KDD. T2S URD place responsibility for changing static data on securities accounts only to CSDs. All instructions for opening/closing would therefore be sent by KDD participants to KDD, who would open, close, maintain static data in T2S instead of participants.

b) It should be ensured that when information on accounts, account holders is split between both systems, the administration is controlled by the CSDs due to their role as registrar for shareholder books which would continue to be performed by the CSDs. Any broken linkages between T2S accounts and data in CSDs could create discrepancies and have serious legal consequences. Therefore, account openings and corresponding static data changes would first have to be recorded in the CSDs and afterwards in T2S, under control of the CSD.

According to the above, direct connectivity for KDD participants is much more cumbersome. In case of direct connectivity to T2S, where accounts static data do not include all required data on account holders, participants would have to send this information to KDD. If participant does not inform KDD simultaneously about this, the connection between account in T2S (with mostly settlement related information and some additional information) and database in KDD (with all information about account and its holder) is not established and holdings on T2S account are not linked to any holder in KDD securities sharebook, which must be synchronized in real time. This could cause risk of corrupted sharebooks and the related complex legal issues (like legal objective responsibility that KDD has in relation to the data accuracy that provides to its members, investors,..).

c) Due to the nature of the settlement process in KDD, where settlement procedures must be performed in the specific sequence and must also take into account real time changes in the static data (for example: - refresh ISIN - open account - transfer securities on account…), changes/updates to static data must be on-line and must be synchronized with lifecycle

management modules and settlement modules in real time. We believe this is crucial to the settlement process which follows the legal requirements (take-overs).

Conclusions:
o **Ad a/b)** The ECB explained that opening/closing of accounts will always have to be performed via the CSD, and that changes to the static data will be made possible in real-time.
o **Ad c)** The ECB took note of the requirement and will try to accommodate it in the URD.

7. Communication/messaging

Identified problems for discussion:
a) We acknowledge that all information on accounts and holdings will be available to CSDs in real time. It is however necessary to deal with the communication requirements (messaging, statements, reports) for direct holding CSD differently then for indirect holding CSDs, due to the huge amount of securities accounts. The necessity to perform registry functions and maintaining shareholder books in the direct holding environment demands that all direct holding requirements on messaging, synchronization, reconciliation and other operating and legal issues are acknowledged and supported in the T2S. For this purpose, communication between T2S and direct holding CSDs' applications should be based on solid legal grounds, real time solutions and small communication costs.

Conclusions:
o **Ad a)** As regards the account positions, the CSDs will be able to choose between different subscription types for obtaining the data on positions required for their processing and registry maintenance (real time synchronization, reports, etc.). Accordingly two open questions for CSDs remain: a) what is the level of replication needed to support legal requirements and market practice, also taking the costs (adaptation and running) into the account; and b) how to perform the replication (push messages, queries).

8. Maintenance window

Identified problems for discussion:
a) Maintenance window is foreseen only for T2S. It should be considered that CSD would also have to maintain their systems within the timeframes, which may be different from those provided for T2S, especially in the night time.

Conclusions:
o **Ad a)** As regards the maintenance window, the T2S schedule will not impose any restrictions on the ability of CSDs to maintain their systems, since T2S can provide the settlement on the accounts of particular CSD without the need for such CSD to be on-line. The information in the changes on account positions during such unavailability of the CSD are stored in T2S and transferred to the CSD when it comes back on-line again.